International search funds: Tracking tomorrow's trend

Invented in the United States, search funds are a growing phenomenon overseas. A biennial study shows promise in Europe, Latin America, Asia and Africa.

September 23, 2014

Do you know what a **search fund** is? If not — especially if you live outside the United States and Canada — you are not alone. According to a study conducted by IESE, in collaboration with Stanford Graduate School of Business (GSB), search funds operating outside the United States and Canada are still struggling for recognition.

First developed in the United States 30 years ago, search funds are investment vehicles that finance entrepreneurs' efforts to acquire a business and grow it. The entrepreneurs at the helm of search funds are usually newly graduated MBAs looking to put their knowledge into practice. Potential investors can be anyone interested in taking a risk on this new and growing asset class.

Stanford GSB has studied and evaluated the performance of search funds since 1996. Its 2013 study found that the aggregate pre-tax internal return on 134 U.S. and Canadian search funds was 35 percent.

To track the growing number of search funds located outside the United States and Canada — called "international search funds" — Stanford GSB partnered with IESE in 2011. In concert with the Stanford GSB biennial study, IESE now conducts its own biennial study of search funds found outside the U.S. and Canada.

IESE's second of these studies — published in 2014, covering funds created through 2013 — tracks 28 first-time funds from four continents through surveys. The study's authors are

IESE's Lenka Kolarova (MBA '11), visiting professor **Rob Johnson** and Stanford GSB's Peter Kelly.

The 28 funds tracked have so far made four successful exits and had two failures. Given these numbers, the authors report that it is still too early to publish meaningful performance data. "However, directionally speaking, the performance seems to mirror the search fund performance data published in the 2013 Stanford GSB note on U.S. and Canadian search funds," the authors write.

Where the funds are

The first fund operating outside United States and Canada was set up in the United Kingdom 22 years ago. The U.K. accounts for 10 of the 28 funds tracked, while Mexico accounts for six. The remaining dozen hail from Austria, Brazil, Chile, the Dominican Republic, Germany, India, Israel, Kenya, Spain and Switzerland.

Over the past decade, the number of international search funds grew notably, with seven first-time funds raised in 2013. New funds and successful exits were also noted in 2014, but they were excluded from the report for consistency with Stanford's study.

The entrepreneurs starting the search funds ranged from 26 to 43 years old at the beginning of the search process, according to the surveys. Consistent with the original search fund model, most of the entrepreneurs (89 percent) graduated from an MBA program, with 71 percent raising their search fund within two years of graduation.

Four stages

The study breaks the analysis of the funds into four stages:

1. Raising a search fund

Raising the funds for the search — which varied from $15,000 to $673,000 — was often reported to be the most challenging stage for the international searchers. Recruiting potential investors was complicated by the fact that there often is no translation for "search fund" in the local language. Entrepreneurs reported that they invented terms, such as "business partnership" (*Unternehmer-Partnerschaft*) in Germany; "investment society" (*sociedad de inversión*) in Spain; and "succession entrepreneur" (*Nachfolge-Unternehmer) in Switzerland.*

The median time to raise funds was six months, longer than the four months noted in the Stanford GSB study for the U.S. and Canadian search funds. There, entrepreneurs have access to serial search-fund investors, while overseas entrepreneurs often have to start from scratch and educate potential investors about search funds.

2. Search and acquisition

When selecting an acquisition target, entrepreneurs generally described themselves as "opportunistic," yet showed some industry preferences. Service providers were popular, with 68 percent of searchers stating that business services was a priority industry. The mean number of companies reviewed before a successful acquisition totaled more than 330 in 2012 to 2013.

There were 13 acquisitions made internationally through the search fund model to date. Of these 13 acquisitions, four were successfully sold, seven are currently operating and two were shut down. The median search fund acquisition had the following characteristics: $7.9 million in revenues, an EBITDA margin of 19%, a purchase price that was 5.6 times EBITDA, and a staff of 70.

3. Operation

Operation was the longest stage, during which the entrepreneurs lead and grow the business they acquired.

Many past and current search fund operators described the role as a combination of a salaried CEO and a significant equity owner. Similar to a salaried CEO, search fund operators seek approval from a Board of Directors to make major financial or strategic decisions.

4. Exit

With only four known exits by international search fund entrepreneurs — two in the United Kingdom, one in Brazil, and one in Mexico — comparisons about this stage are hard to make. Two investments, both in Europe, resulted in the company entering receivership.

There appeared to be a tendency towards shorter holding periods in the international arena, the authors report. While some successful U.S. search funds have had holding periods of over 10 years, international entrepreneurs reported pressure from investors who prefer "flipping" companies and redeploying the returns in new high-return opportunities.

Notably, for one exit in Brazil, the holding period was very brief — less than one year — as the entrepreneur repositioned a company acquired to take advantage of industry growth. In a booming equity market in Brazil, the opportunity to sell came quickly.

To the future

IESE and Stanford are committed to continuing their partnership to track the opportunities and risks provided by search funds. "We look forward to collecting and disseminating the next set of data," the authors state. That is projected for 2016.

On April 24, 2015, IESE plans to hold the first **International Search Fund Conference** with the aim of bringing together search fund entrepreneurs and investors involved in more than 20 international search funds. The conference is also designed to introduce the funded search model to aspiring entrepreneurs and investors interested in a new entrepreneurial investment model.

www.iese.edu/insight