

Opportunities and Risks of Search Funds

Many of today's MBA graduates could well be tomorrow's entrepreneurs thanks to the emergence of so-called "search funds," a new mechanism for acquiring small companies.

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A search fund is an investment vehicle for financing the discovery, negotiation and acquisition of a company considered to have strong growth potential.

In a technical note, IESE's Antonio Dávila, Ian Nieboer and Mathieu Carenzo identify key issues to take into consideration before getting involved with this type of fund.

The main difference between search funds and other investment instruments, such as venture capital or private equity, is that they are created expressly to capitalize on the entrepreneurial and leadership potential of young executives or recent MBA graduates.

As such, those participating in a search fund are betting not only on a company, but also, more importantly, on the talent of the promoter/entrepreneur/searcher.

After all, it is they who must take the initiative, as well as raise capital from private investors, and find the ideal company to acquire and grow.

At the beginning of the process, the fund promoter is paid a salary to focus exclusively on searching for the ideal acquisition, a process that takes, on average, 15 months to complete.

Talent, but no business plan

Another important difference, with respect to venture capital or the sort of investments made by business angels, is that the business opportunities targeted tend not to be start-ups or even early-stage ventures.

Rather, search funds try to invest in companies with established businesses and proven track records.

What's more, they seek majority stakes in profitable companies that are smaller in scale, and require less funding, than those often targeted by venture capitalists.

The life cycle of a search fund

Search funds go through four main stages.

1. *Obtaining Capital to Create the Fund.* The aim is to raise enough money to pay the entrepreneur's salary while conducting the search, as well as cover the costs incurred throughout the process. Typically, the initial search capital can range from around 100,000 to 300,000 euros.
2. *Search and Acquisition.* The entrepreneur identifies a promising target and makes a buyout offer. The decision-making process leading up to the acquisition is guided by variables such as geographic location, industry, earnings before interest, taxes, depreciation, amortization (EBITDA) and other standard business valuation indicators. A typical search fund considers around 300 potential targets before making the acquisition.
3. *Operation and Value Creation.* The fund promoter assumes a key operational role in the acquired company, usually as its CEO, in which they will theoretically remain until an opportunity to exit arises.
4. *Exit.* The search fund promoter provides investors with a substantial cash return on their investments by selling to a strategic buyer or launching an IPO.

The complete life cycle of these funds is normally upwards of eight years, and thus demands a strong commitment by the entrepreneur.

Opportunities and risks

For its promoter, a search fund is a unique opportunity for professional growth.

Not only does it allow entrepreneurs to lead a company right from the outset of their careers, it also gives them a wealth of expertise.

After all, identifying companies with potential, finding investors and negotiating the acquisition of a business are all senior-level management functions.

To create the fund, it is not even necessary to have a revolutionary business idea, since the objective is to identify and develop businesses with untapped potential, but with a market-based business model already in place.

Nonetheless, not everyone is cut out for this type of career. It requires a great deal of courage and commitment.

After all, a search-fund entrepreneur must assume full responsibility for the fund's financial performance, as well as the opportunity costs and reputational risks involved.

Leading a search fund offers a unique chance to carve out a reputation in a relatively short space of time.

That said, failure can do serious damage to your reputation at the very start of your career.

As for investors, the main attraction of a search fund lies in the potential returns they can hope to net, with expected internal rates of return (IRR) for some funds climbing as high as 30 percent in their first years.

Moreover, investors can directly monitor and evaluate the performance of the fund promoter throughout the search and acquisition process.

Even so, search funds are a risky option. According to a study from Stanford University, which analyzed a total of 79 funds, only 38 percent were profitable for their investors, with an average IRR of 37 percent.

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