OCTOBER 2024

Search fund transformations: A path to excellence

IESE
Business School
University of Navarra

Search fund transformations: A path to excellence

Sara Rosenthal

Jan Simon

October 2024

Authors

Sara Rosenthal
Lecturer of management at the Stanford Graduate School of Business and Partner at TTCER Partners

Jan Simon
Professor in the practice of management in entrepreneurship and a managing partner at Vonzeo Capital Partners

Design: IESE Business School: www.iese.edu

Copyright 2024 © IESE.

All the material contained in this document has been provided by the authors based on IESE search fund surveys.

CONTENTS

Introduction.. 5

Act I 7

Act II 13

Conclusion 15

Introduction

This year marks the 40th anniversary of the big bang in search funds, the moment when Jim Southern, a Harvard Business School (HBS) alumnus, launched the first search fund under the mentorship of his HBS professor and friend, Irv Grousbeck. This led to the acquisition of Uniform Printing, which specialized in printing insurance documents. A decade later, Jim exited, returning to his investors 25 times the capital they had invested. He was closely followed by a search fund team – Jamie Turner and Kirk Riedinger – who bought Alta College, Inc. in 1987 and grew it from US$3 million to over US$400 million during their eight years of leadership.

When providing historical context during their 'search and entrepreneurial acquisitions' classes, the authors sometimes ask students to speculate how this asset class would have developed—if at all—if in both cases, searchers would have destroyed value. Similar questions are asked when discussing cases in which, during the first three years, the 'wheels come off.' What would have happened if a board had made a different set of decisions, if the CEO went rogue, or if the original investment turned out to be a dud? The search fund community owes a great deal of gratitude to these early CEOs but equally to the many investors and board members who helped to shape this asset class, its culture, and its performance.

Knowing the history of search funds, as well as being able to contextualize what happened, is not only important to pass the course; it is essential when taking part in this asset class, be it as a CEO, an investor, or a board member. Quantitative data are important, but so are qualitative insights. In what follows, we lean on grounded theory[1] to assist in explaining the outsized returns in search funds.

In a separate study, TTCER, an investment partnership focused on the search fund asset class, looked at 25 high-performing companies (HPCs) that deliver exceptional financial returns for entrepreneurs and investors. The research concluded that these companies, over 90% of which suffered quasi-fatal events during their first three years, all had:

- The ability to create enduring customer relationships
- Intentionally crafted growth-oriented cultures
- Achieved high performance while being low touch on capital (+20% return on tangible capital)
- Been part of growing industries (with a median CAGR of 11%) in which they achieved sustained growth.

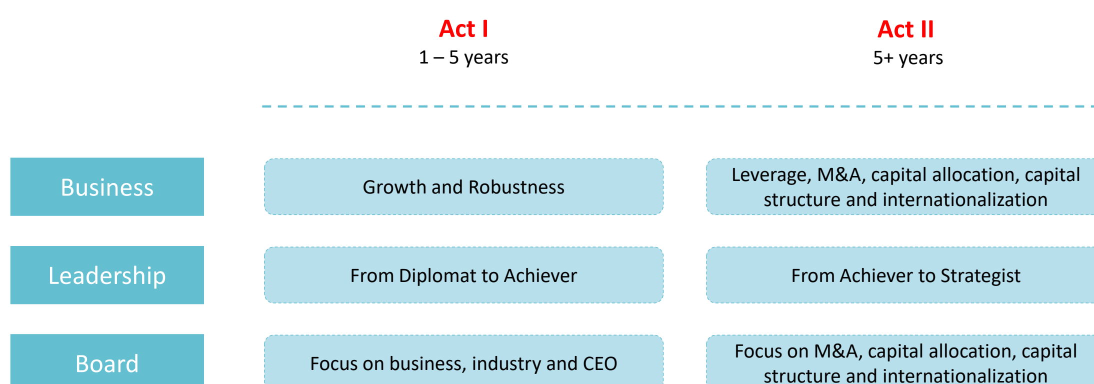
In addition to TTCER's findings, our qualitative research led us to conclude that, to achieve outsized returns, transformation is not only important; it is essential.

Three transformations help explain hyper-returns in search funds. Two of these are critical and need to occur simultaneously to unlock near-to-medium-term excellence (approximately 1–5 years). Further transformation of both, as well as a third transformation, is necessary for long-term top performance (6+ years).

Business transformation and leadership transformation are necessary in the near-to-medium term (Act I). To generate long-term high performance (Act II), both business and leadership will again need to be transformed; however, in this case, a board transformation will also need to happen.

[1] Grounded theory is a qualitative research method using existing qualitative data for developing theories to explain why certain things happen, which, in this case, is the outsized performance of certain search fund CEOs.

Figure 1. Search fund transformations



Connoisseurs of the search fund world will note that, with the average holding period being six years, many exits happen upon accomplishing Act I. In some cases, further value has been created through more complex strategic and financial thinking and execution. These typically happen post Act I in what we consider Act II. This two-step framework not only assists in explaining why certain CEOs have 'knocked it out of the park.' It can also help in shaping future performance and giving context to when to exit or what is needed to create a second run (now typically orchestrated by private equity).

The following discusses these two acts and the transformations – business, leadership, and board – that must transpire.

Act I

Business transformation

US$100 put in the S&P 500 40 years ago would be worth about US$3,100[2] at the time of writing this. Investing and compounding the same US$100 in search funds would now be worth over US$16 million[3]!

While it is true that relative growth becomes more difficult with size, the fact that inexperienced CEOs created over 5,000 times more value (given an equal base) is impressive, to say the least, especially when considering the comparison to some of the world's best-known CEOs.

If top CEOs, surrounded by the best professionals, consultants, board members, and other resources, create about 10% returns on average, then a 32-year-old search fund CEO will not create triple the returns by managing the business as usual. Looking merely at the historical performance of this asset class, one could easily conclude that a search fund CEO's tenure must be transformative.

Business transformations need to lead to the growth of existing revenue streams, heightened robustness, or an improved cash flow outlook. Ideally, these transformations incorporate all three of them. Before we delve into this, let us briefly review how one increases a corporation's worth or enterprise value (EV).

Valuation

Buy low, sell high: This mantra must be as old as trade itself. In the world of small private acquisitions, there are financially three ways of achieving this: (i) increasing the base of the multiple, (ii) increasing (multiple expansion), or changing the multiple, and (iii) deleveraging a company using its cash flow.

For example, let us say one acquires a company at an EV of US$10 million, 50% leveraged (US$5 million debt and US$5 million equity).[4] At acquisition, the company had nonrecurring revenue of US$8 million and earnings before interest, taxes, depreciation, and amortization (EBITDA) of US$2 million, hence an EV at acquisition of 5x EBITDA.

An investor will make money on a sale, all other things being equal, if:

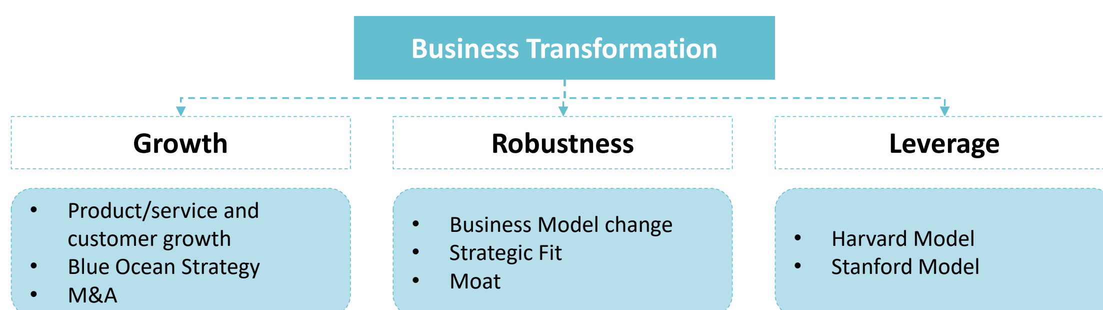
- The number of multiple bases has increased. For example, the exit multiple is still 5x EBITDA, but the EBITDA is now US$4 million. This is further discussed in the following Growth (i) section.
- The exit multiple has increased or changed. An example of the former is that the exit multiple is 8x EBITDA, while the EBITDA remains unchanged. An example of the latter is that the company still has US$8 million in revenue, but unlike at acquisition, this revenue is now entirely recurring (ARR: annual recurring revenue), and the purchaser is willing to acquire the company at 3x ARR. See the Robustness (ii) section for a more in-depth discussion.
- Both the EBITDA and the exit multiple are unchanged, but during a CEO's tenure, the debt has been paid back entirely. This point is addressed in the Leverage (iii) section.

[2] Calculations are based on the S&P 500 increase from 455 to 4,845 and its historic dividend yield of 2.91%.

[3] We used the 35% net IRR from the Stanford study to compound the US$100 over forty years.

[4] Assume cash zero, so debt and net debt are equal.

Figure 2. Business transformations



(i) Growth

One way to create value is by increasing a corporation's EBITDA. This can be achieved either by increasing sales, decreasing the cost of goods sold (COGS), or decreasing operational expenses (OPEX or SGA). Sales, marketing, and competitive strategies influence the top line. Size, negotiation skills, industry dynamics, and operations affect the other two.

While each aforementioned factor can influence EBITDA, a crucial change—the transformational change—needs to take place in revenue. This is where technically and practically the highest opportunity resides (indeed, in our example, revenue could grow by a factor of 10, and if the EBITDA margin is kept equal, EBITDA will grow to US$20 million; however, by keeping revenue unchanged, it will be impossible to achieve US$20 million in EBITDA).

Thus, it is not surprising that TTCER's study of HPCs, found that in the initial years, the HPCs' CEOs spent close to 60% of their time on sales growth. Also, of the 31.0x MOIC these companies created for their investors, 18.1x came from revenue growth. Additionally, 5.7x came from multiple expansions, a big chunk of which can be credited to sales growth. Confirming that COGS and SGA play only a very minor role, of the 31.0x MOIC expansion, a mere 0.4x was due to margin expansion. Note that the remaining 5.8x was attributed to capital allocation.

A prime takeaway is that exceptional value creation must be underpinned by exceptional growth, which will likely result in business transformation. An acquired company will need to outgrow a market, for example, by displacing competitors or increasing market penetration for a prolonged period.

We briefly discuss three examples of growth avenues. The first is product/service or customer growth. The former refers to selling more products or providing more services to existing clients, and the latter to selling available products or services to others, often by expansion into new geographies or customer channels. Good exercises to optimize the most fruitful avenues include assessing product–market fit, willingness-to-pay, pipeline architecture and process, R&D, and market analysis. Additionally, a board and CEO can adjust a company's competitive strategy, enhance its economic moat, and leverage digitalization or tech enablement, to name a few.

The second example is creating hypergrowth by conquering white space untapped by competition or, relatedly, by creating a blue space via the application of a blue ocean strategy (BOS). The latter is achieved via value innovation and the following four questions:

- What should the corporation provide more?
- What can it safely reduce?

- What could easily be dropped?
- What should it provide that it currently does not provide?

The result of an effective BOS is that instead of competing on existing parameters with known competitors in a red ocean, one discovers (or creates) a blue ocean with a product–market fit where competition becomes irrelevant.

A third way in which companies can boost their top lines is through mergers and acquisitions (M&As).[5] It is important to acknowledge that, while an M&A has great potential, it has important drawbacks. First, the degree of difficulty can be high for even the most experienced CEO, and second, even in big-league companies, only around 25% of M&A activity creates shareholder value. Hence, an M&A in search funds is traditionally only explored in what is later described as Act II when a CEO has acquired the necessary experience and expertise.

In short, growth, and more particularly, strong yet sustainable top-line growth is the most important contributor to outsized financial outcomes. Among the top priorities of CEOs and their boards should be to hone in on how a business needs to be transformed to achieve growth since, if well executed, it will have an outsized impact on EBITDA and, consequentially, on overall EV.

(ii) Robustness

A larger EBITDA typically leads to a higher multiple paid upon exit. However, there is another factor that helps explain the fillip in EBITDA-multiple: selling a better business than the one purchased, or as we see it, a more robust business. Several business transformations can improve a corporation's strength or robustness. We discuss the following three: business model change, improved strategic fit, and economic moat.

One way to transform a company's robustness is by making its sales more predictive and stickier. This is typically the outcome of a successful change in its business model (and a consequential effect on its revenue model). Here lies, for example, the attractiveness of turning one-off sales into some form of X-as-a-Service model, resulting in predictable, sticky sales that have the added benefit of contributing to a higher EBITDA-multiple at exit. If one can combine this with high growth and low churn, the outcome might even be an exit expressed not in EBITDA but in ARR[6] (+ NRR[7]) multiples.

A second avenue for transforming a company into a more robust engine is by creating a strategic fit. The idea behind strategic fit is to provide different products or services that reinforce each other or add to each other's usefulness. For example, in the 1960s, a young lawyer named Mark McCormack at the Arter & Haden law firm thought he could help sportsmen and women make some extra money through sponsorship. He engaged in this endeavor without quitting his daytime job because he realized the value proposition was not proven, but *if* successful, it would easily scale. When his first three signings—Arnold Palmer, Gary Player, and Jack Nicklaus – went on to become three of the best golfers in history, IMG was born, and Mark McCormack became a legend. The strength of IMG, however, lies in its strategic fit. By owning sports academies, tournaments, players, and an entire slew of services (e.g., wealth management), each of the company's subdivisions made the others stronger.

[5] Note that both popular and professional press often misuse these terms. A merger is a corporate activity whereby two companies transform in one different legal identity. An acquisition is a corporate activity whereby one legal entity takes over another, resulting in the remaining of the first one. Thus, the distinction has nothing to do with relative siz, nor whether it is the fruit of a friendly or hostile action.

[6] Annual recurring revenue.

[7] Non-recurring revenue.

Another example of a business transformation by strengthening its foundation is by creating or enlarging a company's economic moat. Popularized by Warren Buffet, who compares a company to a castle, the idea is that the stronger the moat, the more defensible (valuable) the castle (company). As such, he finds it more valuable when management focuses on making the economic moat larger than focusing on short-term financial wizardry. Indeed, by increasing a business's sustainable competitive advantage, it will increase and maintain its customer base as well as maintain or even grow its margin—all factors that make a company more attractive to strategic or financial buyers.

The aforementioned transformations have many positive impacts, such as stronger customer relationships, an increased capacity to attract A-players, market and negotiation power, brand recognition, cross-selling and upselling opportunities, and a virtuous cycle of compounding growth via an increasing base of recurring or repeat revenue.

(iii) Leverage

A third financial lever for creating shareholder value is via the traditional leveraged buyout (LBO) mechanism or, in other words, via the leveraging of a corporation's balance sheet and cash flow capacity.

As many financial handbooks point out, the art of leveraging lies partly in acquiring a company with a steady yet predictable cash flow. While this is undeniably true, an eye for covenants, well-calibrated scenario analyses, and trustful bank relationships are also important.

With leverage, a debt provider becomes a stakeholder. The higher the leverage, the more important this stakeholder becomes (and the more the focus shifts from shareholder value creation to cash flow generation). For serial leverage players, such as private equity firms, not defaulting to debt providers becomes mission-critical.

In the search fund world, we refer to this value proposition, whereby shareholder value is predominantly generated by satisfying debtholders via the persistent siphoning of cash flow, as the "Harvard model." Harvard professors Richard Ruback and Royce Yudkoff have many great cases in support of this model.

Note, however, that many institutional serial investors prefer investing in what is known as the Stanford model of acquisitions. These companies, in contrast to the Harvard model, focus on growth. The leverage applied is consequently lower, as generated free cash flow is mainly used for growth rather than paying down debt (with a reminder that search fund acquired companies tend to be asset-light; hence, banks encounter less stable or liquefiable collateral).

While we do see transformational changes in growth and robustness, the application of leverage in 'searchfundlandia' is normally not transformational (at least not in the early years). We believe this is because the essence of the search fund model involves taking concentrated risks by putting a young, ambitious entrepreneur in the CEO seat. Simultaneously, it tries to minimize all remaining industry, financial, economic, and corporate risks. Leverage is a financial risk and, thus, should be moderate so it does not place undue pressure on the growth opportunities or cash flow position of a search fund acquired company.

In short, hyper performance in search funds encompasses corporate transformational change, especially when it comes to revenue growth and robustness. Nevertheless, this needs to be accompanied by a leadership transformation.

Leadership transformation

For context, well-known and much-studied research on leadership transformation identifies the following leadership archetypes: opportunist, diplomat, expert, individualist, achiever, strategist, and alchemist.[8] Elsewhere, we have argued that an MBA education typically transforms experts into diplomats.[9] What we mean by this is that most searchers' pre-MBA experience, knowledge, and action logic can be qualified as specialized (often by functional area), as the following table from the latest IESE search fund study shows.

Table 1. Pre-MBA experience search fund operators

	Pre-2002	2002–2007	2008–2009	2010–2011	2012–2013	2014–2015	2016–2017	2018–2019	2020–2021	2022–2023
Line/General Management	50	14	10	17	0	9	7	17	12	14
Management Consultant	17	0	0	17	33	27	24	14	22	26
Sales	17	0	0	17	0	14	2	0	3	5
Accounting	17	0	0	0	0	0	0	2	0	2
Investment Banking/ Finance	0	57	40	50	58	18	30	17	18	20
Marketing	0	14	10	0	0	0	2	0	2	1
Operations	0	14	0	0	0	0	4	2	9	9
Entrepreneur	0	0	10	0	0	5	6	4	4	4
Law	0	0	0	0	0	0	2	2	1	1
Private Equity	0	0	20	0	8	27	17	25	20	10
Venture Capital	0	0	0	0	0	0	4	0	4	2
Investing (other than VC or PE)	0	0	0	0	0	0	0	6	0	2
Engineering	0	0	0	0	0	0	4	6	3	2
Military	0	0	0	0	0	0	0	2	1	0
Other	0	0	0	0	0	0	0	3	2	2

[8] William Torbert, "Action Inquiry: *The Secret of Timely and Transforming Leadership*", San Francisco, Berret-Koehler Publishers, 2004.

[9] This part leans on findings published in *"Nurturing Leadership on Search Funds"*, J. Simon and Kowalski, A-S, IESE Publishing, 2023.

Someone who becomes a search-fund professional often seeks an MBA because this degree can transform his or her ability to do this job. It is not as much the acquired knowledge of functional areas such as strategy, finance, operations, or marketing. It is more about the behavioral change that an MBA can bring (e.g., self-awareness, management communication skills, the ability to function and lead teams, self-confidence, presentation skills, etc.) that can transform an expert into a diplomat.

The cooperative nature, problem-solving attitude, likability, and team spirit of a diplomat make it the best archetype for the search and acquisition phase as well as for the first year of a CEOship. For an inexperienced seller to transfer his life's work (sometimes referred to as 'his baby') to an inexperienced entrepreneur will require a relationship of trust and likability. This will also mean that the searcher will be able to overcome many obstacles by creating trustworthy solutions.

This unassuming, cooperative, almost osmotic style of leadership also works well when the most important mission of the first year as a CEO is not to change the business but to learn. A CEO is little more than a primus inter pares with few important decisions to make, at least in principle.

Once a CEO and board have an internal understanding of a company and industry, they will need to get to the hard but important work of transforming the business. As we have previously surmised, the high IRRs and MOICs of the search fund asset class have not been achieved through a business-as-usual attitude. In most cases, this business transformation can only be achieved via a cultural shift, as validated by TTCER's HPC study findings: HPC CEOs were intentional in building talent engines and growth-oriented cultures that achieved high performance.

This transformation is difficult. This means promoting and demoting, hiring, firing, and getting A-players in A-positions and B-players out of them. Some people will resign while others will be reinvigorated. New customer and supplier relationships will be formed while others will be severed. However, this is not the work of a diplomat but an achiever. Unlike diplomats, achievers make emotionally tough decisions in the best interests of a company and its shareholders. They can handle the complexity, ambivalence, and uncertainty of these situations and do not need to be liked. They are aware that they create environments where people can be awesome, and if employees do not follow their callings, they do not operate in the best interests of all. The elected clients and suppliers equally need to contribute to the company's objectives. Rather than being popular, they are highly respected professionals who have taken the company's reins.

It is important to understand that the kind of thorough business transformation that leads to high returns goes hand in hand with leadership transformation. In many cases, this business and leadership transformation leads to expected rewards for a CEO and investors, as well as for multiple stakeholders. The fruits are reaped, and an exit transfers a company to another set of investors (and sometimes a CEO) who can bring the company to the next level. In some cases, however, there is an opportunity for a second act.

Act II

What is the road for the search fund CEO and his or her investors, if not an exit? With a business transformed into a more robust, high-growth engine, is it not time to liquify the investment? After all, have the CEO, board, and investors not given their all and now others with uniquely different business and financial tools, capabilities, and experiences better placed for the work ahead?

Oftentimes, the answer to this question will be affirmative but not always. We believe that, in many of the best-performing search companies, a second act was possible because the now-experienced CEO could transform his or her leadership archetype and the business a second time. Also, as explained below, the CEO had the appropriate board for this second set of transformations. Let us first discuss business transformation, followed by the transformation of its leader and board.

Business transformation

It is worth remembering that investors deem putting an inexperienced and young entrepreneur into the CEO seat a risky proposition and, therefore, opt not to take too many of the other risk types—business complexity, leverage, tuck-in acquisitions, product development, etc.—when transforming a business for the first time. However, at the stage where we normally start to consider exiting a business (5–7 years post-acquisition), a CEO is experienced and presumably has tools for business transformation at his or her disposal that were previously unavailable.

One such tool is acquisition. As the CEO now has a good handle of the business, a thorough understanding of the industry, and many stakeholders' trust, buying strategically interesting companies at a reasonable price can be an option. Another option could be to change the corporation's capital structure and use increased leverage to either further grow or lower the equity base.

The following pointers are useful for embarking on M&A in 'searchfundlandia:'

- There needs to be a good strategic reason for engaging in M&A, such as:
  - Increasing market power in a maturing industry
  - Creating a market leader in a fragmented industry (*)
  - Geographical or product/service expansion (*)
  - Acquiring R&D
  - Shaping a new industry
- Valuation needs to be attractive. A successful formula has often been the ability to acquire new companies without the need to raise new equity (i.e., via debt and internal cash flow).
- Understand that execution (also known as PMI or post-merger integration) is highly complex, especially the issues related to HR and culture.
- Start with a small deal and learn as small deals can result in small mistakes while big deals can result in very costly ones.

(*) Typical for search funds.

Leadership transformation

In terms of the leadership archetype, what is needed to successfully transform a company for a second time is a leader's ability to integrate different action logics, target personal and organizational development, and influence the broader environment. In other words, the leader will transform the business a second time while simultaneously transforming himself or herself from an achiever into a strategist. In addition to the discussed characteristics, a strategist will play an increasingly important role in his or her sector.

Take M&A, for instance. Companies have different cultures, with distinctive relationships with their CEOs (for one group, he or she is completely new, but this is not so for the employees of the acquiring company), different processes, incentive systems, IT, and so on. For an integration to be successful, a CEO will need to navigate both cultures, hold on to key employees of both companies, give target-company managers time to familiarize themselves while keeping an unyielding focus on customers, provide strong guidance in synergy capture, etc. An achiever's characteristics do not suffice; rather, a strategist who can deal with this ambivalence and shape a new reality, leading to more pronounced sector leadership, is required.

Board transformation

Upon acquisition, when a board is installed, except for exceptional cases, it should be able to provide mentorship and guidance while being loyal to its fiduciary duties to the CEO. In practice, this means that in year one, the board will assist the CEO in his or her and the board's learning (e.g., by fostering reporting and good corporate governance). It will also try to avoid breaking anything (typically by managing the business as usual).

Once the CEO and board understand the business and the industry better, this same board should be able to guide the CEO through the two transformations discussed in Act I; transforming the corporation and transformation of leadership style. A board should have sufficient experience among its members to lead these transformations. If a board also needs to be transformed during Act I, it probably means that the right board was not in place.

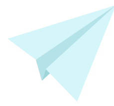
Act II, however, is different. M&A integration, capital allocation, restructuring, and internationalization issues are of a distinctive order compared to topics that typically occur during the first years. Thus, a board transformation is necessary.

Just as the same person transformed his or her leadership action logic during Acts I and II, one could think of the same board transforming into an Act II-ready board. Unless some board members have thorough experience in planned Act II transformations, we argue against the board remaining unchanged. It is important that boards understand which transformations a company will go through over the subsequent three years and assure it has the right board expertise to lead this.

On a separate note, one regularly hears in the search fund community that although investors and CEOs have harvested attractive returns, exits have been premature. This argument is commonly born out of frustration when seeing the valuation that private equity obtains from the companies they acquire from the search fund community.

We believe that to make this argument, the search fund community needs to believe that it can do what private equity can do. Our reading is that they are structured persistently to provide an Act II process. Can we?

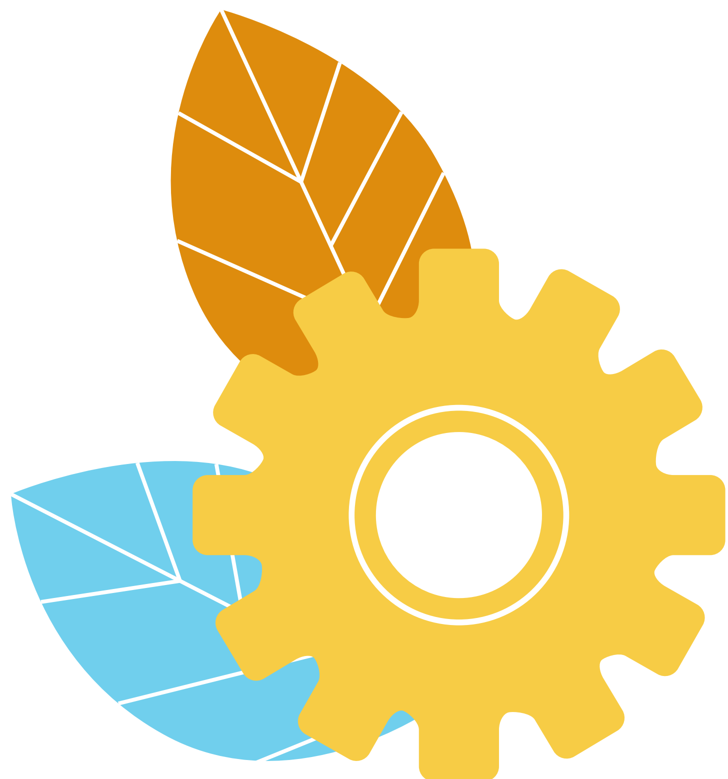
Conclusion



Based on quantitative research, we have made an effort to detect some common practices found in HPCs:

- The first year post-acquisition serves to get to know a business and not break anything (i.e., business as usual).
- For searcher-CEOs to provide the high returns investors have come to expect from this asset class, both business and leadership archetypes will need to be transformed.
- In Act I, a business transformation will typically cover growth and business robustness, while Act II will incorporate more complex manipulations, such as M&As or internationalization.
- The leadership transformation that occurs in Act I is from diplomat to achiever and from achiever to strategist in Act II.
- Business and leadership transformations need to happen simultaneously and often reinforce each other.
- While Act I transformations are common in 'searchfundlandia,' Act II transformations are rather exceptional. Unless board members with Act II transformations are already part of the board, new board members will need to join.

With over 1,000 search funds launched over the past four decades, this report has focused on the three important transformations explaining their extraordinary returns: organization, leadership and board. Outdoing performance in public equities, venture capital and private equity, search fund CEOs in tandem with their boards and investors have acquired good companies in great industries at reasonable prices. Their 'tour de force' has been in transforming ordinary companies in extraordinary vehicles of value creation. In the process CEOs have adopted their leadership style and where due, boards have adopted the capabilities that were necessary to lead their companies to the next level.



www.iese.edu

Barcelona
Madrid
Munich
New York
São Paulo

A Way to Learn. A Mark to Make. A World to Change.