

Search funds: What does not seem to work and what can be done about it?

**Part II: Customer concentration,
market disruption, and government
involvement**

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Introduction

Back in 2014, IESE published one of the first international notes on search funds. The note explored the workings of the search fund model and explained the essential elements at the root of its high performance. It was called “Search funds- what has made them work?”¹

In a two-part note I, explore the other side of the coin by reflecting on *Search Funds – What does not seem to work and what can be done about it?* The analysis is the fruit of the work done at IESE’s International Search Fund Centre, as well as discussions with other investors. Particularly helpful were the plenary sessions during the 6th IESE Search Fund Investors’ Summit, held in Madrid on May 13, 2025.

For good order, Part I looked at the role of the ongoing engagement of the vendor and leadership failures—both at the CEO level and board level—played in value destruction or company demise. It also provides solutions for these issues. This technical note delves into three further causes—customer concentration, market disruption, and government involvement—as well as offers solutions. It is worth noting that the numbering does not reflect ranking. An aspect shared by the topics discussed in this note is that at times, they do not get the deserved attention during due diligence. They are also slightly more technical. This is why they are grouped in the same note. The numbering continues from Part I.

Cause #3: Customer concentration²

As globally search funds have been around for over 40 years, with over 1000 searchers and nearly 500 acquisitions, many lessons have been learned the hard way. Some are more recent, as more data have become available and more research has been done. Others were picked up during the “early innings.” One of those initial findings was that customer concentration often lay at the root of troubles. Flipped around, diversification works! We briefly provide a word on customer concentration and diversification before mentioning an important caveat that informs the remedy part.

The potential problem seems obvious: If some customers represent a large percentage of revenue, their exit can be problematic, even disastrous. True. But merely looking at the share of revenue the top 1, top 5, or top 10 represent does not necessarily do the trick. For instance, if the top 1 customer represents 30% of revenue but purchasing decisions are independently made by 15 decentralized purchasing managers, does this count as one customer or 15? If the top 5 customers are of similar size, and their composite share is “only” 25%, but they are all in the cyclical automotive sector, is it still fair to say that there is “no customer concentration?” And what if the clients operate in a fragmented sector in which Mergers and acquisitions (M&A) activity is accelerating? Is it better to have four clients, each representing 7% of sales with yearly renewable contracts, or two equivalent customers of 14%, with an integrated supply chain and recently having signed five-year contracts? Thus, while customer concentration is important, it is a bit more subtle than is often portrayed.

Naturally, diversification is the solution by excellence for cases in which customer concentration is (too) high.

Nevertheless, it is important to understand how diversification works; if one fails to do so, one may draw wrong conclusions or come up with false remedies. In the previous example, having the top 4 account for 28% of sales may appear to represent a more benign form of customer concentration than having the top 2 account for the same percentage of sales. However, this is not necessarily true.

¹ International Search Fund Center. “International Search Fund Center”, IESE Business School. Last modified 2025. <https://www.iese.edu/entrepreneurship/search-funds/>

² Note that the same reasoning and observations can be made for critical supplier concentration.

Spreading eggs across different baskets seems like a good way to diversify. But what if all baskets are made by the same supplier, or all baskets hang from the same hook 10 feet above concrete?

To fully understand and thus apply diversification, it is worth focusing on the key concepts of correlation and joint variability. Their essence can best be understood through Markowitz's work on portfolio selection.³

As Markowitz pointed out, truly diversifying means lowering risk (expressed as standard deviation σ or variance σ^2). In the case of a client portfolio, this is expressed mathematically by the following equation.⁴

$$\sigma_p^2 = \sum_i \omega_i^2 \sigma_i^2 + \sum_i \sum_{j \neq i} \omega_i \omega_j \sigma_i \sigma_j \rho_{ij}$$

In layman's terms, this tells us that adding clients whose businesses are lowly correlated (the red part in the formula) lowers the risk of a client portfolio. Conversely, adding highly correlated businesses (ρ close to 1) does not really help in diversifying the client portfolio.

It is also worth pointing out that the correlation coefficient between two clients is equal to the covariance divided by their respective risk. Covariance is a measure of the joint variability of two variables; in this case, it is sales to clients.

$$\rho_{X,Y} = \frac{\text{cov}(X,Y)}{\sigma_X \sigma_Y}$$

Again, in layman's terms, if clients' sales behave very similarly (cointegrated)—and there is little uncertainty about this—there is no diversification effect.

I do suggest that you put customer purchase profiles in a time series, but the concepts of correlation and joint variability are nevertheless essential in understanding how diversification truly works. The concepts inform discussions concerning concentration as well as potential solutions. These concepts are helpful in assessing customer concentration risk during due diligence.

Before elaborating on potential remedies, mentioning one caveat is of the essence. It is correct that customer concentration is a frequently recurring characteristic of search fund failures. However, if one analyzes the situation at the time of acquisition of search fund-acquired companies that turned out to be very successful investments, one will very often encounter customer concentration as well. This is because small and medium-sized companies frequently grow together with a couple or a handful of their customers. So, are you doomed if you do, and doomed if you don't? Well, not entirely; this is where remedies come into play.

Remedy cause #3: Customer concentration

When coming up with remedies, the concepts of correlation and joint variability are helpful. Take the following examples, for instance:

- If the top 1 customer is 30% of the business, but purchasing decisions are independently made by 15 decentralized purchasing managers, does this count as one customer or 15? If losing one of them does not affect the 14 others, this indicates low correlation ($\rho \cong 0$) and hence low concentration risk. However, if there is M&A activity in the sector, the correlation coefficient could increase ($\rho \rightarrow 1$) if the acquiring company centralizes purchasing.

³ Markowitz, H. (1952) "Portfolio Selection". *The Journal of Finance*, 7, 77-91

⁴ With: σ_p^2 : Variance of p, σ_i : Standard Deviation of p, \sum_i : Summation 1 till i, ρ_{ij} : Correlation Coefficient between i and j

- If the top 5 customers are of similar size and their composite share is “only” 25%, but they are all in the cyclical automotive sector, is it still fair to say that there is “no customer concentration?” It is; however, both joint variability and correlation will be higher than when representing five different sectors. Here, we notice cyclical-induced joint variability and, hence, correlation.
- And what if the clients operate in a fragmented sector where M&A activity is accelerating? In this case, expected correlation will go up, as clients might merge with each other (increasing client market power) or with nonclients (increasing market power and potential loss of business).
- Is it better to have four clients, each representing 7% of sales with yearly renewable contracts, or two equivalent customers of 14% whose supply chain is integrated with the target and have recently signed five-year contracts? This one is a bit more tedious to respond to, but it is the latter. Long-term contracts and integrated supply chains lower the covariance, the correlation coefficient ($\rho \cong 0$), and ultimately, customer concentration risk. In an investment portfolio, these effects are created by treasury bills.

In addition to being helpful when making an assessment during due diligence, the concepts of correlation and joint variability also point toward solutions that can be implemented as part of acquisition or post acquisition. Here are some examples of how to meaningfully lower customer concentration risk based on these concepts.

- Renew or extend contracts during the acquisition, or if the seller is crucial in achieving this post acquisition, have earnouts in function of success
- Change the business model from a one-off model to a repeat one or from a repeat model to a recurring one.
- Increase product differentiation or develop a tiered pricing structure .
- Build a client portfolio from sectors that are lowly correlated.



Cause #4: Market disruption

A threat to any business—and thus to investors and operators in the search fund world—is the risk that its environment will be disrupted. While this has been true since the Industrial Revolution, the internet and now AI have made disruption not only more prevalent but also easier. **Figure 5** provides some examples of companies that were once bellwethers of their industry only to file for bankruptcy⁵ later.

Figure 5. Market leaders going bankrupt



If towering companies can be disrupted, dismantled, and destroyed, we in the search community should not hold any illusions and should, thus, stay ever vigilant. But how does disruption occur?

Although the idea that capitalism functions as a chain of innovative destructions might have been present in the works of Sombart and Nietzsche,⁶ it was Austrian-born economist Joseph Schumpeter who, on page 83 of his seminal book *Capitalism, Socialism, and Democracy* (1942), wrote,

The opening up of new markets, foreign or domestic, and the organizational development from the craft shop to such concerns as U.S. Steel illustrate the same process of industrial mutation—if I may use that biological term—that incessantly revolutionizes the economic structure from within, incessantly destroying the old one, incessantly creating a new one. **This process of Creative Destruction is the essential fact about capitalism.**

Indeed, from Blockbuster to Netflix, JCPenny/Sears to Amazon, GM to Tesla, Kodak/Rim to Apple, Rex to SolarCity, and Britannica to Wikipedia, Creative Destruction is all around us... permanently. But does this mean that we are doomed? Not necessarily, but we do need to understand how disruption works, as well as how to deal with it and how to engage with it. In what follows, we describe the process of disruption, and under “remedy,” we tackle how to deal or engage with it.

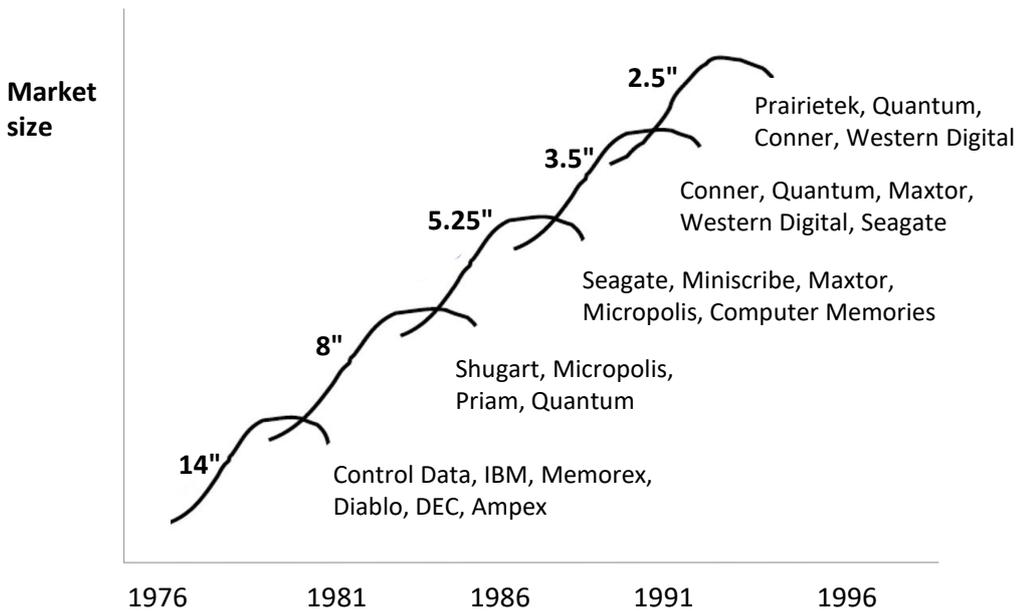
While Michael Porter was interested in why companies succeed, Clayton Christensen, as part of his PhD thesis, wondered why companies fail. It is thus no coincidence that his research still resonates when discussing the causes of search fund failures.

⁵ GM’s present entity dates back to 2009, after the Chapter 11 reorganization.

⁶ Erik Reinert, “Creative Destruction in Economics: Nietzsche, Sombart, Schumpeter (with Hugo Reinert),” in *The Visionary Realism of German Economics: From the Thirty Years’ War to the Cold War*, ed. Rainer Kattel (Anthem Press, 2019), 385–412.

Focusing his research on the producers of microprocessors, he was intrigued by the continuous disruption, innovation, and bankruptcy that was taking place in the industry (see **Figure 6**):

Figure 6. Disruption and innovation in microprocessor companies



Source: Clayton Christensen

From 1976 to 1994, 146 micro processing companies were founded, while 125 faltered. Why?⁷

While we cannot do any justice to a brilliant thesis by reducing it to a couple of lines, a most important aspect why CEOs did not react in time is their lack of understanding of how disruption works. As a starter, by following clients' advice and underestimating the speed of progress of a suboptimal product or service, the moment disruption kicks in, reaction time proves to be too slow. Game over.

⁷ For a more profound discussion, see Clayton Christensen, *The Innovator's Dilemma* (Harvard Business Review Press, 2016).

Figure 7. Disruption trajectory



Source: Clayton Christensen

As **Figure 7** illustrates, the disruptor often starts with a suboptimal product or service. Think, for instance, of the 8" micro-disk at the end of the 1970s. When Control Data asked its mainstream and high-end customers if they would be interested in such a disk, the answer was something along the lines of "no way, it looks cute, but it cannot store a sufficient amount of data." Consequently, Control Data doubled down on the 14" market. The company and its customers failed to see that innovation would rapidly increase the storage capacity of 8" devices. In the early 1980s, the 8" provided sufficient storage ability, causing the demand for the 14" to evaporate since size became a differentiating factor. With it, all companies who had doubled down on 14" were erased. Incredibly, the same happened when 5.25", 3.5", and 2.5" floppy disks were introduced.

Remedy Cause #4: Market Disruption

There are three primary remedies: avoidance, initiation, and strategic shift.

At the time of due diligence, a good question to ponder is whether the target market is ripe for disruption. If the assessment is positive, giving the opportunity a pass is probably a wise move (avoidance). The main reason is that in general, disruption is best initiated by a start-up backed by venture capital. It is also true that the DNA of a typical search fund CEO tends to be different from the "move-fast-and-break-things" attitude of founders. These CEOs subscribe to the mindset of "move slow, don't change anything before truly understanding your business". Thus, it is best to avoid throwing them into the deep end of an industry that goes through disruption. It is also true that the pockets of venture capitalists are deeper—much deeper—than those of search fund investors.

However, there are situations in which, typically after the first year, a board decides there is an opportunity for the search fund company to be a disrupter. For instance, through the business model innovation. For example, by being the first company in the sector to change its business model from one-off product sales to a recurring service provider model (initiation). Another proven way is the initiation of digitalization in a fragmented archaic sector. Going forward, there will be an increasing

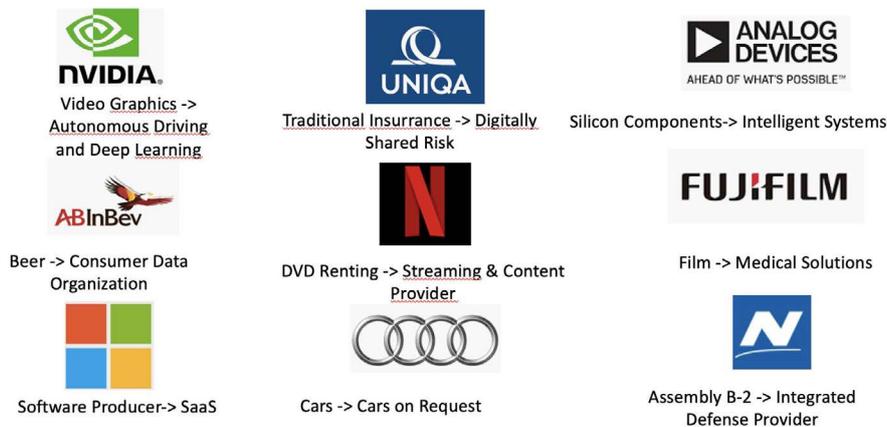
number of opportunities where a search fund–acquired company can initiate disruption by integrating AI into its operations. In these cases, it is critical to understand where disruptions in the supply chain are driven by AI companies and where they are driven by non-AI companies integrating AI.

Another opportunity lies in disruption by reorienting the company strategically (strategic shift). The best-known example in the search fund world is Asurion. In 1995, Kevin Taweel and Jim Ellis acquired Road Rescue, a Houston-based roadside assistance company with about \$20m in revenue. Later, they pivoted the company first into specialty insurance covering mobile phones and then later into an insurer of digital instruments, such as smartphones, tablets, consumer electronics, and satellite receivers. It now has over 20,000 employees and close to \$10bn in revenue.

For most companies, such a strategic shift while simultaneously becoming a disruptor is a mere pipedream. Even in the big leagues, very few companies have been successful in achieving this.

Figure 8 provides some examples of companies that engaged in strategic disruption.

Figure 8. Successful strategic disrupting shifts



Cause #5: Government

The final relevant risk factor is when the government plays an important role in a sector or when a particular company depends on it. These can be local, state, or national governments.

One needs to be mindful of the following: (i) governments always play a role, (ii) in some cases, the government's involvement is positive, and (iii) some searchers have done very well in sectors dominated by governmental agencies. Let's unpack each of these.

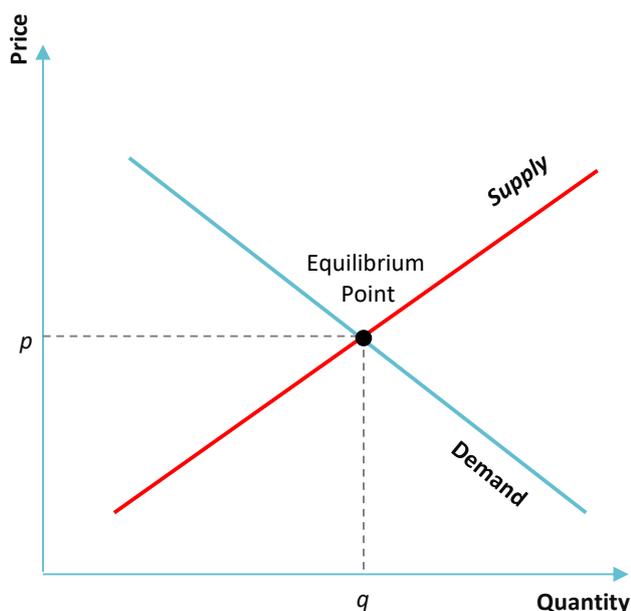
All companies have governments as stakeholders since they are all regulated by laws—from tax laws and social security laws to property laws and corporate laws. In addition, investors in search funds take a special interest in the protection of minority owners in the countries in which they invest. Thus, to the extent that governments organize a society in which companies can create value for their shareholders, searchers, CEOs, and investors are happy to operate and deploy capital.

In sensitive sectors such as healthcare, defense, or cybersecurity, the government's involvement helps create and protect value. In healthcare, for instance, regulators make sure that the companies operating in this sector are well supervised and obtain stamps of approval. Without it, patients would have less trust (and thus a lower willingness to pay) because anyone could set up shop (no barriers to entry).

However, in other situations, when governments get involved, value gets destroyed. Typically, this is because their intervention artificially affects supply or demand, which influences pricing. Fortunately, the field of macroeconomics provides tools to think about how government interventions affect revenue, EBITDA, and cash flow. Let's see how this works.

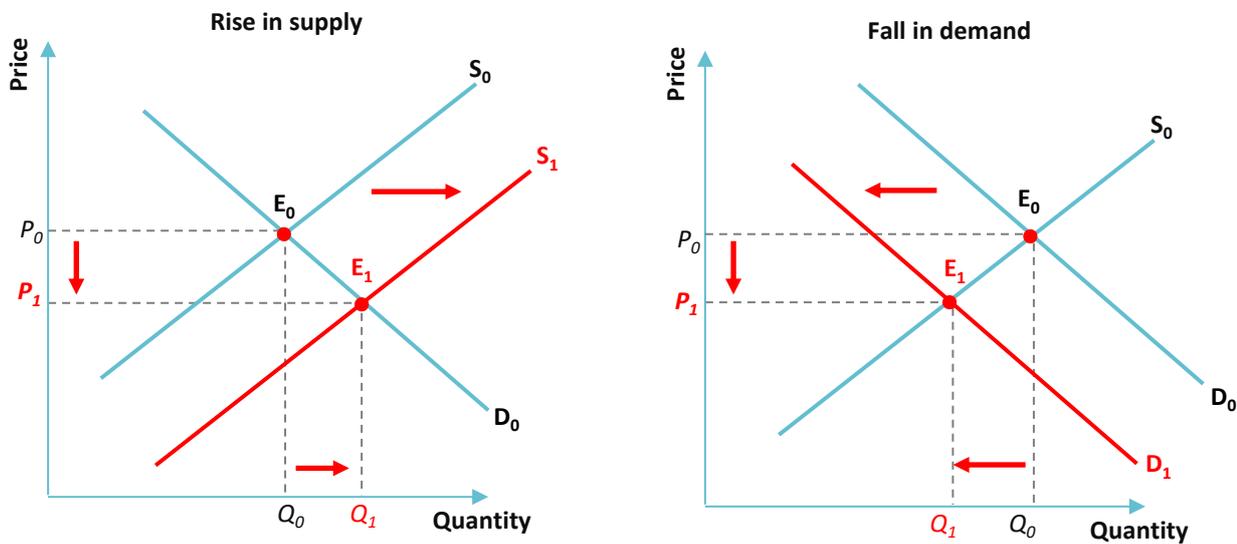
Ideally, prices are set in a free way by a free market. If and when this is the case, even by proxy, services and products are provided at a certain equilibrium spectrum (i.e., at a spectrum around economists' equilibrium price p , as per **Figure 9**). At the time of writing, a caffè latte is around EUR 2.8–4.5 (quality being an important differentiator).

Figure 9. Equilibrium price



Prices will fall if, as per **Figure 10**, either supply increases (e.g., competition has increased) or demand falls (e.g., a decrease in willingness to pay due to a recession).

Figure 10. Equilibrium price bis



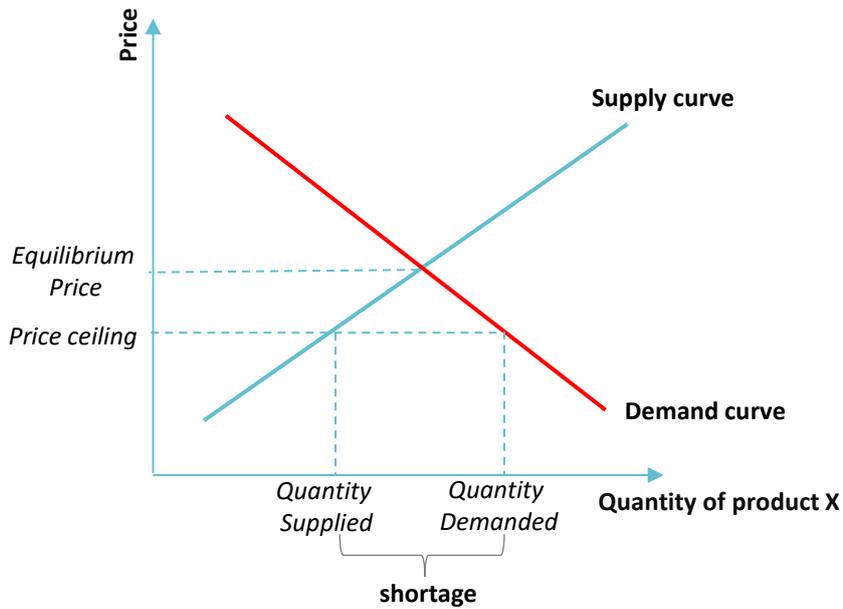
Operating within market-driven dynamic demand and supply curves is the task of the CEO. Competitive strategy, for instance, involves defining the target customer and developing an appropriate strategy to address why the target customer would buy from the firm and not its competitors. Conversely, in the blue ocean strategy, the intent is to make the competition less important while increasing customers' willingness to pay through value innovation.

In a nutshell, many of the things that CEOs and boards do are aimed at growing sales, increasing the EBITDA margin, and making the company more attractive to potential buyers. This will lead to EBITDA growth and a higher exit multiple.

But markets are seldom free, and thus, prices are not necessarily governed by dynamic, free supply and demand curves. Governments do intervene. When this intervention is sudden and unexpected, investors and CEOs are wrongfooted. There are three important ways that this can affect investors in search funds: price ceilings, subsidies, and taxes (e.g., tariffs). I proceed by briefly explaining their impact before explaining the risks they present in today's political reality.

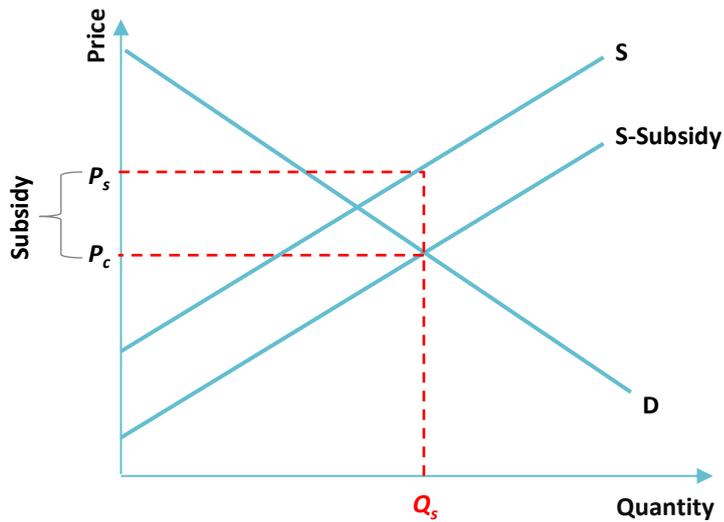
When governments impose price ceilings on a product, service, or sector, it tends to make some consumers happy (see **Figure 11**). But since it creates a shortage, other stakeholders are dissatisfied. For CEOs, investors, and other stakeholders, it subdues many companies, as margins, cash flow, and EBITDA get squeezed.

Figure 11. Price ceiling



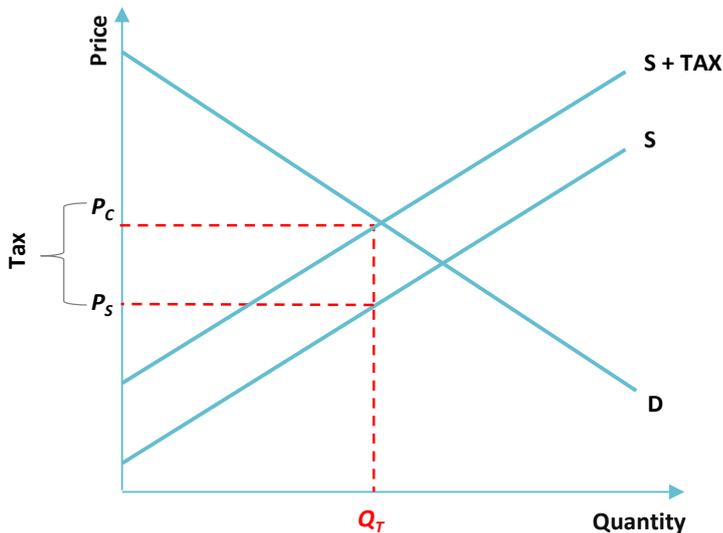
The second way search fund-acquired companies might be affected by government intervention is through subsidies (see **Figure 12**). When the government grants a subsidy, it shifts the supply curve to the right. The price consumers pay decreases, and the after-subsidy price sellers receive increases. Note that quantity inflates. The risk for companies is not the granting of a subsidy but its revocation. In that case, demand falls, and overcapacity leads to price wars that negatively affect both sales and margins.

Figure 12. Subsidies



The third effect is the application of taxes. When a government imposes taxes, the supply curve shifts to the left (see **Figure 13**). The new equilibrium quantity decreases, the price consumers pay increases, and the after-tax price sellers receive decreases. So, for corporations, this translates to lower volume and lower prices—a double whammy.

Figure 13. Taxes



In search funds, value has been destroyed because of government involvement—whether through the imposition of price ceilings (e.g., Medicaid), the halting of subsidies (e.g., in support of solar energy), or increased taxes, all of which are unanticipated. However, we believe that “actual and potential government policy changes” should be part of a searcher and investor risk assessment for the following reasons:

- The debt burdens of many governments are at historic record highs:
 - USA +\$36 trillion (at the time of writing)
 - European Union (27): +\$16 trillion (at the time of writing)
- Many countries have started initiatives to reduce the debt burden
- Societies are becoming more polarized, with populism on the rise
- A substantial number of companies are enjoying subsidies either directly (e.g., alternative energy companies) or indirectly (e.g., companies selling into subsidized universities)
- Where progressive movements are on the rise, taxes are seen as a means of redistribution, and sectors providing luxury are more prone to tax increases than sectors assisting the vulnerable
- The US administration is using tariffs as a way to correct the trade imbalance (or to negotiate it)

In light of the potential increased government involvement, what can be done?

Remedy cause #5: Government

Unexpected government interventions such as price ceilings, tariffs and taxation changes, and termination of subsidies can have devastating impacts on SMEs. This is because all three severely affect corporations' oxygen systems—cash flow—which puts companies in crisis mode. If possible, one should avoid investing in companies in which shareholder value creation is dependent on government activity or inactivity. At the same time, one should be aware of analysis paralysis or putting an undue high-risk assessment on the target. So, let's discuss (a) risk assessment during due diligence and (b) measures to deploy in times of crisis.

a. Risk assessment during due diligence

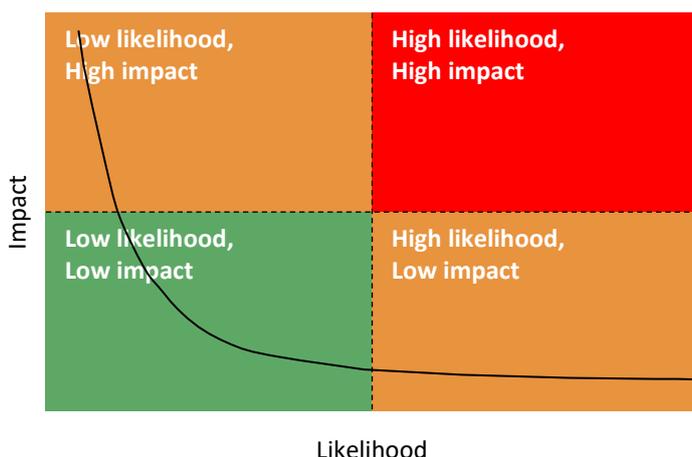
Much of the due diligence activity is assessing whether the acquisition of the target qualifies as buying a good company in a great industry at a reasonable price. In it, one investigates the "benignness" of the sector (fragmented, noncyclical, growing, etc.), the attractiveness of the company (quality of revenue, growth, business model, etc.), and its valuation.

A second, more in-depth analysis tackles credit, market, and operational risk. Operational risk is split into five buckets:

- Internal process risk: the lack or failure of the target's processes and procedures
- People risk: risk associated with employees leaving and employee error or fraud
- Systems risk: related to the (lack of) use of technology, AI, data, and computer systems
- Legal risk
- External risk: related to events that are not directly controlled by the target

Government risk, for lack of a better word, relates to external risk and is assessed as part of possible events that are not under the control of the target. As with all risk discussions, try to allocate government risk (e.g., price setting, subsidy removal, tariffs, tax regime change, etc.) in one of the following four buckets:

Figure 14. Risk impact–likelihood quadrants



Source: Richard Apostolik, Christopher Donohue, and Peter Went (Foundations of Banking Risk, Wiley, 2009)

Most important are the risks that have a high impact on the target and its cash flows, i.e., the top two rectangles. In reality, the discerning ones are the low likelihood–high impact risks, especially when the company has lots to go for. High likelihood–high impact risks are not troublesome as the uncertainty is low, which makes the decision an easy one.

When looking at the low likelihood–high impact quadrant, a useful way of discussing the issue is by focusing on catalysts that might change governments' stands on certain issues, such as elections, budget deficits, and scandals. Thereafter, one can proceed by talking about the expectations and perceptions that these might materialize.

Needless to say, when a decision is made to not invest as a result but the company goes on to perform excellently, it hurts. However, this is how risk management works. Done diligently, this creates more value over time.

b. Measures to deploy in times of crisis

But what remedies can one apply when unexpected government decisions have a disrupting effect on the company? Decisions that affect earnings or taxes and, ultimately, cash flow? These systemic government collisions tend to be seismic and thus often fatal.

While we have—at the time of the COVID-19 pandemic—discussed more in-depth measures to take when a company faces an existential crisis,⁸ here are a few reminders about efficient action:

- Exude positive energy: while fixing the boom, sails, and rudder, everyone feeds from the energy of the skipper
- Business focus: demand a relentless focus on attending to customers and delivering the best service from all employees
- People first: leadership matters always—more so in times of crisis. Leadership is about character, ethics, and mental strength, but this triumvirate is there to serve people
- Increased communication: crisis is uncertainty. The effect of crises on people can dramatically be reduced through communication. A communication void can strangle the company
- Engage with the board: good boards are able to reduce the probability of bankruptcy. Not engaging also makes the CEO liable
- Liquidity, capital structure, and long-term solvency are of the essence
- Secure critical supply
- Deploy your designated crisis strategy

A last word: When a risk is qualified as low likelihood–high impact, and an investment decision is made, the board needs to reorient the company in such a fashion that governmental risk—or any risk for that matter—becomes low likelihood–low impact. Depending on the situation, the board and CEO can do so by changing the client mix, extending contracts, increasing the value of the service, having a stronger integration, controlling cost control, and attracting more clients.

⁸ Simon Jan, (2020). "Letter to a Young Operator on Managing During a Crisis," *IESE Publishing*.

Conclusion

Ten years after “Search Funds- What has made them work?” was published, and over 40 years since Irv, Jim, Jamie, Jeff, Peter, (another) Jim, Kevin, and others started a very entrepreneurial and successful contraption called search funds, I believed it was a good time to reflect on some of the common factors leading to failure. Based on input from the search fund community and work done at the International Search fund Center, this and a previous note distinguish five recurring factors: ongoing seller involvement, leadership, customer concentration, market disruption, and government. In some cases, one of them lay at the origin of value destruction, while in many cases, it was a combination of factors that created havoc.

The notes have also made an effort to come up with solutions to the ailments. Needless to say, a) these are situation dependent, and b) these are not exhaustive. They are, however, based on practices that have worked. Hopefully, they will help to avoid value destruction in some cases and correct it in others. Ideally, they will provoke further discussions, debates, and ideas that will serve CEOs and board members of our search fund community.

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