

Re-Thinking Search Fund Incentive Structures

Purpose

Search funds have become a popular model for young entrepreneurs seeking to become equity-owning managers and run their own business. They have also become an interesting investment class for experienced private equity investors and other individual investors.

This note addresses several topics regarding the structure of search funds. The purpose of the note is to stimulate discussion among key people in the search fund community. While it does offer possible solutions to certain issues, this note is not meant to be prescriptive; rather, it is designed to provide a framework for further discussion of the issues raised. One of the main reasons search funds have worked well in the past is because both the searcher and his/her investors have understood that the whole process is a real partnership – a collaborative effort to achieve value for both the searcher and the investors. It is in this spirit that issues are addressed here.

It should be noted that these issues, as well as others not addressed in this note, are part of an entire package; and it is not intended that one should pick selectively from the issues discussed here without taking into account other structural issues that make up the complete package. [Note to new searchers: In practice, some of these issues are acquisition-specific; and it is in everyone's interest, including that of the searcher, to wait until finding a deal before trying to agree on all of those details.] Keep in mind that the objective is to ensure alignment between the searcher and the investors in order to achieve everyone's overall goal of value creation.

Background

Serial search fund investors have worked closely with searchers and legal advisers to mold details of the search fund model into a relatively standardized package, which includes norms for a number of the terms in a search fund and its ultimate acquisition. Stanford Graduate School of Business has codified many of these details in *A Primer on Search Funds*¹, and a number of law firms now have boilerplate search fund legal documents that incorporate these details. When people refer to “the search fund model,” these terms are part of what they are referring to.

¹ Stanford Graduate School of Business. 2017. *Search Fund Primer*, [Online] [Accessed July 2017]. Available from: <https://www.gsb.stanford.edu/faculty-research/centers-initiatives/ces/research/search-funds/primer>.

One of the generally accepted terms in the ultimate acquisition financing is a preferred return on the funds invested by investors; i.e., investors receive their capital back plus a fixed return on that capital before anything is shared with the entrepreneur(s).

Another generally agreed term involves the earned equity of the entrepreneur once an acquisition has been made. Typically, a single searcher earns up to 25% ownership, while a team of two searchers usually earns up to 30% between them. That earned equity is usually split into three equal tranches, the first of which vests (i.e., becomes fully owned) upon closing of the acquisition. The second third vests over a 4-5-year period, and the final third vests based on achieving specified IRR targets upon exit.

There are reasons, however, to question whether these terms – the preferred return, the earned equity structure, and the IRR hurdles – actually achieve the best possible alignment between investors and searchers and whether there might be a better way to achieve such alignment. This note explores that question.

Preferred Return

In any buyout financial structure, the capital provided by investors may be invested in any number of financing instruments, from loan notes to preferred shares to common (or ordinary) shares. In many cases investors' funds will go into a single instrument like a participating preferred share, which incorporates the characteristics and rights of most or all of these instruments.

There are two important characteristics of these financing structures. (1) Seniority, or preferred capital: Virtually all of the investors' capital ranks senior to management's equity, which means that in any exit or liquidation the investors will get their capital back before management gets anything. This is sometimes referred to as a "liquidation preference." (2) Preferred return: When a preferred return is also included, those investors also get a return on top of the repayment of preferred capital before management gets anything. Usually this preferred return is in the form of a dividend on preferred shares and/or interest on a loan note, so the return is calculated annually as a percentage of the amount of the preferred capital.

In traditional buyouts, this kind of structure makes sense: "I will provide the capital if you structure the financing so that I can get my capital back with a market return on it first, and then we will split any remaining gains based on our ownership percentage."

Investors often include a preferred return in the financial structure of a search fund acquisition; however, the traditional logic for including it in a search fund may fail to take into account the entrepreneur's performance vesting schedule. As mentioned earlier, the entrepreneur's final one-third vests based on the ultimate IRR achieved for investors upon exit. Typically that final tranche vests on a sliding scale, with no vesting until the IRR on investors' invested capital reaches 20% and then vesting proportionally until the IRR reaches 35%, at which point the shares are fully vested.

It is this final performance hurdle that needs to be taken into account when considering whether a preferred return is needed – or, indeed, even desired – by the investors.

The Math

It is instructive to look at the impact of a preferred return on overall returns in light of the performance vesting for the entrepreneur. **Exhibit 1** is part of a model for doing just that, showing the assumptions underlying the model.

The first five lines show the investment and exit numbers, followed by two lines with different preferred return rates. All of these variables can be changed to allow one to examine different scenarios. The bottom two lines show the entrepreneur's fixed vesting schedule. The model uses these assumptions to calculate the returns for investors and for the entrepreneur, automatically adjusting everyone's ownership according to the entrepreneur's vesting schedule.

Exhibit 2 shows the results from this model for three different scenarios: one with no preferred return, one with a 5% preferred return, and one with a 10% preferred return. The resulting returns are shown in the bottom four rows of each box.

Exhibit 3 then compares the effect of the preferred return on the investors with the effect on the entrepreneur for all of these scenarios. The section headed “Exit Value” shows the absolute amounts for the searcher and the investor under each scenario at different exit values. The section headed “Impact on Each Party” summarizes an analysis of those results. (Note: Exhibit 3 does not automatically update when variables are changed in the model; it must be prepared manually.)

Results

Focusing on the last section of **Exhibit 3** (“Impact on Each Party”), one can see immediately that the impact on the searcher is very significant at lower exit values and is still significant at higher exit values, while the effect on the investor is nominal at *all* exit values.

Clearly at a high exit value, and arguably even at a mid-level exit value, the difference to the investor is nominal; and, indeed, that fits with the underlying argument for a preferred return. At higher exit values most investors would willingly forego a preferred return; it is at lower exit values that the investor wants to ensure some minimum return – that is why the preferred return is there. Yet it is at these lower exit values that another issue arises: the motivation of the entrepreneur.

Consider the numbers. At a \$35 million exit value after 6 years, the difference to the investors between no dividend and a 10% preferred return adds \$632,100, or 2.3%, to the investors’ return (of over \$27 million on a \$4 million investment); however that additional \$632,100 for investors reduces the entrepreneur’s return by 8.2%. In IRR terms, the difference to the investor between a 10% dividend and no dividend is a drop from 36.6% to 36.1%. At a lower exit value, the difference is much more. At a \$15 million exit value and a 10% preferred return, the investors gets an additional \$421,484, or 3.2%, while the entrepreneur’s return is reduced by 23.4%. With no dividend as compared with a 10% dividend, the investors’ IRR drops from 21.2% to 20.6%. While the difference to the investor does matter, it is not critical; yet the difference to the entrepreneur is significant, indeed worryingly so.

Again, one may argue that this is as it should be: ensuring a decent return for investors before the entrepreneur gets to participate in any rewards. As the authors themselves have often pointed out, capital has a cost associated with it; however, a misaligned financial structure also has a cost associated with it, and the impact on the entrepreneur (and thus on the company) of such a structure may not be what the investors originally intended.

In the United States one attempt to address this issue has led to a “dual-preferred” structure, whereby half of the preferred capital is redeemable and includes a dividend and the other half is non-redeemable (except in a re-capitalization or at exit) with no dividend. In many cases the dividend on the redeemable preferred shares is relatively high. Its purpose is not so much to generate return, but to influence the behavior of the first-time CEO by encouraging him/her to focus on cash generation in order to redeem those shares as soon as possible. With those shares redeemed, it then becomes easier mathematically for the searcher to hit the IRR hurdles by growing the business further.

Whatever approach is taken, search fund investors might learn from start-up investors, who know from experience that multiple rounds of financing can dilute the entrepreneur. He/she might consequently have little incentive to remain with the company. This is especially a concern when the entrepreneur is one whom the investors respect and want to keep in the lead role. It can even result in having to negotiate a “carve-out” for the entrepreneur upon the prospect of an exit that is attractive to investors but not to the entrepreneur.

Whether in a start-up or a search fund acquisition, watching a preferred dividend continue to accrue and grow on the balance sheet can worry and distract an entrepreneur from efforts to increase operating cash flow. In a search fund, this anxiety is compounded by the pressure to earn the performance-based equity tranche. If the exit IRR doesn’t hit the stated target, not only does the preferred return come out first, but the entrepreneur also ends up with a lower share of the remaining proceeds. Failing to hit the IRR target means that the investors end up with a bit more ownership among them and thus a larger share of any exit proceeds, irrespective of any preferred return.

One could argue that this performance incentive alone effectively achieves a preferred return for investors at a lower exit value. In the last example (\$15 million exit value after 6 years), an additional 8.3% ownership was effectively transferred from the entrepreneur’s vesting pool to the investors, which

translates into an additional return of \$898,474, or 7.3% more. In other words, this IRR-based vesting mechanism may obviate the need for an additional preferred return in the financial structure.

At a lower exit value, investors still get an extra amount of return, but the structure does not further penalize the entrepreneur with an ongoing accrued dividend. Further, the performance-based tranche may be incentive enough to encourage the search-CEO to return capital to investors as fast as possible in order to “lock in” the IRR. Even with the dual structure described above, there may be little need to have a high interest rate on the loan note, as the searcher already has the incentive to pay off the loan as soon as possible in order to begin earning his/her performance equity. Thus there is still a significant performance incentive, and there is no longer a negative incentive effect.

Searcher’s Earned Equity

Now let’s take a further look at the earned equity incentive structure. It is generally agreed that the searcher should vest a portion of equity upon closing the acquisition and that a performance-based portion makes sense. Recently, however, a number of experienced investors, looking back at the results of many search funds, have questioned the value of the middle, time-based vesting tranche.

Perhaps it makes sense to eliminate the middle tranche altogether and have only two tranches: one upon closing a deal and the other tied to performance. Since the performance-based tranche already effectively includes a time-vesting element (i.e., if the search-CEO leaves the company, the performance-based shares are forfeited), there is no real need for a separate time-based tranche.

The first tranche, vesting upon closing the acquisition, could be, for example, 50% of the searcher’s potential total equity, with the remaining 50% in the performance-based tranche. With this structure, it probably also makes sense to widen the IRR range; for example, starting vesting at 15% and fully vesting at 35%.

Again, consider the numbers. Using the same model, **Exhibit 4** shows the model for a structure using the 50:50 split for the vesting shares with an IRR range of 15% to 35% for the performance-based tranche. In the model the searcher vests 50% of his/her total shares upon closing the acquisition, and the remaining shares vest based on achieving the IRR targets. **Exhibit 5** shows the results, and **Exhibit 6** compares those results to the original model (the three-tranche structure with dividends).

As these exhibits show, the proposed structure is relatively benign for the searcher, and in the few cases where it is not, the amounts do not tend to be substantial. The added advantage of this proposed model is that it makes the performance element more powerful, while also enabling the searcher to begin earning equity at a lower IRR. The 50:50 split used above is just one of several possibilities; indeed, one could opt for a larger performance-based tranche combined with a lower starting IRR.

Performance Measure: IRR vs. Multiple of Capital

Probably the most complex issue in the structure is the performance measure, which has traditionally been the exit IRR on the investors’ capital. Many individual investors point out that they are in these investments for the long term and are much more interested in achieving a good multiple of their capital than in focusing on the IRR. Indeed, everyone recognizes that using an IRR hurdle has the potential to encourage the entrepreneur to seek an early sale in order to lock in his/her performance tranche.

Conversely, using a multiple of invested capital (“MOIC”) can have the opposite effect, causing the entrepreneur to hold on too long. Both approaches have the undesirable effect of encouraging “game-playing,” even by searchers with the highest integrity. It appears clear that to achieve the best kind of alignment between the searcher and the investors, some kind of balance must be found.

Investors have debated different solutions to this dilemma, some suggesting a combination of IRR and MOIC or a sliding scale of multiples over time that essentially reflect an acceptable IRR level, allowing for

the IRR to decline over time as long as the multiple remains at or above an acceptable level. One such proposal from Tom Matlack is currently being widely discussed.²

Trying to cut this Gordian knot has fueled lots of debate, but so far it has also defied a solution that eliminates the gaming option and that is acceptable to searchers and investors. In essence the debate is an investment-philosophy one, going back to Markowitz' risk-return analysis. In his portfolio selection work Markowitz points out that we serve two sovereign masters while investing: risk and return.

Investors in traditional asset classes such as stocks and bonds, with relatively predictable cash flows, will model pricing based on expected cash flows and a hurdle rate composed of the risk-free rate plus a risk premium. Their thinking follows an IRR-approach. For example, over the past 20 years (ending December 2016) the annualized return of the S&P 500 was 6.4% (8.4% with dividends included and 4.1% inflation adjusted). With an IRR in the single digits it does not make sense to talk in MOIC-terms. Private equity investors, because of similar financial-modeling tools and cash-flow predictability, also tend to look at the world from an IRR perspective.

At the other end of the spectrum, instead of investing in companies with steady or quasi-predictable cash flows, venture capitalists invest in people with new ideas for start-ups that are highly risky with unpredictable cash flows. The risk premiums here are so exorbitant (IRR of 80% are often the norm) that it makes sense to talk in MOIC terms. Additionally, the binomial path of these investments, with very few but sometimes spectacular home runs, makes the timing a less critical issue than in traditional bonds and stock investments or indeed in private equity.

Another way of looking at this dichotomy is by focusing on what differentiates IRR from MOIC: time. When time and timing do not affect the value of money, using MOIC makes sense. This is the case when IRRs (i.e., hurdle rates incorporating the cumulative effect of expected nominal growth, expected inflation and a risk premium) approach zero. Interestingly, it also makes sense to ignore the time value of money in an environment where the probability of failure far exceeds the chance of success. Mathematically this makes for aforementioned steep hurdle rates, leading to a multiple narrative.

Where do search funds fall, and which performance metric should be applied? Search funds have in common with venture capital investing that both endorse young, entrepreneurial, ambitious talent without extensive experience. This would argue for an MOIC-approach. The companies that are acquired by searchers, however, are not start-ups. On the contrary, these are often wonderful companies bought at a fair price. Indeed, serial search fund investors typically would not invest in acquisitions of turnarounds nor in start-ups. Consequently, like in buyouts, an IRR-view may be closer to the mark. Indeed, both Stanford's and IESE's latest studies on search funds³ provide risk-return statistics that are more closely correlated to what is normally encountered in private equity rather than in venture capital.

Finding a Solution

One proposed solution is to earn the performance equity based on a time-limited aggressive MOIC followed by more benign IRR targets. This would reduce the pressure to sell in the beginning while still allowing for long-term value accretion. The largest uncertainty rests with the inexperience of the searcher; hence, it makes sense to use the MOIC approach of venture capitalists during the earlier phase. The uncertainty surrounding this inexperience, as well as the inexperience itself, fade over time, allowing investors then to apply a more reasoned risk premium and use IRR targets for later years. Models applying sliding scales of lower multiples or IRRs over time apply the same reasoning without metric regime changes.

If these models make sense, then why have entrepreneurs and investors not been able to come up with a solution? One reason is behavioral: once a certain performance measure has been set, it proves difficult to change it (behavioral economists call this 'anchoring'). Yet experienced search fund investors are now

² Tom Matlack, "A new Idea on how to calculate Search Fund Performance Equity". *LinkedIn*, 2 June 2017, [Online], Available from: <https://www.linkedin.com/pulse/new-idea-how-calculate-search-fund-performance-equity-tom-matlack>, last accessed July 2017.

³ Stanford Graduate School of Business. *Search Funds*. 2017. "2016 Search Fund Study: Selected Observations". [Online] Available from: <https://www.gsb.stanford.edu/faculty-research/centers-initiatives/ces/research/search-funds>, last accessed July 2017. Lenka Kolarova, Peter Kelly, Antonio Dávila, Robert Johnson, *International Search Funds – 2016, Selected Observations*, IESE Business School, 2016, Available from: <http://www.iese.edu/Aplicaciones/upload/STO415E.pdf>, last accessed July 2017.

more engaged in discussing this topic. The bigger issue is the difficulty in finding a solution that truly works for all parties.

When we tried to come up with an improved model using the approach described above, we realized how easily inconsistencies creep into the model. Examples included performance proceeds to searchers being higher in later years while the exit price was the same, or performance proceeds being lower although value had been added. Solutions based on changes in performance measurements, such as switching from MOIC to IRR, can weaken the behavioral effect that these ‘motivators’ are intended to have. Once again, what is meant to be an incentive could still lead to adverse behavior (i.e., gaming) – not in the best interests of all shareholders.

The Role of the Board

While acknowledging that there may not be a perfect performance measure, we believe that the combination of a searcher with integrity and a board that understands value creation and the role of the searcher in it might lead to the best recipe for success. Indeed, this is consistent with the Stanford / IESE approach to search funds.

In some instances, where there have been traditional IRR targets, the board of directors has initiated a relatively early change in the vesting provisions for the search-CEO, essentially vesting him/her based on the general performance of the company. Sometimes the search-CEO is fully vested after it has become clear that substantial value has truly been created and IRR hurdles likely achieved, with more value-creation opportunities clearly in sight. Other times, usually earlier in the company’s development, the searcher and the investors may agree to vest most of the final tranche and simply eliminate the remaining shares.

Usually this vesting change is implemented specifically to remove any concerns of the CEO about his/her ownership and to encourage him/her to focus on building value in the business. Thus, the searcher is encouraged to focus on how best to allocate his/her own capital, which is now (i) fully his/hers but also (ii) essentially tied up in the equity of the company.

There is no way to put this solution in a formula; rather, it requires a board that fully understands how the search fund model works and is focused on building long-term value for the shareholders. Experienced search fund investors (and searchers, too) will recognize that this means having on the board experienced and flexible people whose judgment they trust. In fact, this has been one of the strengths of the traditional search fund model (see pages 11-12 of *Search Funds – What Has Made Them Work?*⁴ for a discussion of such boards).

Many legal documents include a provision addressing this matter, allowing the board to recommend a change in the vesting provision, subject to approval by a majority of the shareholders. In practice, where a board includes serial search fund investors, it would be unusual for many experienced search fund investors to vote against such a recommendation from the people closest to the business and to the entrepreneur.

Again, the intent is to marry the investors’ interest in building long-term value with the searcher’s understandable desire to secure his/her equity and remove anxiety over that issue so that they can focus on the business. Where investors are comfortable with the board composition, this is perhaps the best place to deal with this tricky issue.

⁴ Rob Johnson, *Search Funds – What Has Made Them Work?*, IESE, 2014, [Online], Available from: <http://www.iese.edu/research/pdfs/ST-0357-E.pdf>, last accessed July 2017.

Conclusion

Both searchers and serial search fund investors rightly point out that the search fund model is designed to align everyone's interests, and the results of search funds tend to bear this out. Yet with a few minor tweaks, as suggested in this note, this alignment can be made even more solid and work in everyone's favor.

Removing the preferred return would increase the entrepreneur's level of motivation when this is most needed without substantially affecting returns for investors. Restructuring the searcher's equity vesting schedule would allow for an appropriately larger part of the earned equity to be performance-based while still being beneficial to performing searchers. Finally, giving the board the authority to initiate vesting decisions in order to keep the search-CEO motivated and focused on the business would benefit all parties.

The authors hope that serial search fund investors and experienced searchers will use the information above to advance the discussion of the issues raised and agree on a way forward for future search funds. As noted in the beginning, it is also important to understand that many of the details discussed above are better sorted out at the time of an acquisition, since they can be deal-specific. In keeping with the partnership approach, taking guidance from experienced search fund investors on what to address early and what to leave for later should serve everyone's interest. Finally, remember that the issues discussed above are part of a package, and any changes need to be addressed in the context of the overall package in order to achieve the best possible alignment for everyone.

Postscript

At the Stanford Search Fund CEO Conference in September 2017, an informal group of thirty individuals – serial search fund investors, past search-CEOs and current search-CEOs – discussed issues of searcher compensation and alignment between searchers and investors, including the topics covered in this note. Those discussions are continuing on an informal basis.

The one consensus that emerged from the discussion involved the key role of the board of directors. It was agreed that in the past when vesting issues have arisen in a growing company, boards with investors who were experienced in advising new CEOs and who understood the collaborative nature of search funds have addressed those vesting issues effectively, to the satisfaction of both search-CEOs and investors. The feeling was that potential vesting conflicts are best addressed by the board, with shareholder approval, once the company has matured and its prospects have become reasonably clear, rather than by trying to solve the IRR / MOIC dilemma up-front.

Exhibit 1

Model Assumptions

Assumptions							
General							
Search fund investment	\$300,000						
Acquisition investment	\$4,000,000						
% Preference shares	98%						
Holding period (years)	6						
Exit value	\$35,000,000						
e.g. A) % Preference dividend	5%						
e.g. B) % Preference dividend	10%						
Ownership Searcher @ IRR							
IRR Hurdles	<20% (*)	20%	23%	26%	29%	32%	35%
Ownership Searcher	16.67%	16.67%	18.34%	20.01%	21.68%	23.35%	25%
(*) automatic vesting time-based shares							

Source: Prepared by the authors.

Exhibit 2

Exit Scenarios

Result without Dividend	
Total investment	\$4,300,000
Preference shares	\$4,214,000
Ordinary shares	\$86,000
Exit value	\$35,000,000
Repayment pref shares	\$4,214,000
Repayment ord. shares	\$30,786,000
IRR Hurdles	35%
Ownership Searcher	25.00%
Proceeds to searcher	\$7,696,500
Proceeds to investor	\$27,303,500
Investor IRR	36.1%
Investor multiple	6.3

e.g. A) Result with Dividend	5%
Total investment	\$4,300,000
Preference shares	\$4,214,000
Ordinary shares	\$86,000
Exit value	\$35,000,000
Preference dividend	\$1,264,200
Repayment pref. shares	\$4,214,000
Repayment ord. shares	\$29,521,800
IRR Hurdles	35%
Ownership Searcher	25.00%
Proceeds to searcher	\$7,380,450
Proceeds to investor	\$27,619,550
Investor IRR	36.3%
Investor multiple	6.4

e.g. B) Result with Dividend	10%
Total investment	\$4,300,000
Preference shares	\$4,214,000
Ordinary shares	\$86,000
Exit value	\$35,000,000
Preference dividend	2,528,400
Repayment pref. shares	\$4,214,000
Repayment ord. shares	\$28,257,600
IRR Hurdles	35%
Ownership Searcher	25.00%
Proceeds to searcher	\$7,064,400
Proceeds to investor	\$27,935,600
Investor IRR	36.6%
Investor multiple	6.5

Source: Prepared by the authors.

Exhibit 3

Differences Traditional Model vs No-Dividend Model

Some Calculations w/4-year exit							
Exit Value	\$10,000,000	\$15,000,000	\$20,000,000	\$25,000,000	\$30,000,000	\$35,000,000	\$40,000,000
No Div/Proceeds Searcher	\$964,526	\$2,338,405	\$3,946,500	\$5,196,500	\$6,446,500	\$7,696,500	\$8,946,500
No Div Proceeds Investor	\$9,035,474	\$12,661,595	\$16,053,500	\$19,803,500	\$23,553,500	\$27,303,500	\$31,053,500
IRR Investor	20.4%	31.0%	39.0%	46.5%	53.0%	58.7%	63.9%
5% Div/Proceeds Searcher	\$824,031	\$2,155,686	\$3,735,800	\$4,985,800	\$6,235,800	\$7,485,800	\$8,735,800
5% Div/Proceeds Investor	\$9,175,969	\$12,844,314	\$16,264,200	\$20,014,200	\$23,764,200	\$27,514,200	\$31,264,200
IRR Investor	20.9%	31.5%	39.5%	46.9%	53.3%	59.0%	64.2%
10% Div/Proceeds Searcher	\$683,537	\$1,972,967	\$3,525,100	\$4,775,100	\$6,025,100	\$7,275,100	\$8,525,100
10% Div/Proceeds Investor	\$9,316,463	\$13,027,033	\$16,474,900	\$20,224,900	\$23,974,900	\$27,724,900	\$31,474,900
IRR Investor	21.3%	31.9%	39.9%	47.3%	53.7%	59.3%	64.5%

Impact on Each Party

\$ Investor is better of 5% Div	\$140,495	\$182,719	\$210,700	\$210,700	\$210,700	\$210,700	\$210,700
% Investor is better off 5% Div	1.6%	1.4%	1.3%	1.1%	0.9%	0.8%	0.7%
% Searcher is worse off 5% Div	-14.6%	-7.8%	-5.3%	-4.1%	-3.3%	-2.7%	-2.4%
\$ Investor is better off 10% Div	\$280,989	\$365,438	\$421,400	\$421,400	\$421,400	\$421,400	\$421,400
% Investor is better off 10% Div	3.1%	2.9%	2.6%	2.1%	1.8%	1.5%	1.4%
% Searcher is worse off 10% Div	-29.1%	-15.6%	-10.7%	-8.1%	-6.5%	-5.5%	-4.7%

Some Calculations w/6-year exit							
Exit Value	\$10,000,000	\$15,000,000	\$20,000,000	\$25,000,000	\$30,000,000	\$35,000,000	\$40,000,000
No Div/Proceeds Searcher	\$964,526	\$1,798,026	\$2,895,152	\$4,506,405	\$6,021,031	\$7,696,500	\$8,946,500
No Div Proceeds Investor	\$9,035,474	\$13,201,974	\$17,104,848	\$20,493,595	\$23,978,969	\$27,303,500	\$31,053,500
IRR Investor	13.2%	20.6%	25.9%	29.7%	33.2%	36.1%	39.0%
5% Div/Proceeds Searcher	\$753,784	\$1,587,284	\$2,663,298	\$4,232,326	\$5,725,840	\$7,380,450	\$8,630,450
5% Div/Proceeds Investor	\$9,246,216	\$13,412,716	\$17,336,702	\$20,767,674	\$24,274,160	\$27,619,550	\$31,369,550
IRR Investor	13.6%	20.9%	26.2%	30.0%	33.4%	36.3%	39.3%
10% Div/Proceeds Searcher	\$543,042	\$1,376,542	\$2,652,846	\$3,958,248	\$5,430,650	\$7,064,400	\$8,314,400
10% Div/Proceeds Investor	\$9,456,958	\$13,623,458	\$17,347,154	\$21,041,752	\$24,569,350	\$27,935,600	\$31,685,600
IRR Investor	14.0%	21.2%	26.2%	30.3%	33.7%	36.6%	39.5%
\$ Investor is better off 5% Div	\$210,742	\$210,742	\$231,854	\$274,079	\$295,191	\$316,050	\$316,050
% Investor is better off 5% Div	2.3%	1.6%	1.4%	1.3%	1.2%	1.2%	1.0%
% Searcher is worse off 5% Div	-21.8%	-11.7%	-8.0%	-6.1%	-4.9%	-4.1%	-3.5%
\$ Investor is better off 10% Div	\$421,484	\$421,484	\$242,306	\$548,157	\$590,381	\$632,100	\$632,100
% Investor is better off 10% Div	4.7%	3.2%	1.4%	2.7%	2.5%	2.3%	2.0%
% Searcher is worse off 10% Div	-43.7%	-23.4%	-8.4%	-12.2%	-9.8%	-8.2%	-7.1%

Source: Prepared by the authors.

Exhibit 4

Model Assumptions

Assumptions							
General							
Search fund investment	\$300,000						
Acquisition investment	\$4,000,000						
% Preference shares	98%						
Holding period (years)	6						
Exit value	\$35,000,000						
Ownership Searcher @ IRR							
IRR Hurdles	<15% (*)	15%	19%	23%	27%	31%	35%
Ownership Searcher	12.50%	12.50%	15.00%	17.50%	20.00%	22.50%	25.00%

(*) automatic vesting time-based shares

Source: Prepared by the authors.

Exhibit 5

Exit Scenarios

Result without Dividend	
Total investment	\$4,300,000
Preference shares	\$4,214,000
Ordinary shares	\$86,000
Exit value	\$35,000,000
Repayment pref. shares	\$4,214,000
Repayment ord. shares	\$30,786,000
IRR Hurdles	35%
Ownership Searcher	25.00%
Proceeds to searcher	\$7,696,500
Proceeds to investor	\$27,303,500
Investor IRR	36.1%
Investor multiple	6.3

Source: Prepared by the authors.

Exhibit 6

Differences Traditional Model vs New Model (No dividends & 50-50 Performance)

Some Calculations w/4-year exit							
Exit Value	\$10,000,000	\$15,000,000	\$20,000,000	\$25,000,000	\$30,000,000	\$35,000,000	\$40,000,000
No Div/Proceeds Searcher	\$867,900	\$2,157,200	\$3,946,500	\$5,196,500	\$6,446,500	\$7,696,500	\$8,946,500
No Div Proceeds Investor	\$9,132,100	\$12,842,800	\$16,053,500	\$19,803,500	\$23,553,500	\$27,303,500	\$31,053,500
IRR Investor	20.7%	31.5%	39.0%	46.5%	53.0%	58.7%	63.9%

Present Model							
Exit Value	\$10,000,000	\$15,000,000	\$20,000,000	\$25,000,000	\$30,000,000	\$35,000,000	\$40,000,000
5% Div/Proceeds Searcher	\$824,031	\$2,155,686	\$3,735,800	\$4,985,800	\$6,235,800	\$7,485,800	\$8,735,800
5% Div/Proceeds Investor	\$9,175,969	\$12,844,314	\$16,264,200	\$20,014,200	\$23,764,200	\$27,514,200	\$31,264,200
Investor IRR	20.9%	31.5%	39.5%	46.9%	53.3%	59.0%	64.2%
10% Div/Proceeds Searcher	\$683,537	\$1,972,967	\$3,525,100	\$4,775,100	\$6,025,100	\$7,275,100	\$8,525,100
10% Div/Proceeds Investor	\$9,316,463	\$13,027,033	\$16,474,900	\$20,224,900	\$23,974,900	\$27,724,900	\$31,474,900
IRR Investor	21.3%	31.9%	39.9%	47.3%	53.7%	59.3%	64.5%

Difference Proposed Model-Present Model							
Exit Value	\$10,000,000	\$15,000,000	\$20,000,000	\$25,000,000	\$30,000,000	\$35,000,000	\$40,000,000
Proposed vs 5% Div/ Δ to Searcher	\$43,869	\$1,514	\$210,700	\$210,700	\$210,700	\$210,700	\$210,700
Proposed vs 5% Div/ Δ to Investor	\$43,869	\$1,514	\$210,700	\$210,700	\$210,700	\$210,700	\$210,700
% Searcher is better off	5.3%	0.1%	5.6%	4.2%	3.4%	2.8%	2.4%
% Investor is better off	-0.5%	0.0%	-1.3%	-1.1%	-0.9%	-0.8%	-0.7%
IRR impact Investor	-0.2%	0.0%	-0.5%	-0.4%	-0.3%	-0.3%	-0.3%
Proposed vs 10% Div/ Δ to Searcher	\$184,363	\$184,233	\$421,400	\$421,400	\$421,400	\$421,400	\$421,400
Proposed vs 10% Div/ Δ to Investor	\$184,363	\$184,233	\$421,400	\$421,400	\$421,400	\$421,400	\$421,400
% Searcher is better off	27.0%	9.3%	12.0%	8.8%	7.0%	5.8%	4.9%
% Investor is better off	-2.0%	-1.4%	-2.6%	-2.1%	-1.8%	-1.5%	-1.3%
IRR impact Investor	-0.6%	-0.4%	-0.9%	-0.8%	-0.7%	-0.6%	-0.6%

Exhibit 6 (Continued)

Some Calculations w/6-year exit							
Exit Value	\$10,000,000	\$15,000,000	\$20,000,000	\$25,000,000	\$30,000,000	\$35,000,000	\$40,000,000
No Div/Proceeds Searcher	\$723,250	\$1,617,900	\$2,762,550	\$4,157,200	\$5,801,850	\$7,696,500	\$8,946,500
No Div Proceeds Investor	\$9,276,750	\$13,382,100	\$17,237,450	\$20,842,800	\$24,198,150	\$27,303,500	\$31,053,500
IRR Investor	13.7%	20.8%	26.0%	30.1%	33.4%	36.1%	39.0%

Present Model							
Exit Value	\$10,000,000	\$15,000,000	\$20,000,000	\$25,000,000	\$30,000,000	\$35,000,000	\$40,000,000
5% Div/Proceeds Searcher	\$753,784	\$1,587,284	\$2,663,298	\$4,232,326	\$5,725,840	\$7,380,450	\$8,630,450
5% Div/Proceeds Investor	\$9,246,216	\$13,412,716	\$17,336,702	\$20,767,674	\$24,274,160	\$27,619,550	\$31,369,550
IRR Investor	13.6%	20.9%	26.2%	30.0%	33.4%	36.3%	39.3%
10% Div/Proceeds Searcher	\$543,042	\$1,376,542	\$2,652,846	\$3,958,248	\$5,430,650	\$7,064,400	\$8,314,400
10% Div/Proceeds Investor	\$9,456,958	\$13,623,458	\$17,347,154	\$21,041,752	\$24,569,350	\$27,935,600	\$31,685,600
IRR Investor	14.0%	21.2%	26.2%	30.3%	33.7%	36.6%	39.5%

Difference Proposed Model-Present Model							
Exit Value	\$10,000,000	\$15,000,000	\$20,000,000	\$25,000,000	\$30,000,000	\$35,000,000	\$40,000,000
Proposed vs 5% Div/ Δ to Searcher	\$30,534	\$30,616	\$99,252	\$75,126	\$76,010	\$316,050	\$316,050
Proposed vs 5% Div/ Δ to Investor	\$30,534	\$30,616	\$99,252	\$75,126	\$76,010	\$316,050	\$316,050
% Searcher is better off	-4.1%	1.9%	3.7%	-1.8%	1.3%	4.3%	3.7%
% Investor is better off	0.3%	-0.2%	-0.6%	0.4%	-0.3%	-1.1%	-1.0%
IRR impact Investor	0.1%	-0.1%	-0.2%	0.1%	0.0%	-0.2%	-0.3%
Proposed vs 10% Div/ Δ to Searcher	\$180,208	\$241,358	\$109,704	\$198,952	\$371,200	\$632,100	\$632,100
Proposed vs 10% Div/ Δ to Investor	\$180,208	\$241,358	\$109,704	\$198,952	\$371,200	\$632,100	\$632,100
% Searcher is better off	33.2%	17.5%	4.1%	5.0%	6.8%	8.9%	7.6%
% Investor is better off	-1.9%	-1.8%	-0.6%	-0.9%	-1.5%	-2.3%	-2.0%
IRR impact Investor	-0.3%	-0.4%	-0.2%	-0.2%	-0.3%	-0.5%	-0.5%

Source: Prepared by the authors.