



STANFORD

GRADUATE SCHOOL OF BUSINESS

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SEARCH FUNDS—2005: SELECTED OBSERVATIONS

EXECUTIVE SUMMARY

Since 1996, the Center for Entrepreneurial Studies (“CES”) at Stanford Graduate School of Business has conducted a series of studies on the performance of search funds. This study, as well as its predecessors in 1996, 1998, 2001, and 2003, portrays the aggregate profile of search funds and the entrepreneurs who formed them, and evaluates the investment returns generated by *first-time* search funds to their *original investors*.¹ Together, these studies reflect changes in the characteristics of search fund entrepreneurs and the performance of their funds over time. Using conservative assumptions, the blended pre-tax internal rates of return (IRRs) for individuals investing an equal amount in each of those funds was 37.3 percent or 37.7 percent, depending on the method used to calculate the terminal values.

OVERVIEW OF THE SEARCH FUND CONCEPT

A search fund is a pool of capital raised to financially support the efforts of an entrepreneur, or a team of entrepreneurs, to locate a privately held company for acquisition. While the lifecycle of a search fund often includes up to four stages (fundraising, search and acquisition, operation, and exit), search funds are primarily used to finance the search stage (the identification, evaluation,

¹ As of December 2005, we collected information on a total of 71 first-time search funds that agreed to participate in this study.

Mike Harkey prepared this case under the supervision of H. Irving Grousbeck, Consulting Professor of Management, as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation.

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and negotiation of acquisitions). Acquisitions made by search fund principals are financed using additional sources of capital.

Since the first known search fund was formed in 1984, would-be entrepreneurs have been drawn to search funds for two reasons: First, they offer relatively inexperienced professionals with limited capital resources a quick path to owning and managing a small business. Second, search funds have proven to generate significant financial returns for a small but growing number of principals. Notwithstanding these benefits, few recent business school graduates raise search funds each year.²

The narrow appeal of search funds may be explained at least partially by the nontraditional financial outlook for search fund principals. While many post-MBA compensation packages include a high starting salary and a signing bonus, the principal of a search fund commands a relatively low income through most of the process. The financial upside to the principal, if it comes, occurs upon exit.

The following is an overview of the four stages in the lifecycle of a search fund. A more detailed analysis of principals and search funds can be found in the “Search Fund Research” section.

Stage One: Raising the Search Fund

The first step in raising a search fund is to write a formal proposal or business plan. A search fund proposal can serve as an initial point of contact with potential investors and can be a signal of the principals’ commitment and professionalism. These documents typically include several sections: an executive summary; an overview of the search fund process; a list of specific criteria that will be used in the acquisition screening process; a detailed timeline with expected completion dates for specific activities; an explanation of the financing sought and the structure of the search fund vehicle; a detailed breakdown of the expected use of proceeds; an outline of the potential exit alternatives, and a summary of the personal backgrounds of the principals and allocation of future responsibilities.

Principals often need to tap a wide network of potential investors to raise a search fund, including friends and family, business associates, business school faculty, business owners and executives, and institutional search fund investors. Typically, ten or more investors purchase one or several units of the initial capital of the search fund, at about \$20,000 to \$35,000 per unit.

Given the inexperience of most principals, they commonly look for investors who also can serve as high quality advisors. The best investors can also offer expert guidance, assist in generating deal flow, and provide leverage with lawyers, accountants, and bankers. In many cases, investors are drawn by more than simply the potential financial returns of an investment in a search fund, but also the psychic benefits of being involved with young entrepreneurs.

Stage Two: Identifying and Making an Acquisition

² Since 2001, the Center for Entrepreneurial Studies at Stanford Graduate School of Business has tracked about 10 new search funds each year.

There are three steps in identifying target companies for acquisition: generating deal flow, screening potential candidates, and assessing seller interest. The first step, creating a stream of potential deals, can be difficult for principals, many of whom have little buyout experience. Typically, principals focus their search either by geography or by industry, although many also review deals opportunistically (e.g., deals sourced from third parties such as brokers, bankers, professionals that may be outside of a search fund's primary scope of interest).

Having a geographic focus can help a principal logistically, particularly during the negotiation phase of an acquisition. On the other hand, finding a deal is a bit of a numbers game, and applying any limitation on the world of opportunities may be imprudent in light of the fact that 24 percent of all the search funds we studied failed to make an acquisition. Additionally, 42 percent of all search funds that fail do so for this reason.³

Industry-based searches generally target two to four industries. Employing this search strategy can bring credibility with sellers and intermediaries and can enable principals to more quickly screen candidates. Conversely, principals run the risk of spending too much time trying to identify the perfect industry. One former principal reported that a thoughtful industry screen can take between 4 and 8 months of nearly full-time effort.

In order to mitigate operating and investment risk, search fund principals generally target industries that are not subject to rapid technology change, are fairly easy for them to understand, and are in fragmented geographical or product markets. The hypothesis is that industries fragmented across one or more dimensions offer enhanced opportunities for growth, either through acquisition or product or market extension.

Within the preferred industries, companies are targeted based on their sustainable market position, their history of positive, stable cash flows, and opportunities for improvement and growth. Search fund principals and their investors tend to prefer healthy, profitable companies with a proven second-tier management team to turn-around situations. By adhering to such a disciplined list of acquisition guidelines, search fund investors have been able to greatly reduce the risks typically associated with investing in individuals possessing little operating experience.

In aggregate, searching for an acquisition target and completing a transaction is a time-consuming process. The general economic environment, industry characteristics, sellers' willingness to sell, and regulatory issues are among the factors that can prolong or derail the acquisition process. Depending on the complexity of the deal, it can take six months or more from the time the principal signs the letter of intent until he or she closes the deal.

When a target is identified, each search fund investor is given the pro-rata right of first refusal on the capital required to fund the acquisition. Commonly, the search fund investment is stepped up by a certain percentage (e.g., 50 percent) in the acquisition round, irrespective of whether the investor decides to participate in the transaction. In addition to the follow-on equity investment from the original team of investors, the funds for acquisition can come from a combination of other sources: seller's debt, bank loans, and equity financing from new investors. Investor debt, commonly in the form of subordinated debt, may also be added to the capital structure.

³ A failed search fund is defined as a fund that has closed without providing a positive return to its investors.

If the target is a sustainable business with only modest growth, oftentimes it will sell for a multiple equivalent to 70 percent to 130 percent of revenues. Purchase prices generally range from \$5 million to \$20 million, with the equity portion of the completed transaction between \$1 million and \$7 million, or between 10 percent and 75 percent of the total purchase price. The acquisition is expected to be at fair market value. Ideally, the acquired company would provide adequate cash flow and be without significant debt service, so that the short-term survival of the company does not rely on immediate, significant improvement in company performance by the principals.

If the initial capital is exhausted before a target can be identified, principals may choose either to close the fund or to solicit additional funding to continue the search.⁴

Stages Three and Four: Operation and Exit

After completing the acquisition, principals will recruit a board of directors for the company, which often includes substantial representation from the initial investors. In the first twelve to eighteen months after the acquisition, principals typically make few radical changes to the existing business, opting instead to gain management familiarity.⁵ After becoming comfortable operating the business, principals then begin to make changes as they see fit.

After a company is purchased, principals can create value through one or more of the following ways: revenue growth, improvements in operating efficiency, appropriate use of leverage, or expansion. Typically, these means of creating value are not mutually exclusive; ideally, more than one will apply to a search fund investment. Revenue growth may result from internal growth initiatives, pricing improvements or scale attained from acquiring like businesses. Original search fund investors may be invited to participate in subsequent acquisitions and these amounts are included in computing the rates of return in this study.⁶ After a growth plan has been executed, the resulting company can be expected to be much more valuable, even when sold at the same multiple for which it was purchased. Improvements in operating efficiency can obviously make a business more profitable. Purchasing a company with leverage can enable the equity in the business to grow as debt is paid off successfully.

Most search funds are established with a long-term outlook, often no less than a three- to five-year time horizon. Even so, investors and principals share a desire to realize returns at some point. Liquidity events for investors and principals can occur in a number of ways, as is true for equity-holders in any privately held company, including: Acquisitions can be sold or taken public; Investor equity may be sold to other investors or bought by the company, and dividends may be issued. Consequently, principals will be forced to evaluate exit alternatives throughout the life of the business.

⁴ For the purpose of this study, the “initial capital” or “initial investment” includes all investments made prior to acquisition or liquidation.

⁵ For this reason, the series of search fund studies excludes companies with fewer than twelve months of operation from the computation of IRRs.

⁶ Please note that IRRs thus calculated do not represent the rates of return to investors who did not contribute the *initial* search fund capital.

SEARCH FUND RESEARCH

As of December 2005, we collected information on a total of 71 first-time search funds that agreed to participate in this study. Of the 71 completed search funds, 12 were still looking for a company to buy, 26 had made an acquisition and the acquired firms were still being operated by the search fund principals, and the remaining 33 had failed to make an acquisition, sold, or closed down their acquired firms. The investment return analysis portion of this study includes 49 search funds that had either terminated or had been in operation for at least one year.⁷

Like its predecessors, this study includes only first-time search funds, thus excluding “serial search funders” whose track record may imply different fund-raising techniques, management and operational capabilities, and perceptions by investors and sellers. Since the focus of the CES search fund series is to understand the returns from investing with a new entrepreneur in an industry in which he or she has limited prior experience, we exclude the non first-time funds from this study. For consistency, this study also maintains the tradition of excluding search funds that later became start-ups.

For each of the search funds, we collected information on demographic characteristics of principals as well as key metrics of fundraising, acquisition, company operations, and liquidity events. As is common to all small samples, the statistical significance of aggregate metrics is limited and is greatly influenced by a few out-liers. Entrepreneurs and investors interested in search funds are encouraged to pursue more intensive investigation.

Search Funder Profile

In 2005, most search funders still conformed to the typical profile of a relatively young, recent business school graduate. Of the 30 new principals we studied in 2005, 47 percent were recent business school graduates (less than one year post-MBA), and 83 percent were under 36 years old. Interestingly, the pool of search funders under 30 years old grew from 12 percent in 2003 to 30 percent in 2005. (See **Exhibit 1** for more information on search funder profiles).

As was the case in 2003, we found no female search funders in 2005.

However, there is diversity in the professional backgrounds of search fund entrepreneurs. 26 percent of the search funders we studied in 2005 were consultants or investment bankers earlier in their careers, continuing a downward trend from 33 percent in 2003 and 49 percent in 2001. More search funders had experience in operations and private equity in 2005 than in previous studies, 16 and 11 percent respectively. A few investors have reported that they have demonstrated no preference for one background or another in their search fund investments. (See **Exhibit 2** for more information on search funder experience).

⁷ 22 of the 71 search funds we tracked were not included in the investment return portion of the study because 12 search funds were still searching for a company to buy; eight had purchased companies within the last 12 months, and two elected to not participate in this study.

Key Search Fund Metrics: Fundraising and Search

Most of the key fundraising metrics we studied remained about the same from 2003 to 2005. A similar percentage of search funds were headed by more than one principal in 2005: 58 percent in 2005 compared to 59 percent in 2003. Notably, the principals under 30 years old were more likely (+20 percent) to be paired with a partner. The median number of months spent fundraising was five in 2005, up only slightly from 2003. Additionally, the total number of investors per fund remained about the same (12). However, the median search fund size grew to \$395,000 in 2005, up from \$350,000 in 2003. (See **Exhibit 3** for a comparison of search fund metrics).

One possible explanation for the growth in fund size is that search funders are increasingly aware of the high incidence of failure to find a company (previously cited herein, 24 percent) and are now budgeting for a longer search. Acquisitions made by search fund entrepreneurs that we studied took an average of 19 months from the start of the search to the closing of the deal, and 49 percent of acquisitions took more than 20 months. In light of these statistics, principals may be attempting to buy more time to search by increasing the size of their funds (See **Exhibit 4** for search fund acquisition statistics).

A high percentage of search funders (65 percent) targeted service and manufacturing sectors in their search, in keeping with past studies. However, there was an increase in the percentage of opportunistic searches, from 13 percent in 2003 to 32 percent in 2005. There appears to be some correlation between opportunistic searchers and those with private equity experience, as was noted in a study by Harvard Business School.⁸ 67 percent of the new searchers we studied in 2005 who reported that they had no industry focus had private equity experience.

It is too early yet to draw any conclusions about the relative success rate of opportunistic searches because our sample size is very small. Nevertheless, we can offer the following preliminary report: 50 percent of the opportunistic searchers we studied are still looking for a company to purchase, 38 percent have made an acquisition, and 12 percent closed their fund without an acquisition. By comparison, 28 percent of the industry-targeted searchers we studied are still looking for a company to purchase, 45 percent have made an acquisition, and 27 percent closed their fund without an acquisition.

Key Search Fund Company Metrics: Acquisition and Financial Performance

Search funders continue to acquire relatively small companies with profitable business models. 40 percent of all acquisitions we have tracked were purchased for \$4 million to \$7 million. The median purchase price of acquisitions increased slightly from \$5.4 million in 2003 to \$5.7 million in 2005. 100 percent of acquisitions made after 2003 reported positive EBITDA margins, and 46 percent reported better than 20 percent margins.⁹ Many of the key statistics on acquisitions are consistent with the 2003 study because the sample consists mainly of firms that had already completed their acquisitions by 2003. A small number of these funds elected to disclose only partial information about their transactions. (See **Exhibit 4** for search fund acquisition statistics).

⁸ Joel Milne, *Search Fund Challenges*, Harvard Business School Independent Study, January 21, 2003.

⁹ EBITDA = Earnings Before Interest, Taxes, Depreciation and Amortization

In this study, IRRs are calculated on a cash flow basis, with cash infusions or distributions treated as occurring on the first day of the month (when month and year were available) or the first day of the year (when only the year was available). For funds that had either sold or liquidated their companies or closed their funds down without having purchased a company, the terminal value was straightforward. In the cases of companies still under search fund management, we made several assumptions in order to determine investor returns. If a liquidity event had recently taken place at a company, we used the value of the event to determine a current valuation. Otherwise, we used two methodologies. The first assumed that companies were sold at the purchase multiple of EBITDA paid at acquisition, and the second assumed that companies were sold at a “current market multiple” of EBITDA for their industry, minus a 30 percent private company minority interest discount. The 30 percent discount, although arbitrary, seems conservatively realistic for the purposes of this study. It is also used for consistency with prior studies. In all cases, the study assumes that all debt was repaid and that funds were disbursed to the original search fund investors in proportion to the equity and/or subordinated debt owned by them. All returns are calculated on a pre-tax basis to investors.

Adopting the methodology described in the previous section, we calculated the blended IRR for a person investing an equal amount in each of the 49 “first-time” search funds at the same start date to be (see **Exhibit 5** for more search fund IRR information):

- 37.3 percent if the terminal value was based on the original purchase price/EBITDA multiple
- 37.7 percent if the terminal value was based on a 30 percent discount to the current estimated multiple

Individual IRRs varied widely, ranging from -100 percent (implying a complete loss of investor capital) to over 200 percent per year for a highly successful company. 43 percent of all funds demonstrated a positive IRR, and 10 percent had an IRR greater than 50 percent (see **Exhibit 6** for a histogram of search fund IRRs).

The top quartile of IRR performers had characteristics at acquisition very similar to the median statistics for all acquisitions. (See **Exhibit 7** for a comparison of acquisition statistics). However, it appears that the top performers were purchased for more money and at a higher multiple of EBITDA. Companies that performed in the top quartile were acquired for a median price of \$8.5 million (compared to \$5.7 million for all acquisitions) at a median of 5.6 times EBITDA (compared to 4.6 for all acquisitions).

Exhibit 1
Comparison of Search Funder Profiles

<i>Categories</i>	Pre-2001	2001-2003	Post-2003
Age at Start of Search:			
Minimum	26	28	28
Median	30	31	32
Maximum	35	60	47
Under-30	N/A	12%	30%
30-35	N/A	65%	53%
36-40	N/A	12%	10%
Over-40	N/A	12%	7%
Number of Post-MBA Years before Search Fund:			
Minimum	N/A	0	0
Median	N/A	2	1.3
Maximum	N/A	10	18
<1 year post-MBA	N/A	N/A	47%
1-3 years post-MBA	N/A	N/A	17%
4-7 years post-MBA	N/A	N/A	23%
>8 years post-MBA	N/A	N/A	13%
Gender:			
Male	96%	100%	100%
Female	4%	0%	0%

Exhibit 2
Comparison of Search Funder Experience

Professional Background:	Pre-2001	2001-2003	Post-2003
Management Consulting	26%	23%	10%
Investment Banking	23%	10%	16%
Sales	12%	1%	3%
Venture Capital	8%	3%	5%
Line/General Management	5%	27%	7%
Marketing	5%	2%	4%
Law	4%	0%	2%
Operations	4%	7%	16%
Entrepreneur	2%	13%	8%
Accounting	2%	0%	3%
Engineering	2%	0%	5%
Military	2%	1%	8%
Insurance	2%	1%	0%
Private Equity	1%	5%	11%
Others ¹	0%	7%	2%

Note:

1. Includes teaching, professional sailing, geology, government, casewriting for business school, and non-profit management.

Exhibit 3
Comparison of Search Fund Metrics

<i>Categories</i>	Pre-2001	2001-2003	Post-2003
Number of Principals:			
Single	68%	41%	42%
Partners	32%	59%	58%
Amount of Initial Capital Raised:			
Minimum	\$40,000	\$125,000	\$150,000
Median	\$290,000	\$350,000	\$395,000
Maximum	\$1,000,000	\$10,000,000	\$750,000
Number of Search Fund Investors:			
Minimum	2	1	3
Median	12	12.5	12
Maximum	25	20	24
Number of Months Fundraising:			
Minimum	N/A	1	2
Median	N/A	4.5	5
Maximum	N/A	9	12
Targeted Industries: ¹			
Service	50%	30%	35%
Manufacturing	19%	30%	25%
Manufacturing/Service Combination	12%	0%	5%
Distribution	8%	5%	3%
Retail/Service Combination	8%	3%	0%
Retail	4%	0%	0%
Media	0%	13%	0%
Utilities	0%	6%	0%
No Preference	0%	13%	32%

Note:

1. The pre-2001 column refers to the sectoral distribution of **acquired** search fund companies, while the other two columns refer to the distribution of industries **targeted** by post-2001 search funds.

Exhibit 4
Selected Statistics for All Search Fund Acquisitions

Total Number of Months From Start of Search to Deal Close:	All Acquisitions
Minimum	5
Median	19
Maximum	50
0-10 months	19%
11-20 months	32%
21-30 months	32%
31+ months	17%
Purchase Price Statistics ¹	All Acquisitions
Minimum	\$ 0.56 M
Median	\$ 5.7 M
Maximum	\$ 30.6 M
<\$4M	24%
\$4M to \$7M	40%
\$8M to \$11M	18%
\$12M +	18%

Additional Statistics for All Search Fund Acquisitions

Categories	Minimum	Median	Maximum
Search Fund Investor Capital Raised for Company Purchase	\$ 0.0 M	\$ 2.2 M	\$ 7.0 M
Company Revenues at Purchase	\$ 0.37 M	\$ 7.0M	\$ 43 M
Company EBITDA at Purchase	\$ (1.6) M	\$ 1.0 M	\$ 6.1 M
Company EBITDA Margin at Purchase	-3.7%	17.0%	45.8%
Purchase Price / Revenue Multiple	0.3x	0.9x	3.4x
Purchase Price / EBITDA Multiple ²	2.1x	4.6x	18.0x
Company Employees at Purchase	7	57	740

Notes:

- Summary statistics are based on financial information provided by search funders themselves. In many cases, this financial information has not been audited. Information regarding a small number of acquisitions was incomplete.
- The minimum is calculated by excluding all negative EBITDAs.

Exhibit 5
Search Fund IRRs to Original Investors ¹

	2001 Study Figures	2003	2005
Individual IRRs:			
Minimum	(100)% ²	(100)%	(100)%
25 th Percentile		(100)%	(100)%
Median	17.6%	(23.7)%	(16.1)%
75 th Percentile		21.9%	24.8%
Maximum	98.3%	84.8%	215.0%
(100)%			26.5%
(51)% to (99)%			12.2%
(1)% to (50)%			14.3%
0% to 25%			22.4%
26% to 50%			14.3%
50% to 75%			4.1%
76% to 100%			2.0%
>100%			4.1%
Aggregate IRRs with Same Starting Dates:			
Actual Cash Flows with Original EBITDA Multiples	37.6%	31.7%	37.3%
Actual Cash Flows with Estimated Current Multiples minus 30% Discount ³	35.7%	33.0%	37.7%

Notes:

1. Summary statistics are based on financial information provided by 49 funds that were either closed, or have sold or operated acquired companies for more than a year. In many cases, this financial information has not been audited.
2. Negative 100% IRR equates to a total loss of investor capital.
3. When firms elected not to provide an estimate of current EBITDA multiple, the original multiple is used. When respondent provided a range of EBITDA multiple estimates, we used the average figure.

**Exhibit 6
Histogram of Search Fund IRRs**

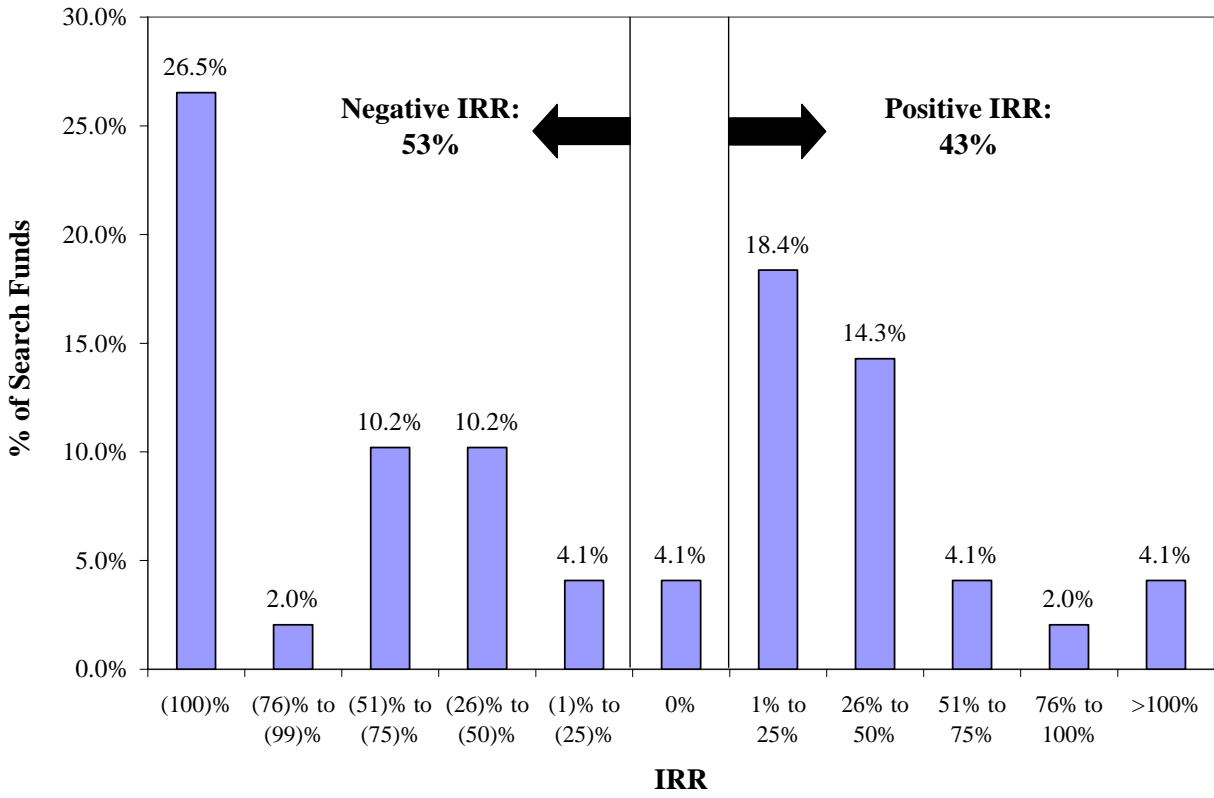


Exhibit 7
Comparison of Search Fund Acquisitions
 Median Statistics for All Acquisitions vs. Top Quartile Performers ¹

<i>Categories</i>	All Acquisitions Median Statistics	Top Quartile Performers Median Statistics
Purchase Price	\$ 5.7 M	\$8.5M
Search Fund Investor Capital Raised for Company Purchase	\$ 2.2 M	\$2.3M
Company Revenues at Purchase	\$ 7.0M	\$6.5M
Company EBITDA at Purchase	\$ 1.0 M	\$1.4M
Company EBITDA Margin at Purchase	17.0%	22.0%
Purchase Price / Revenue Multiple	0.9x	0.95x
Purchase Price / EBITDA Multiple	4.6x	5.6x
Company Employees at Purchase	57	65

Note:

1. "Top quartile" is based on IRRs computed in the manner described on pages 6 and 7.