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SEARCH FUNDS—2007: 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 conducted in 1996, 1998, 2001, 2003, and 2005 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. 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 rate of return (IRR) for individuals investing an equal amount in each of those funds was 52 percent.

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, and negotiation of acquisitions). Acquisitions made by search fund principals are financed using additional sources of capital. However, in the typical search fund, the bulk of this capital is raised from the investors that contributed initially.

Sean Harrington 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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Since the first known search fund was formed in 1984, would-be entrepreneurs have been drawn to search funds for two principal 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 proved 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.

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

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, and 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 partly a numbers game, and applying any limitation on the world of opportunities may be imprudent in light of the fact that 18 percent of all the search funds we studied failed to make an acquisition. Additionally, 52 percent of all search funds that have failed did so for this reason.¹

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 four and eight 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 s/he 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.

If the target is a sustainable business with only modest growth, oftentimes it will sell for a multiple equivalent to 70-130 percent of revenues. Purchase prices generally range from \$5-\$20 million, with the equity portion of the completed transaction between \$1 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

¹ A failed search fund is defined as a fund that has closed without providing a positive return to its investors.

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.²

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 12 to 18 months after the acquisition, principals typically make few radical changes to the existing business, opting instead to gain management familiarity.³ 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 similar 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. After a growth plan has been executed, the resulting company can be expected to gain value, 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. For example, acquisitions can be sold or taken public; investor equity may be sold to other investors or bought by the company; or dividends may be issued. Consequently, principals are forced to evaluate exit alternatives throughout the life of the business.

SEARCH FUND RESEARCH

As of December 2007, we collected information on a total of 95 first-time search funds that agreed to participate in this study. Of the 95 search funds sampled, 22 were still looking for a company to buy, 23 had made an acquisition and the acquired firms were still being operated by the search fund principals, and the remaining 50 were classified as terminal—after buying and selling a company, failing to make an acquisition, or closing down the acquired firm. Of the 50 terminal search funds, 34 percent concluded without an acquisition, 60 percent purchased a

² For the purpose of this study, the “initial capital” or “initial investment” includes all investments made prior to acquisition or liquidation.

³ For this reason, the series of search fund studies excludes companies with fewer than 12 months of operation from the computation of IRRs.

business, while 6 percent used the initial capital raised in a way that significantly diverged from the typical search fund model. The investment return analysis portion of this study includes 61 search funds that had either terminated or had been managing an acquired company for at least one year.

Like its predecessors, this study includes only first-time search funds, thus excluding “serial search funders” whose track record may imply different fundraising techniques, management and operational capabilities, and perceptions by investors and sellers. Since the focus of the CES search fund studies is to understand the returns from investing with a new entrepreneur in an industry in which s/he has limited prior experience, we exclude the non first-time funds. For consistency, this study also maintains the tradition of excluding search funds that later pursued a materially different model, such as putting the initial capital toward a start-up or purchasing multiple companies, when calculating investment returns.

For each of the search funds, we collected information on demographic characteristics of principals as well as key metrics relating to fundraising, the 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 outliers. Entrepreneurs and investors interested in search funds are encouraged to pursue more intensive investigation.

Search Funder Profile

In 2007, 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 2007, 33 percent had graduated from an MBA program within a year of raising their fund, and 80 percent were under 36 years old. However, we also saw a new category of search fund principals emerge in the study—individuals without a graduate degree in business—which represented 13 percent of new searchers. Although it is too early to gauge whether this will be a lasting effect or a passing trend, it does show the search fund model is gaining understanding and acceptance beyond graduate business school programs. As was the case in all previous studies, we found no female search funders in 2007. (See **Exhibit 1** for more information on search funder profiles.)

There continues to be diversity in the professional backgrounds of search fund entrepreneurs. The percentage of new search funders with management consulting or investment banking experience jumped from 26 percent in 2005 to 54 percent in 2007, while those with a background in operations dropped from 16 to 1 percent. A few investors have reported that they have no preference for one background or another in their search fund investments. (See **Exhibit 2** for more information on search funder experience.)

Key Search Fund Metrics: Fundraising and Search

The median amount of capital raised for search funds initiated since the 2005 study was \$385,000, which was down slightly from the \$395,000 figure for the period from 2003 to 2005. However, given that the number of search funds headed by one individual (as opposed to two) increased from 42 percent in 2005 to 75 percent in 2007, the capital raised per principal jumped by 27 percent over the same period—going from \$276,250 to \$350,000. Additionally, while the median number of search fund investors increased slightly from 12 to 14, principals typically

spent less time fundraising, as the median number of months taken to raise a fund dropped from five to three. The overall rate of new search funds initiated has remained fairly consistent in the last six years, as the CES has tracked 10 to 15 new entities each year. Although there was the potential that funds existed unbeknownst to the CES, it is likely this number was fairly small given the tightly knit network of search fund entrepreneurs, investors, and advisors. (See **Exhibit 3** for a comparison of search fund metrics.)

One possible explanation for the decrease in the proportion of search funds operated by two principals is that the partnership model was forcing entrepreneurs to feel increased pressure to buy ever-larger companies. With a partnership, a greater initial capital pool was required to support two searchers, which resulted in a larger pool of “stepped-up” equity granted to investors once a business was acquired. The search fund principals would then have to build that much equity in the acquired company before earning any equity of their own, which created strong incentives to buy a larger business.⁴ An individual search funder, who required less initial search-phase capital, had more flexibility to pursue smaller acquisition targets.

Since 2001, search funds have increasingly chosen to target services firms over all other types. In 2007, over two-thirds of new searchers were aiming to acquire companies that provide some suite of services, up from 35 percent in the 2005 study and 30 percent in 2003. Meanwhile, the percentage of those interested in manufacturing businesses dropped from 30 percent to 14 percent over the same timeframe. This was likely due to the overall decline in U.S.-based manufacturing during that period, as the American economy was steadily becoming more heavily weighted on services. In addition, a few of the most well known and successful search funds had acquired service-oriented firms, and new principals may have been attempting to model after these exemplary cases.

Key Search Fund Company Metrics: Acquisition and Financial Performance

Search funders continue to acquire relatively small companies with profitable business models, as 34 percent of all acquisitions we have tracked were purchased for \$4 million to \$8 million. However, the typical purchase price has noticeably increased in the past two years. Acquisitions consummated since 2005 had a median purchase price of \$9.4 million, compared to \$5.7 million for those occurring prior to 2005. All acquisitions made after 1984 reported positive EBITDA margins, and 44 percent of all companies studied reported better than 20 percent margins.⁵ Many of the key statistics on acquisitions are consistent with the 2005 study because the sample consists mainly of firms that had already completed their acquisitions by 2005. A small number of these funds elected to disclose only partial information about their transactions. (See **Exhibits 4 and 5** for search fund acquisition statistics.)

⁴ In most search funds, the principals were granted equity that was subordinate to investors’ participating preferred shares. As such, search funders would only earn equity once investors had been paid back their original capital plus interest.

⁵ EBITDA = Earnings Before Interest, Taxes, Depreciation and Amortization.

In this study, IRRs were calculated from the perspective of search fund investors⁶ on a cash flow basis and both debt and equity payments were included. Cash infusions or distributions were 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 down without having purchased a company, the terminal value was straightforward. In those cases where companies were 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 conservatively assumed that companies were sold at the purchase multiple of EBITDA paid at acquisition.⁷ In all cases, the study assumed 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 were calculated on a pre-tax basis to investors. Although we made every effort to accurately calculate IRRs, it is extremely difficult to obtain precise information for every cash infusion or distribution, especially for search funds with longer histories and/or more complex capital structures. Further, as with previous studies, a few known search funds chose not to provide information in 2007, which could have contributed to a slight bias in the results.⁸ As such, it is critical that investors and entrepreneurs interested in the search fund model take these limitations into account when considering the IRR results presented in this study.

Adopting the methodology described above, we calculated the blended IRR for a person investing an equal amount in each of the 61 search funds at the same start date to be 52 percent, marking a significant increase over the results from previous years. Since 2001, the blended IRR has fluctuated between 32 and 38 percent. The marked increase observed in 2007 is likely due to two main factors. Firstly, there were a few search funds that acquired companies since 2004 (thus not included in the IRR calculation for the 2005 study) that performed very well. Secondly, a small number of highly successful search funds had liquidity events since the last study was performed. In these cases, the actual terminal value significantly exceeded previous valuation estimates, which used the EBITDA multiples from the time of purchase. (See **Exhibit 6** for more search fund IRR information.)

Individual IRRs varied widely, ranging from –100 percent (implying a complete loss of investor capital) to over 100 percent per year for a highly successful company. Forty-eight percent of all funds demonstrated a positive IRR, and 8 percent had an IRR greater than 50 percent. (See **Exhibit 7** for a histogram of search fund IRRs.)

Although the blended IRR is heavily influenced by a small number of highly successful search funds, it is important to note that the principal returns for all risk capital portfolios came from top performers. When the three best performing search funds are removed from the calculations, the

⁶ Search fund investors included anyone that participated in the initial search or initial acquisition. Investors that contributed in subsequent rounds of financing, if there were any, were excluded.

⁷ In certain rare exceptions when EBITDA was greatly reduced (or negative) due to growth capital requirements, we used other methods of valuation, such as revenue multiples.

⁸ We suspect that poorer performing search funds are more likely to opt out of the study. However, given that the IRR results are most significantly impacted by a small number of very successful search funds, we believe this bias was small.

blended IRR is 37 percent, and when the top five firms are removed, the return drops to 16 percent. On the other hand, when the 17 funds that closed down without an acquisition were excluded from the calculations, the blended IRR increased only slightly to 54 percent.

Search funds that have performed better have tended to buy larger, faster-growing companies with better EBITDA margins. When we compared acquisition statistics for the top quartile firms with those of the bottom three quartiles, there were some dramatic discrepancies. The median purchase price for the top quartile was \$12.8 million compared to \$5.7 million for the others. Similarly, the median annual growth in EBITDA prior to acquisition for top performers was 35 percent compared to 10 percent, and EBITDA margins were 22 percent compared to 17 percent. Although the higher growth rates and profit margins would normally imply higher purchase price multiples, top quartile search funders actually paid slightly less for their acquisition targets in terms of EBITDA multiple (4.5x compared to 4.8x.) This may have been due to the fact that growth was not being commensurately factored into the purchase price by the sellers. Alternatively, some search fund principals may have simply negotiated more successfully (see **Exhibit 8**).

Exhibit 1
Comparison of Search Funder Profiles

<i>Categories</i>	Pre-2001	2001-2003	2003-2005	Post-2005
Age at Start of Search:				
Minimum	26	28	28	27
Median	30	31	32	31.5
Maximum	35	60	47	50
Under-30	N/A	12%	30%	33%
30-35	N/A	65%	53%	47%
36-40	N/A	12%	10%	10%
Over-40	N/A	12%	7%	10%
Number of Post-MBA Years before Search Fund:				
Minimum	N/A	0	0	0
Median	N/A	2	1.3	1
Maximum	N/A	10	18	16
No MBA	N/A	N/A	0%	13%
<1 year post-MBA	N/A	N/A	47%	33%
1-3 years post-MBA	N/A	N/A	17%	27%
4-7 years post-MBA	N/A	N/A	23%	20%
>8 years post-MBA	N/A	N/A	13%	7%
Gender:				
Male	96%	100%	100%	100%
Female	4%	0%	0%	0%

Exhibit 2
Comparison of Search Funder Experience

Comparison of Search Funder Experience				
Professional Background:	Pre-2001	2001-2003	2003-2005	Post-2005
Management Consulting	26%	23%	10%	26%
Investment Banking / Finance	23%	10%	16%	27%
Sales	12%	1%	3%	7%
Venture Capital	8%	3%	5%	1%
Line/General Management	5%	27%	7%	15%
Marketing	5%	2%	4%	0%
Law	4%	0%	2%	0%
Operations	4%	7%	16%	1%
Entrepreneur	2%	13%	8%	7%
Accounting	2%	0%	3%	0%
Engineering	2%	0%	5%	2%
Military	2%	1%	8%	1%
Insurance	2%	1%	0%	2%
Private Equity	1%	5%	11%	4%
Others	0%	7%	2%	8%

Exhibit 3
Comparison of Search Fund Metrics

<i>Categories</i>	Pre-2001	2001-2003	2003-2005	Post-2005
Number of Principals:				
Single	68%	41%	42%	75%
Partners	32%	59%	58%	25%
Amount of Initial Capital Raised:				
Minimum	\$40,000	\$125,000	\$150,000	\$200,000
Median	\$290,000	\$350,000	\$395,000	\$385,000
Maximum	\$1,000,000	\$10,000,000	\$750,000	\$550,000
Amount of Initial Capital Raised per Principal:				
Minimum	N/A	N/A	\$106,250	\$175,000
Median	N/A	N/A	\$276,250	\$350,000
Maximum	N/A	N/A	\$750,000	\$540,000
Number of Search Fund Investors:				
Minimum	2	1	3	10
Median	12	12.5	12	14
Maximum	25	20	24	23
Number of Months Fundraising:				
Minimum	N/A	1	2	1
Median	N/A	4.5	5	3
Maximum	N/A	9	12	10
Targeted Industries:¹				
Service	50%	30%	35%	69%
Manufacturing	19%	30%	25%	14%
Manufacturing/Service Combination	12%	0%	5%	0%
Distribution	8%	5%	3%	0%
Retail/Service Combination	8%	3%	0%	0%
Retail	4%	0%	0%	0%
Media	0%	13%	0%	0%
Utilities	0%	6%	0%	0%
No Preference	0%	13%	32%	17%

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
Statistics for Recent Search Fund Acquisitions

<i>Categories</i>	All Acquisitions	Acquisitions since 2005
Length of Search (months)	20	19
Purchase Price	\$7.9 M	\$9.4 M
Equity Invested at Purchase	\$2.4 M	\$4.2 M
Investors' Debt	\$0.3 M	\$0.0 M
Company Sales at Purchase	\$8.0 M	\$9.1 M
Company EBITDA at Purchase	\$1.7 M	\$2.0 M
LTM EBITDA growth rate at purchase	18.0%	16.5%
Company Employees at Purchase	55	60
Purchase Price / Sales	0.9x	0.9x
Purchase Price / EBITDA	4.9x	5.2x
EBITDA Margin	18.2%	18.2%

Exhibit 5
Selected Statistics for All Search Fund Acquisitions

Total Number of Months From Start of Search to Deal Close:	All Acquisitions
Minimum	5
Median	20
Maximum	50
<10 months	12%
11-20 months	41%
21-30 months	32%
31+ months	15%
Purchase Price Statistics	All Acquisitions
Minimum	\$0.6 M
Median	\$7.9 M
Maximum	\$30.6 M
<\$4 M	17%
\$4 M to \$8 M	34%
\$8 M to \$12 M	21%
>\$12 M	28%

Additional Statistics for All Search Fund Acquisitions

Categories	Minimum	Median	Maximum
Search Fund Investor Capital Raised for Company Purchase	\$0.0 M	\$2.4 M	\$12.0 M
Company Revenues at Purchase	\$0.4 M	\$8.0 M	\$43.0 M
Company EBITDA at Purchase	-\$1.6 M	\$1.7 M	\$6.1 M
Company EBITDA Margin at Purchase	-3.7%	18.2%	47.1%
Purchase Price / Revenue Multiple	0.3x	0.9x	3.4x
Purchase Price / EBITDA Multiple	NM	4.9x	18.0x
Growth of EBITDA over 12 months leading up to acquisition	0%	18%	223%
Company Employees at Purchase	5	55	740

Exhibit 6
Search Fund IRRs to Original Investors

	2001	2003	2005	2007
Individual IRRs:				
Minimum	-100%	-100%	-100%	-100%
25 th Percentile		-100%	-100%	-100%
Median	18%	-24%	-16%	0%
75 th Percentile		22%	25%	25%
Maximum	98%	85%	215%	189%
Distribution of Individual IRRs:				
(100)%			27%	28%
(51)% to (99)%			12%	10%
(1)% to (50)%			14%	11%
0% to 25%			22%	25%
26% to 50%			14%	18%
50% to 75%			4%	2%
76% to 100%			2%	2%
>100%			4%	5%
Aggregate Blended IRR	38%	32%	37%	52%

**Exhibit 7
Histogram of Search Fund IRRs**

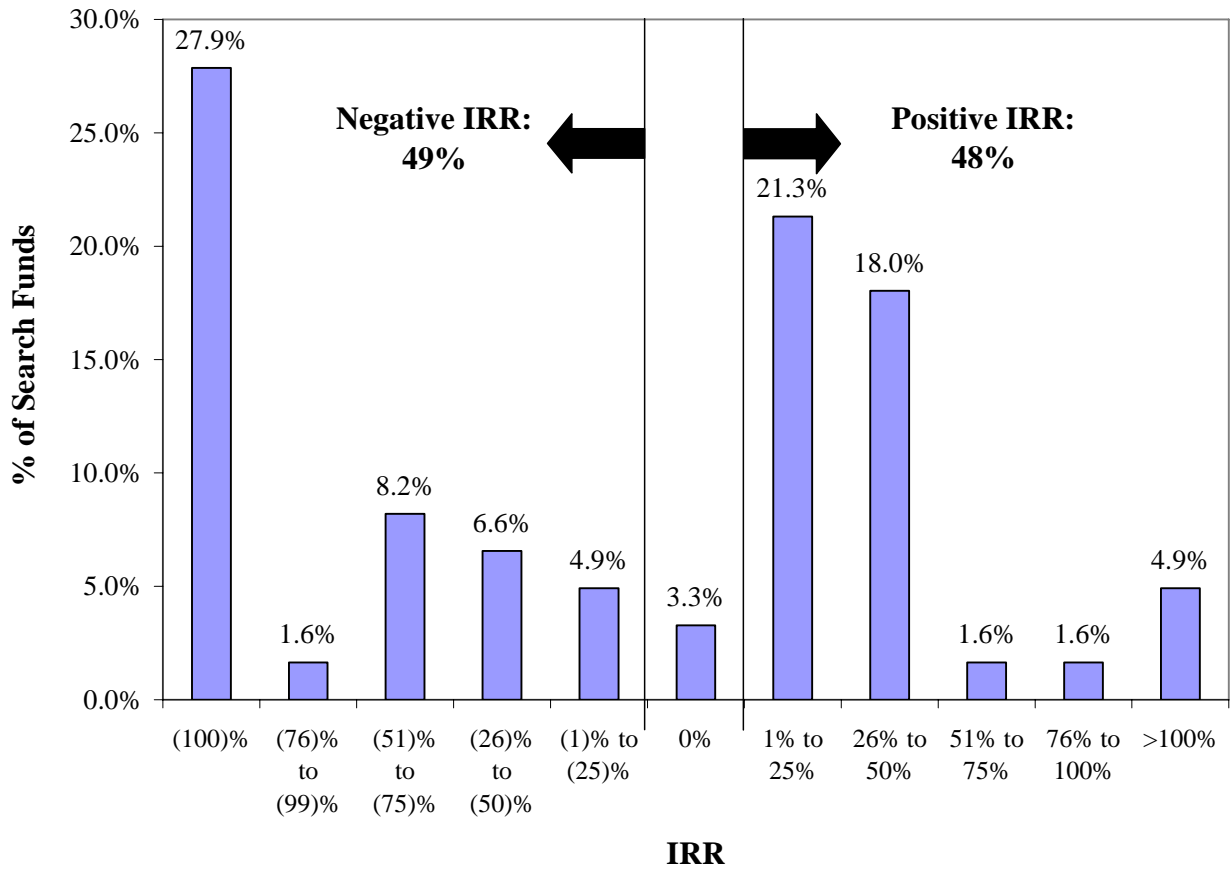


Exhibit 8
Comparison of Search Fund Acquisitions: Top Quartile Performers¹

<i>Categories</i>	Bottom Three Quartile Performers Median Statistics	Top Quartile Performers Median Statistics
Average Age of Principals (start of search)	30	28
Amount of Initial Search Funds Raised	300,000	375,000
Length of Search (months)	21	18
Purchase Price	\$5.7 M	\$12.8 M
Equity Invested at Purchase	\$1.2 M	\$2.0 M
Investors' Debt	\$0.5 M	\$1.4 M
Company Sales at Purchase	\$7.0 M	\$14.9 M
Company EBITDA at Purchase	\$1.1 M	\$2.7 M
LTM EBITDA growth rate at purchase	9.9%	35.0%
Company Employees at Purchase	63	105
Purchase Price / Sales	0.9x	0.9x
Purchase Price / EBITDA	4.8x	4.5x
EBITDA Margin	17.0%	22.0%

Note:

1. "Top quartile" is based on IRR ranking for all search funds that acquired a company, where IRRs are computed in the manner described on page 7.