

Search Funds 101

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Gone are the days of venture capitalists handing money to freshly minted Stanford MBAs. Gone are the days of the 20-something CEOs. Or are they?

As investor sentiment stays focused on industrials and the king of all metrics (cash), search funds have become an intriguing way to run your own business early. That heightened interest was manifested on November 18, when there wasn't even standing room available at the Search Fund Panel hosted by the Center for Entrepreneurial Studies (CES).

The search fund concept has been around since 1984 and our very own Irv Grousbeck helped found it. A search fund is an investment vehicle in which investors cover the operating expenses of an entrepreneur's efforts to locate and acquire a privately held company. According to John Fowler, GSB '00, the average annual salary a search funder takes is \$70,000.

The search entrepreneur writes an offering memo emphasizes the planned search process and acquisition criteria. The search funder circulates the memo to individuals who typically invest \$20–25k each. A CES study found that the median first-time search funder raises \$290,000 from 12 investors.

In return, the search fund investors receive both a carried interest in the eventually acquired company, as well as pro-rata right of first refusal on subsequent acquisitions. The CES study found that the median first-time search funder takes 17 months to find an acquisition, and the median acquisition price is \$6.5 million.

The beauty of the search fund for aspiring entrepreneurs, is that you don't have to have gray in your hair or years of experience on your resume. The median age of first-time search funders was 30, with a range from 26 to 35. The top prior experience of search funders was management consulting and investment banking. Only two of the studied 46 funds raised between 1984 and 2000 were raised by women.

Thirty three percent of the funds were raised by a team rather than an individual searcher. The question of whether to have a partner was frequently discussed by the panel.

The Panel

Grousbeck moderated panelists Fowler, Rafael Somoza, GSB '96; Barry Reynolds, GSB '92; and John Moran, HBS. The panelists had a nice diversity of experience and were in different stages of their searches (from start to industry consolidation).

Fowler raised the money for his search fund, Montebello Capital, with a partner. The funding took less than five months and currently Montebello is in the heat of looking for an acquisition in the Western U.S. with \$1–5 million EBITDA parameters. Fowler found the network of other search funders a helpful guide for advice and for investor names. When asked about the necessity of having private equity or deal experience, Fowler said that lack of such experience was not a disadvantage (he was previously a consultant).

Somoza's fund, Quest Management Corporation, is focused on Puerto Rico. He talked about the difficulties of the search process when targets that looked attractive had either cooked books or the founders walked away at the last minute. Such is what happened to a deal in the outdoor advertising space, so he decided to found his own company in this space—an atypical result for a search fund. The investors were on board, and his company now has 22 employees.

Reynolds represented the investor perspective. Search funds make up 25 percent of his private equity fund, Housatonic Partners, which currently has seven portfolio companies that originated as search funds. One of their investments, Asurion, is by some accounts the most successful search fund ever. Kevin Taweel, GSB '92, and Jim Ellis, GSB '93, bought Road Rescue in 1995. The company, now called Asurion, has grown 40 times and was named E&Y's Entrepreneur of the Year in Northern California.

Reynolds shed light on what makes a successful search fund. The primary factor, in his view, is the quality of the businesses. "As we look back, it is very clear that a poor business is going to overwhelm even the greatest manager." He evaluates a potential entrepreneur by assessing the way he/she in turn evaluates businesses. He also stressed that beyond economics, a search funder should find a business that he/she is passionate about.

And that is what the last panelist, Moran, did: "I had a passion for partying." He bought Classic Party Rentals in 1996 through a search fund and since then has begun to consolidate the party rental industry. Classic Party Rentals has cracked the \$30 million revenue mark and has 400 employees. They have completed six acquisitions to date. Moran talked about the acquisition process and the need to build trust with the seller.

He, like the other panelists, found that attractive valuations and lack of strategic player initiative combine to make it a good time to buy if one can find hard-to-get debt financing.

So, should you go start your own search fund or do you need some industry experience? Most panelists felt that industry experience was not necessary. Somoza's perspective is that once you take a traditional job, it is that much harder to take the risk to start a fund. Fowler said no investor turned down Montebello because of lack of experience. Reynolds said that although Housatonic does look for seasoned individuals for second- or third-time funds, first-time funds are still a good investment. In fact, the CES study found a blended IRR on the first-time funds in its survey to be 36 percent based on original purchase price multiple.

Shuddering at the thought of going b2b (back to banking) or b2c (back to consulting)? Start searching!

Sources: Stanford GSB Search Fund Panel on 11/18/02, CES Search Fund Survey, Housatonic Partners Web site: www.housatonicpartners.com