Search Fund Panel
Transcript of Discussion
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Gene Baker
Dale Blocher
Jim Ellis
Nick Mansour

Note: Minor edits have been made for greater clarity.
My name’s Joe Welsh. I got here just in time. I graduated in ’94. I got into this by choosing to work for Irv Grousbeck as a case writer the year after I graduated. And, actually even before I made that decision, I decided I didn’t want to talk about other people’s companies. I wanted actually to work at a company because I was looking at consulting and banking and probably the same sort of thing that everybody out there is looking at. So I worked for Irv for a little bit over a year. I raised my funds in the summer of ’96 and searching ever since.

Okay, Nick Mansour. I graduated in ’96. I’m definitely the youngest on the panel. Probably the least wise on this panel too, . . . . I did consulting before business school and actually was working on a political campaign also before business school. So sort of a traditional and non-traditional background at the same time. I also did the case writing for Irv Grousbeck after business school, so I think I’ve earned distinction by telling him beforehand that I didn’t think I wanted to do the search for him. And that’s not a prerequisite for being a case writer - I should just plug that right now. Anyway, just raised the fund October of ’97 with a classmate of mine, Doug Tudor, who unfortunately couldn’t be here today. And we’ve been looking for the last six months.

Hi, my name is Gene Baker. Am I the senior member of the panel here? Class of ’92 and I think the unique thing I could address for everybody is I’m a guy who worked for four years after business school before deciding to pursue the search fund. I was very interested in the search fund, developed a relationship with Irv as a student. But prior to business school was an Army officer, sort of one notch below a non-profit environment. Actual business experience, particularly finance and marketing were pretty new to me. So after considering it for a while, decided that working was the thing to do to build that experience up. Also, I’m an engineer by trade, and so I did two sort of technology start ups, one each year after business school, both of which, I’m happy to report, are still functional businesses. And finally reached the point where I was both ready and was given the opportunity to exit my last assignment gracefully and decided now is the time. And “now is the time” was in late ’96 and I’ve been searching for about a year, and been working on a deal for the last six months. I’m actually waiting for a call right now, to see if I still have a deal or not.

It seems like an everyday occurrence wondering whether your deal is still going or not going. I’m Dale Blocher. My story is somewhat similar to Gene’s. I graduated in ’93, then spent four years after business school working, that was basically four years in management consulting. And was really just a financial decision for me because I knew when I was in business school that I wanted to be in search funds. Professor Grousbeck convinced me at about the second day in his class that it was a good idea. I don’t think he tried to convince me more than anyone else does. But it was pretty clear to me that that made sense. I closed my fund in June of 1996 and have been searching ever since. I think Joe and Gene and I closed within a few months of each other. And I got a deal right now I’ve been working on for the past 4 months total; it’s going fairly well so far, so we’ll see what happens with that.

My name’s Jim Ellis. I went to GSB, ’93. My partner, Kevin Taweel, GSB ’92. I was also a case writer, as was my partner for Irv. I didn’t know what I wanted to do when I was a case writer, whether it was the search fund or something by way of a start up. But I knew I wanted to do something entrepreneurial. Kevin and I overlapped as case writers. Kevin had already raised his fund by the time I was case writing. Kevin and I started working on a couple of industries together; looking at certain types of consolidation opportunities in terms of highly fragmented low technology businesses. Came up with towing. Spent about 6 months in the towing industry and consolidating tow trucks, you know, grease monkey kind of stuff. And about 5 and a half months into it, really decided that the model we were looking at wasn’t going to work for a whole lot of reasons. Fragmented industry is good, but forty thousand companies and opportunities, it’s too much to consolidate. You couldn’t do an acquisition big enough and the transaction costs really eat you up. There were a whole bunch of other things about the dynamics of the industry that made us turn away from that. But in that process, we actually came across roadside assistance/dispatch companies that actually dispatch calls to roadside assistance companies, consolidating services offered by automobile manufacturers, other kinds of motor club type programs. This was September of ’95 we made an offer on a company, no, September of ’94 we made an offer on this company going through the process. We started
February of ’95 and ended up closing almost three years ago, July of 1995 we bought the company. And we’ve been running it ever since. The company is located in Houston. Kevin, who married a classmate and I, who married a classmate, Wendy Becker, all four of us moved to Houston for a year. It’s been about a year, 18 months, we’ve been trying to get the company up and going from where it was. Then about 18 months later moved back here to the Bay Area. We hired a chief financial officer here. So the three of us, kind of our corporate headquarters are here, but 80%, 75% of the company’s employees are still there. And we’ve been running it ever since.

Questions’

Question: You guys seem to spend a lot of time searching, trying to work on deals. Were the expectations going into this that you wanted to run a company? What drove you to do this?

Wanting to run a business.

Yes, well the __ can speak for themselves. Going into it I knew that 2 to 2 and a half years is sort of the norm. People have gotten things done as quickly as five or six months and people have taken 4 to 5 years. If you look at the steps involved, you’ve got to determine an industry, which is totally non-trivial. Find businesses in those industries, which is totally non-trivial. Find a business in that industry that’s willing to come to the table and talk to you about selling, negotiate letter of intent, close the deal and then step in a run it. At any point, something can blow up and it does blow up. I mean, I’ve come close on somewhere around 6 or 7 companies in 18 months plus time and you know, that’s about the average because it just takes time. The investors are a great group of people and they understand that. But the whole motivation is to be running a business, not to be a deal broker type guy.

I think they’re very different, ___ process anyway, now that we’re running a company. The processes are very different. They require somewhat different skills and different patience levels. Everyday, I remember doing the deal, when we were trying to close our transaction. Like you said, everyday is a binary outcome. I can’t tell you how many times I went to the Goose and had beers and said this is it, over, done, what are we going to start doing tomorrow. And, fortunately, we don’t have that issue today. Today if something goes wrong, we still get to keep running the company tomorrow. So when you’re searching, it’s is a very binary, sort of lonely process, cold calling all the time. So running a company is probably what you’d expect ____ of other companies.

I think I’ve got one thing to add that, I don’t know if you’re asking this or not. But my motivation in coming to business school and in doing what I did after school and pursuing a search fund first and foremost was to have autonomy over my life and to be the decision maker and to have more control over things than you would working for somebody else. Being your own boss and needing autonomy, I think, is something you look back on and say, that’s why I’m doing this and that’s what’s going to make all the pain I’m going through right now worth it. So I think that is a critical motivator, it’s been a critical motivator for me, definitely.

And adding to that is the opportunity to build equity

Right, right.

I don’t think anyone’s in it, nobody’s in it for the search. Everybody’s in it to run a business. If you’re just in it for the search, if you just want to be a deal guy, you should go work for a private equity fund. And that’s fun too, I mean, don’t get me wrong. I’ve learned a lot, and I’ve only been out there six months and I’m having a lot of fun at this point. But if that’s your motivation, you’re really an investor, not one to run a company.
Question: You say some portion of the process takes place before you actually get your investors to commit. You actually identify the industry before you get your investors to commit, and also how much capital ____ are investors willing to invest, and what are their expectations?

Has anyone ever bought a business that was in the search fund document? I don’t think so.

I know because I’ve been asked that question a hundred times. The investors are really - this is something Irv says a lot - the investors are backing the jockey. Yes, they’re interested in hearing what industries your thinking of trying to buy something in. Yes, they want to hear your ___ philosophies. But for the most part they’re checking you out to see if you’re the type of person who does what they say they’re going to do, if you’ve got the gumption to go through the whole process. And I genuinely believe that their expectations are 50/50, financial and psychic, meaning working with the young person who’s trying to find a business and buy it. We’ve got many common investors. We’ve got one in particular, I’m thinking of RKO, who is like another partner, you know. He called up, he goes out and looks at companies with us, and he’s very helpful, and has got as much feel as we do about the whole process. So I think that’s their expectations. Anyone else?

On the numbers side, they’re expecting - our investors invested $20,000 each initially - they do get to write a ___ they’re expecting $100,000 to $350,000 - in that range. We have some investors who could put in way more than that and would be willing to do that if we needed it.

Question: What’s the range in sizes?

Well, you mean historically or...?

Historically, or.

God, I knew these numbers really good six months ago. I think the average is in the $2M range?

Around $10 M.

And I think the smallest is $5M and the largest is.

$35M?

Something like that, but I think most of them are clustered around $10M.

Question: You talked about how

Yes, we had some investors who invested in the search fund route who didn’t invest in the transaction. If you’re looking for a couple hundred thousand dollars or a million dollars for an investor to invest, you’re going to have to put together a pretty thorough prospectus. You know, doing anything you would for anyone selling a company, because in essence that’s what you’re doing is selling to your investors. We had some investors who opted out. We had one investor who sold his unit to another investor. We had a couple investors who decided that for whatever reason they didn’t have the capital or they weren’t interested in the industry, didn’t step to their pro rata ___ refusal. We had about 12 people who were in the search fund initially. We now have 15 investors - one sold his unit - so we probably have 4 outside investors who came and brought in money, people we met on the way, people who were advisors, people who said, hey, I’m not really interested in making a $20,000 commitmen, that’s not what I do, but when you have a good opportunity, why don’t you come back and talk to me. So we went back to some of those people and talked to them and got ___. So, it’s really mixed. In our group at least, there are probably two or three lead folks, and if those people said no, we would probably have tossed the idea of starting something else, which in terms of the non-leader group of investors, you’d probably expect that.
Question: This sort of related to the first question. I was wondering if any of you plan to start your own business down the road, and if you look at the search fund as a way to get management experience __.

Speaking for myself, I think it’s definitely an option. I don’t have any set idea what I’ll be doing 5 or 10 years from now. But I think if you do a search fund and it’s successful, it’s going to be that much easier to raise money to start a business from scratch and it’s something I’m thinking of.

I have some experience. I started a company, and I joined a start up and I helped my wife start a company. My sense is that it’s a very, very different type of work to start a company versus take over a company with a hundred employees and run it. It’s very, very different. It doesn’t mean that your track record as a search funder wouldn’t allow you to raise capital necessary for a start up. But I don’t know that there is certainly going to be some skill overlap, but there are a lot of differences.

Seems like, too, that there are differences in investors as well. A lot of investors like buying existing businesses. Some like buying start-ups. And so, one of the things you’re doing in addition to building your own skills is pulling your network of investors and contacts that you have, and if they don’t overlap, then you’re kind of starting from scratch again. And so what you tend to see with a lot of search funders is - well, not a lot, but at least some - have bought a company, sold a company, bought a second company, and are continuing to work in that process.

Actually, there’s already a woman who did a search fund for a couple years and didn’t find a company to buy, and so started a company using, I think, most of her search fund investors, and there is now a second person who is beginning the same process. So, it’s been done.

And for whatever it’s worth, going into it, my thinking was that I had worked at a start up before hand and I often wanted to start something. And yes, I was thinking this would be a great opportunity if nothing else to get some management expertise and build some credibility with an investor group.

Question: I was wondering what kind of advice would you give us about the use of partners.

It’s been a great relationship for us. I think add it all up both in terms of the personal benefits as well as the financial benefits to our investors, I think I might disagree with what you said in terms of the fact partners don’t necessarily help in the search. I think from our perspective, we cover a lot more ground, and we spend a lot more time doing that. As Joe pointed out, some of those steps I would say one of them that starts to be more time consuming once you pick an industry is the number of companies that you contact. You can get a lot more coverage with a partner. I also think - I don’t know, some of you guys were alone out there doing it - it’s probably one of the most, even with a partner, sometimes it can be probably one of the more solitary things you can do. I mean, you’re kind of stuck in an office cold calling companies, and you’re dealing with rejection, it’s almost like being a car salesman - constant rejection. So I think having someone to weather those up and down storms was really helpful during our search process. And I think ___ the company; it depends upon the business that you’re actually looking at. I’d say our growth rate’s about 20 to 30% higher because we have two of us and we can cover a lot more ground in terms of new industries and things like that. So I think it’s been highly helpful. I think it also depends tremendously upon the individual, whether you work better with a partner, or whether you have the right person. I guess I wouldn’t recommend trying to find a partner because you think you want a partner. But if you get somebody whom you want to do it with, your chance of success in that environment is probably a lot higher.

I sure think it would be valuable - I mean I’m doing it by myself - but there are many many days when I just have too much to do and so little time to get it done in.

I would add one thing. It’s that, you know, as I mentioned, I’m working on a specific deal right now. I would agree with what you said, it’s that I’ve worked alone and I’m at the point of wanting to get in the driver’s seat of this company. I have very aggressively gone after some people to join in as sort of an
operating partner in a specific deal. And I would absolutely agree with Jim’s perspective that my concept is two guys can go faster, there’s synergy. You go a lot faster working as a team.

Question: Did you have to renegotiate with your investors?

Yeah, my investors were very enthusiastic when I they saw that I was interested in bringing in a partner and also willing to set aside a significant amount of equity for that person. They viewed that as a sign of maturity on my part and because they do feel that that would grow their equity faster as well. So that turned out - I didn’t know how it was going to go - but that turned out to be in my plus column with my sophisticated investors.

Yeah, I have something real quick to add. I do have a partner and I would definitely say it has helped us a lot in the search phase. We definitely covered twice the number of industries, twice the ground. I’ve looked at four or five industries in depth; he’s looked into four or five industries in depth. We’re looking at a company right now that we’re really excited about that he has found. I think on top of that you’re going to work a lot smarter. It’s really easy, I think, to get involved in an industry and to hold on to an industry for a long time, and your partner can take a very, sort of, logical _____ and say we’re wasting time here or he can say these risks are not worth what we can take. So I think - and that too - you know, we’re all from the business school, we’re all a little competitive. You know, I think my partner and I have a fair, a healthy amount of competitiveness between us, that we’re both working in there hard, and one of our ---

Like a forced rivalry

- yeah, one of our investors said, you know, he thought we were probably working harder than we would independently because it’s not just the competitiveness, it’s the accountability. You could, any day sleep in until 12 o’clock if you really wanted to, and, don’t go tell my investors that. But, you know, knowing that there’s somebody else there who’s expecting you and counting on you gets me up and makes me work a little bit harder.

Question: A question about investors. You’ve all talked about the investors you have. We hear a lot that money’s plentiful here in the valley. But what about finding the right investors. What was the process like? And were you able to find them easily or did it take a while?

For us the process actually worked because to some degree it’s a little bit different if you _____ because you’ve got kind of a built-in network of people who have done it before, some people you can talk to while you’re in the case writing process and even while you’re in business school. I think for us that was really helpful. You know, we thought long and hard about the people we let in, actually, after we had the transaction, we had the opportunity to let other people in and decided to go with a certain group of folks. And it kind of depends on what your objectives are out of it. As Joe pointed out, one of the things you’re doing is building a network of investors and people who hopefully further down the line you can make money for again. So it’s kind of looking at those, whether you’re targeting a specific industry or _____ add some value, whether you’re looking purely for capital, whether there’s somebody... We were talking about somebody before - one of our investors - _____ search fund, who’s really a value-added investor. It really depends upon what your options ___. There are other people I know, like ____ & ___, going out and cold call 700 people and I think for them it was 12 warm bodies with a checkbook. You know, I think it really depends on what your situation is. I think you can make almost any group of investors work.

I think ... you don’t want 12 warm bodies that are just going to write you a check. You want people who are going to help through the process, know how to evaluate companies and add more than just money.

Question: And easy to find, I guess, is my question.

Well, think, being a case writer does ease the process a little bit.
Question:

Yeah, I’m just trying to think about how I can capsule that whole drama. For me, it was three or four months, so it wasn’t the biggest challenge that I faced, although one thing that seems to have happened is that as search funds become more widely known, well - it may be easier now than it was before.

You’re selling two things, you’re selling a concept and you’re selling yourself. And there are kind of two groups of people. There are people who understand the concept who don’t know you, so you only have one sell to make. There are people who know you that don’t know the concept, and those people are probably easier. The people that don’t know the concept and don’t know you probably represent more of a challenge than any other group. And only you can determine which set of those you guys know.

And I would actually - sorry, one more thing to add - I would encourage people to be sort of as selective as possible. I mean, we could have easily closed our funds sooner, and only seen the 18 people that we needed if we wanted to. But we really pushed ourselves and said, you know this is the guy we’d like and we didn’t end up getting him but if we had it, would have been worth it.

I remember when I was doing it, I was very careful about it. I talked with Jim and Kevin a bunch. Talked to everybody I possibly could and I literally had a file, a little word file, that just had the shit list that I ranked - I put them in 5 different buckets of priority - based on skill sets, networking, financial capital, how we interacted - that was really a very, very important part of it - you need people that you just feel you can connect with - and that was actually a really fun process, raising money.

Question: How much competition did you guys see? You target industries then you cold call these companies. Once you find a company for sale, are you competing with anyone else or are you just competing trying to....

Yeah, I would love to answer that question. This white-hot market affects everything, right? I was just talking to somebody about this very issue today. If you look back say eight years ago and you’re doing what we were doing, there wouldn’t be a lot of competition going after businesses. However, valuations were lower, there wasn’t as much debt capital available, the equity markets weren’t trading as high a multiple as they are now. So it’s sort of the analogy that all boats rise in a rising ocean. Today, the markets are white hot. I know that Jim was just looking at doing some sort of secondary deal, it was at a pretty steep what you would call a pretty steep price, right? So valuations are up. I mean, if you talk to people who are buying search fund companies buying anything a few years ago, you always toss around 5 or 6 times cash flow. Well, now, especially in deals that are above $10M, you’re really not paying 5 times, you’re paying 7 times, you’re paying 8 times. I think the average acquisition last year; all told, was 12 or 13 times, cash flow. So my point is that you’ve got competition. The good news is that getting debt money is a piece of cake, better businesses are being sold because people see it as a good market. So it’s one of those things that always cuts one way or the other. If it’s a down market, valuations are lower, but you’re not going to see good deals. If it’s an up market, you got a lot more competition, prices are higher, but you’re going to see better businesses.

So valuations may be higher.

Question: But I guess what I don’t understand is what you do on a daily basis. You call a guy and you say, you know, I want to buy your business. Are you bidding versus someone else? Are you just bidding versus the market?

I just had this today. I was doing cold calls all day today. Almost everybody I talk to says, “I get calls from you guys almost everyday”. There are all the LBO funds; all the financial entities have rooms full of junior
associates that are just calling up businesses, sending out letters, pulsing people. So it gets to be more art and science to talk to these people and explain to them who you are and what you’re trying to do. I don’t know if that directly answers your question but there is a lot more competition.

The first industry I went after, I went after a deal, a company in Dallas, really like it, made an offer on them that I thought was reasonable. It was about as go to make the numbers work as a financial buyer. They had a strategic buyer come in a quadruple my offer, and that’s what the company sold for. I sort of threw in the towel on the industry because that deal screwed up the whole industry from a financial buyer’s point of view. Everybody’s waiting to win the lottery and it’s a highly fragmented industry but all these mom and pops are waiting for that magic knock on the door that magic phone call from a strategic buyer. So as a relatively small financial buyer, I decided that I didn’t have a reasonable good chance of getting a reasonably priced deal. And, you know there are three things you do in the search fund. You buy well. You operate well and you sell well. And if you don’t buy well to begin with, you’re really putting yourself at a disadvantage to be successful on the whole process.

I guess I just have one more thought on that. When I was in business school, getting the best place to live was somewhat of a challenge, right? Getting the best house, wherever it is. And I’ve been contacting companies where I’ve felt exactly the same way. There are going to be 10 people that want this house and I’ve got to do whatever it takes in order to be the person that ends up getting it. And a lot of times, that means finding those non-financial things the seller cares about, making sure you’ve got rapport with the seller, doing all those kinds of things, and acting very, very quickly to get to that point so that you kind of beat out those other people that are interested in the company.

**Question:** I have a question for the people who worked in a corporate environment after B school. Just wondering, the choice to do this kind of thing, if you could comment a little bit on the strings that you felt tug on you such as your family situation. Did you give yourself a deadline, did you say I’m going to be supported, did the time just feel right?

Well, I joined a start up. Actually what I did was I joined a public company and I started a new company as a division of that company, so I got to do an entrepreneurial start up within them. Another company. And I did that for a couple years, and our CEO changed in our parent, that totally changed my whole situation personally. And it was at that point that I decided leaving this company, and I thought about doing a search fund at that point. So this is two years out of business school. And then, through a venture capitalist, I came across another start up and they wanted me to join as a manager, and it sort of came down to should I do the start up or should I do the search fund at this point. And there wasn’t really a family oriented situation, although I’m married, my wife and I didn’t have any children at the time. And the new start up opportunity was just so interesting at the time, I decided to pursue that. But it was always in my mind that if this doesn’t work out, I’m going to do the search fund. Even the first job, if this doesn’t work out I’m going to do the search fund. So I kept getting interesting opportunities, and then when the second one sort of didn’t go in the direction that I had hoped, I said that’s it, I’m going to do a search fund at this point. And wait long enough, and part of it has to do with this autonomy thing that I mentioned, and not having the autonomy that I thought I would want, and convincing my wife to move to a different part of the country was probably the biggest part of the family situation. It wasn’t a big financial consideration.

I didn’t work for a corporation after business school. I did consulting, so I think that applies to the corporate side. For me, I just felt ready, you know, it was time to move, time to get on with my life and make something happen.

**Question:** I’m wondering what your relationship with the investors is like. You mentioned that you had one who’s very actively involved in your search. I’m wondering if you guys could talk about what that’s like, do you have fights with him over things? Do you meet with him regularly? You never hear from him?

At a minimum, I update them quarterly, send them a very casually worded letter which just describes exactly what’s going on. Invariably, I get a phone call back from 80 to 90% of the ones I don’t talk to.
regularly, either responding to something I said in the letter. There’s a few I talk to very regularly; there’s a couple I really haven’t talked to that much since I raised the fund. But I think everybody knew what the deal was going in and as long as the expectations are set clearly up front - that’s really an important part of it, setting the expectations up front. But I think every interaction I’ve had with investors has turned out positive. They’re great. I almost wonder. It’s funny; people ask me if my investors are getting antsy because I’m two years into it. I say they’re probably the ones who are most supportive.

If you’re fighting with your investors, you’re doing something wrong already. Even through the process of running the company, the investors are pretty supportive. If you’ve done a decent job, they’ll support you. I mean you’ve got the luxury of being able to do that. They’re on your side. You’re not in the situation, depending on your perspective what you’re looking to get out of the whole situation is you really want to do good by your investors, you want to do well by them. You want to make sure you’ve got good relationships with them. And by and large, you’ll find different opinions, but it’s usually different opinions about how to get to the same objective. And if you’re fighting or arguing with them, you might want to take a step back, figure out where to go. It’s much more friendly capital than going to an institutional source to raise money.

Question: We wondered if you could talk about just the acknowledgment of the fund economics.

I think the economics from a salary level are about as unattractive as you can get coming out of business school. Just straight salary. I’m making about $55k a year - I feel comfortable telling you that - it’s probably more than most search funds at this point just because I took what people did the year before and added a little bit more. So they’re getting better, but they’re not keeping up with consulting. From an equity standpoint, it all depends on the size of the deal. I think, again, I had a partner, so we were sort of thinking between the two of us, it’d be 20 to 30% of the total company and that a third will vest the day we buy the company, a third will vest over time, a third will be performance based, something like that. If you’re one person, I think 20 to 25% is probably a reasonable range.

But larger transactions tend to be 10 to 15%. No one’s going to give you a 50% share.

My approach has been IRI driven. I take much more the perspective of a start up which is it’s my company and I’m going to sell the amount I need in order to track the capital that I need and it’s really just a risk/return calculation on my part to say here’s the IRI I need to deliver to my investors in order to track that capital. This is Silicon Valley and there’s really two perspectives, the LBO equity guys say, we, KKR, are buying this company and we’re going to bring in management to run it for us and we’re going to give them the amount of equity that it takes to attract the best management that we need. On the other end of the spectrum is if you’re a start up that says I’m going to sell only as much equity in my company as I need to take me to these objectives of my business plan. And I think the search fund is somewhere in between, and just where in between depends on the dynamics of your investment group and you.

It’s expected that usually five years after you buy something you sell it.

Kirk and Jamie are 10+ years doing it. Other people like David Dodson in two years. You see a mix. Kevin and I, we’ll stay with it as long as it continues to be fun, as long as there continues to be upside opportunity. If somebody were to come by and offer a ridiculous amount of money, we’d obviously bring it to our investors and if they want to sell, we’d go with them, but right now we’re not necessarily looking for an exit. I think it all depends upon each person’s kind of situation. And your investors will either be patient or sell out.

Jim Southern offered a number of different buy backs and dividends over a ten year period to give his investors liquidity and sold it after 10 years and I think the price he got on the sale was very little impact on the return that his investors got.
And my partner, we’re different in that, I think he’d probably die if I say this, but I think he’d love to find a company where he’ll stay there 20 or 50 years and I don’t know if I could stay that long. I think that’s an option, potential.

But you don’t have to make that decision.

Question: This sounds like a very good business model and I just wondered if there’s any track record at all of the returns that these investments generate. Also, a follow up question.

Well, first of all, there has been some research on the return, I think overall it’s averaged 32% return or something like that. Brigitte, I think, has all that information.

That analysis was based on 9 companies, it’s got a median and an average and a high and a low. Pretty interesting. Most of the companies in it hadn’t sold yet. So it was sort of what’s the projected market value today if it was sold. But the numbers are very good.

The interesting thing is that those are portfolio bases, venture-like returns, 25, 30%. There haven’t been any clean outs.

TAPE 2

I think the worst one is one where people got back 60% of their money.

I would say it has to do with a few things. One, you’re investing in mature businesses that have got some brick and mortar, that have got business practices and markets established. Two, the board of directors you tend to put behind these businesses are pretty impressive. The board that Kevin and Jim have on their company, I would argue, is as good as any board of directors in the country. Really quality people who have run a ton of businesses and are very good at looking over the shoulder and saying hey, you’re doing good here and you’re screwing this up. And that has a lot to do with it.

In terms of characteristics or criteria, if you look at any of the buys that have been done by people who raise a search fund: no technological obsolescence, no large competitor the market that’s going to put you out of business, no regulatory risk, no environmental risk. The whole name of the game is really to minimize risk. I think one of the things that’s driven in return is that you don’t have these things crashing and burning because, I can tell you, it’s hard to screw up. We screwed up a lot, and we haven’t been able to drive it into the ground yet. But seriously, it’s because you will get some criteria when you pick the business so that tomorrow you’re not out of business!

And I would say that he gave you a bunch of characteristics that people say they’re going to avoid and the ones that people say they’re looking for are fragmented industry, recurring revenue or repeat business, I’ll just name growth potential, there’s a couple others- you can look at my document, I don’t even remember.

Question: How do you guys differentiate yourselves?

There’s a pretty good gentlemanly agreement. But as far as differentiating from a big fund or a big pool committed capital, that’s really tough. If you’ve got a seller whose primary motivation is to make the most money today, you’re probably better off walking away and looking at another business. If you’ve got a seller who cares about _____, and they want to work closely with an entrepreneur who’s going to take over, then we’re a better fit. We’ll admit that in 8 cases out of 10, that doesn’t matter. So you’ve got to quickly sort through that and cut bait and move on.
I think competing against other funds; the one thing that differentiates you from another fund is that you want to actively manage it whereas others need management. So if the seller is somebody who wants to retire, it’s difficult for a professional fund to really buy unless they can line up a management team. So that’s one of the differentiations. Secondly - I mean, I have not bought a company yet so take this with a big grain of salt, but I think there’s just a lot of reasons that go into selling a company and as long as you get the same price and you can establish a better rapport. They’re offering two times the money or whatever forget it, but if you’re in that range I think there’s a lot of things that might make somebody sell to you versus somebody else that’s got a higher price.

That’s actually one of my criteria that I continue to do a poor job of sticking to is that not being an industry full of strategic acquirers. I had a business down to the wire, it would have been about a $28M transaction, and a strategic acquirer walked in with $55M cash on the table. And so the owner’s a nice guy, he calls me up and says, so what do you think I should do? I said, well if you don’t sell it to them, I’m going to buy it from you and flip it!

Developing a good relationship with the seller, I mean that’s one of the things that you have an opportunity. You’re obviously investing, you know. You present yourself as being a professional management acquisition company. But when you really get to negotiate with the seller, you develop a personal, hopefully positive one, a good relationship with him. In the end, actually right before, literally three weeks before the deal closed, somebody came in with an offer that was higher than ours. And this is how we just said, look, we’ve been down this nine months in the process, we’re going to finish it up together. And we ended up closing. You’ve got a little bit different experience. But if you’re in a competitive bid situation where DLJ’s doing an auction on a company, chances are it’s unlikely it’s going to work. You don’t want to be there.

Question: Jim, what were the roles you said you and your partner took in the company and how did the employees react when two business students took over the company?

I’ll answer the last question first. How the employees reacted was - first of all, we didn’t tell anybody that we’re from Stanford - it wasn’t the topic of conversation. It eventually came up though, I’m sure all the employees know it today. It obviously wasn’t - I mean if you’re using that as your main criteria, you’ve got bigger problems than just how they’re going to react. In terms of the roles that people split up, basically, we do pretty much everything that’s kind of corporate overview together - strategy, policy, financing decisions, strategic decisions like acquisitions, hires and fires of key people. We approve; each of us approves the salaries of whatever it is we’re working with from a managerial level. In terms of how we split up our responsibility, we divided up existing accounts between the two of us, so we both did account management on a few accounts. Kevin took operations and finance and I took sales and marketing. So, and we may change that at some point in time. But at this point in time it works pretty well. In terms of decision making within our own areas, we often consult each other, but if there’s a disagreement, the person whose area it is can make that call. If it’s a strong disagreement, we’ll bulk it up, not from a competitive standpoint, but we’ll call in an investor and say, hey, we’re here looking at a couple options, how would you handle this situation? And get some advice. We never had a board vote on a topic, we never had to bring something that way. I think, you kind of develop your own set of guidelines when you get a partner as to how you’re going to resolve those issues and handle them. And you do it not in the heat of battle, you do it before hand, say here’s the ground rules, here’s how we’re going to address situations. Then when it comes up, you say, hey, this is how we agreed to it. Sometimes it comes down to literally - we flip coins on some stuff. Neither of us care, we have an opinion, neither of us has a strong sense on it, we’ll go either way would work.

Question: Has any sort of tension built?

We sort of say an 80/20 rule. 80% of our time we spend looking at industries that we like and cold calling. And 20% of our time is meeting with business brokers from the ____ investment bankers, lawyers, accountants, etc.
Question: I just had the same question, but about the brokerage firm in particular? Have you had good or bad experiences with business brokers?

My opinion is a mixed bag. There are certain companies - I don't know if you're familiar with Geneva, in Southern California - but their business is to create options for companies. And so, if you get anything from them that looks like a pretty good deal, you know that there's... I got a deal booked from them; for example, this deal booked number 132. Okay, think about that for a sec. You know how many people are looking at this thing. There are lots of smaller deal people who in essence are doing the same sort of thing we're doing. They're picking industries, they're making cold calls, they're mailing out letters, and they're cultivating relationships. And some of those are okay, but in general, I sort of lean towards doing the work myself. That's my opinion.

You know, I retained a buy side broker and my deal was sourced through this guy. I would agree with Joe's comments that I think - and I've talked to a number of brokers along the way - I think brokers are a mixed bag and it's highly dependent on the skills, experience and abilities of an individual broker which I felt extremely unable to calibrate based on an interview or meeting somebody. And the person that I hired was referred to me by some of my investors, someone extremely confident and adept. And I can tell you this guy has one of the most abrasive personalities I've ever met in my life. And the only reason I'm still working with him is that he gets the job done. Oh my god, everyone who deals with him from the bank - one of my investors says, now use him for the deal but don't let him get near any bankers. So it's been highly effective. I wouldn't use him except for he was referred to me and he sourced a deal... He's great at getting good prices out of people like that; getting in their office and getting them to tell you stuff. You'd be amazed at how hard it is for somebody to tell you what their revenue is or what their... any of this information, people are very suspicious. He's good at getting information like that from small mom and pop operators and as a result, developing rapport. So he's not too abrasive with them. But... you know... anyway.

Just one other quick comment and just something to keep in mind. A lot of these brokers, well put yourself in their shoes. You've got a deal. On one hand, you can show it to Nick Mansour who's going to buy it and then he's going to be off to the market. Or, you can go show it to a partner in Company A or B. So not only do you have somebody who's got a bunch of money sitting in their little drawer to buy something, but then you build a relationship with somebody who can keep showing deals. So guess where they take most of the good deals?

We had terrible luck with bankers and with brokers and third party agents. Our best source was getting into the industry, being really understanding, joining the association, we met the president of the association, he gave us references to trade rag, we found the person's who works in circulation for the trade journal, we found out that Joe want to sell because his wife is sick. I mean you kind of use whatever works best, but we found that networking through people like that was much more productive than brokers. That can waste an awful lot of time, brokers.

If you just have them send to you - mine's a little different in that I retained him on contract and paid his expenses and so it was proprietary deal flow.

That's a big difference.

All that said, though, at the end of the day, you only need one deal, you don't know where it's going to come from. We had one of our investors tell us brokers are all horrible but I got my company through a broker. Most brokers, I think, are probably not the best source. I found one good broker who doesn't have a lot of people that were slightly above his usual deal size. So he doesn't have a lot of contacts where he can hand off larger deals. We're basically it for him, and he knows he's going to get a lot more money off of it and he's pretty good at going out there and being a little proactive. So I think he's let us do a couple of interesting things so far and he's worth keeping in touch with.
They can be a pretty good source of ideas, industry ideas and company ideas and niche ideas within industries.

One of the things Joe mentioned - and this doesn't necessarily have to pertain to brokers, but we thought it pertains to people like accountants, lawyers, banks and so forth - people do think of it that way, I think, is that hey, I can deal with somebody who's going to be in this game for long time versus you who's going to be in it once. One of the things we've pitched, I think pretty successfully, I think, to our third parties it is us, but it's also this whole search fund 'network', and you know, there are people who are going to be out here doing it again. We had one executive recruiter, a headhunter for us, who's done searches for three or four companies; he had gone in at banks that have done multiple transactions through people. So you do have some of that, I think, to sell.

I think the search fund concept is getting known, somewhat known in the Bay Area now among these intermediaries that we share.

And you get a lot, I think by pitching that, you get a lot better quality of help than you would otherwise. I think you have much better time spent than you definitely, definitely deserve at this point in time or could pay for because people want access to the folks that we do business with.

**Question: Tell us about the search fund network.**

I think - we kind of joke about it, three of us, at least four of our group that was doing search fund with a case writer - but there's a group out of Wharton that just boasts a couple transactions, there's a bunch out of Harvard, people out of London School of Business. I mean, I think, yes, certainly that helps, but it could be anybody. I mean, there's a couple folks who are probably common investors in all of our search funds. If you developed a relationship with them, they could be your Irv, I guess, in a way. I think it really depends upon what - you take advantage of what it is you have to do. There are a lot of folks who don't even know Irv or some of our investors, who have done their search funds completely without that inner group who have invested in multiple rounds. I mean, I think it helps, but having a relationship, I think it's harder to force a relationship after the fact.

My case, I have few of the core 'network' in my fund. I developed relationships in this four-year period after business school where a good group of my investors came from that. And you know, one comment that I don't know if I should throw this out or not, but maybe you guys could comment on it, but I've heard it from more than one of our peer group is that once you expect your investors to be there and help you with deals and kind of add value in the search process and I think it's my experience and a number of other people's experience that investors add little or no value to the search process except in terms of sourcing deals. In terms of evaluating opportunity, I think that there's been some value added there. But my experience has been that my investor group looks to me to do the work of sourcing ___.

Oh, in terms of sourcing? I agree with you 100%.

In terms of evaluating deals, I'm not talking about that. That's a big part of it. So the money can come from anywhere. I was not in a position to sort of take my pick among investors. Everybody's experience is different. It was not joy for me to raise my search fund. I'll give you an Irv anecdote that Irv told me once. He said - I don't even know if he told me or somebody else, you repeat these things so many times, but - he rates the phases, you know - the raising the money, the putting a deal together and running the company, and on a scale of one to ten, he rated raising the fund as a 5, doing a deal is an 8 out of 10 in terms of difficulty, running a company is rated as a three. And that's a model. You're buying a company that's easy to run, you're not buying Intel or a competitor of Intel.

Last comment. Yeah, I don't think there is really a Grousbeck 'network'. There are some associates of Irv's that have been more involved than others. That said, I think it helps to get to know Irv, not because you can
I would say the most important thing is if you can get a sort of qualified introduction to somebody that you’re looking to raise money from. So, let’s say I wanted to get money from Jim, rather than me calling up Jim if I could get say, Nick to call him on my behalf and say, Joe Welsh will be calling you, you’ll find the person you’re calling has got open arms.

I think be very selective who you meet first because it’s an honor to go to someone, and it’s part of the selling point to say we chose you first or we chose you the first week because we really want you on our board, and also because if you can sort of get a name right off the bat that other people will recognize, it helps when you can say, I’ve already got so and so as an investor. I think that worked well. I think something that we didn’t listen to previous people that we probably should have is people told us go get my document, copy it and change the names and use that. And obviously, they’re being a little facetious, but we probably reinvented the wheel a lot more than we needed to, spent nearly a month writing this document that shouldn’t have taken this long. And another thing that I think we didn’t do enough on is you do have some industries picked, you know you want to have three, we had four industries that you can talk reasonably intelligently about, like this is why we’re looking at this. And we did a fair amount of research on that. I think that’s somewhat of an area where we should have done a little bit more. I mean we had some investors ask us some pretty stupid questions, when I think about it, that we didn’t have the answers to and thank god one guy asked us a question then his phone rang at the same time and he forgot the question and just let it go. It’s the truth.

Another important thing, especially if you’re going to investors that have invested in other search funds, is if you can go get a few new investors in your group, a few people who have never invested in search fund before, then you can show with credibility that hey, not only am I going to do this, but I was able to get money from somebody who has no idea what this concept is into my group. I found that was really valuable. In fact, I had people ask me, “Were you able to get anybody else?” And you say, “Yes,” and that helps.

One last addition. I think you have to, besides the technical things and techniques and networking, you have to convey a fire in your belly. You have to convey the motivation that this is what I want to do and I will do this and I will not quit, and conveying your intensity in that one on one, I always thought, was my number one priority, any time I got face to face, or even on the phone, with somebody. That’s critical.

Ask for the order.

Seriously.

Make sure you say to them I would like to have you as an investor. It would be wonderful if you could decide to write a check and join me. A lot of times people are sitting there waiting for you to say it.

I think there’s a different philosophy. If you’ve got some obvious people who should be investing and if you’ve got some obvious investors, my opinion - other people may differ - I think you’re better off hitting those people up first, because when you go around asking other people, they’re going to ask you why isn’t your mentor with you. I mean, people are going to ask you questions like that. If you don’t do it, you better have a good answer. You know, if you’ve got a lovely family and wife, if your family and friends aren’t willing to back you, should I be worried? And there are other people who say, hey, I want to go out and strike the hard ones first and then go...

No, go out and get the sympathetic ones first, get a couple notches on your belt and then you can go after the hard ones. I mean, it comes with practice.

I even got that question from people asking me, you know, do you have any partners from BCG investing? And I shouldn’t say I didn’t think about approaching them, but I didn’t think they were the best investors I could have gotten out there. It would have been a lot easier if I had just one, and I could have said, yeah, it’s lined up...
get access to some Grousebeck ‘network’, but because he’s in almost every search fund that’s out there. He’s a really smart guy, and he, more than anybody else, is probably the most accessible person out there to just give you advice on once you’re in the search phase and run your company and trying to raise the money. And, you know, to develop that relationship and I think it makes sense to try to get into his class, first of all. If you’re interested in being a case writer, that can’t hurt. I actually didn’t know that much about him and I went to him my first year and he sat down to help me decide what, a little bit about what job I should take for that summer. And that’s how he started with me. And I would say with him, if you’re interested in the search fund, I think it’s worth getting to know him and the sooner the better.

Within the search fund, although I agree that there’s not a Grousebeck ‘network’, there is a search fund ‘network’; there is a strong, tight linked group of search funders and people who have done it. Pretty much everybody will be out there for them. If you’re serious about what you’re doing, I know Kev and I, we both take time out of our day to talk with anybody who is serious about what they’re doing. If you’re looking at McKinsey versus a search fund and you really want to go do consulting and you’re maybe not sure, then, I guess if you want to spend time, but probably not a day, going over stuff. But I think to the extent that you’re really interested in it, everybody else has been really helpful. Talking to the folks who have done it before and other people who offered investors. There are people who have open investors who say, hey, I want to see everybody. If you like them send them on to me. And there are other people who say, I don’t really want to meet other searchers because I’m backing you, I don’t really want to talk to anybody. But it depends. You get ideas and suggestions for sourcing investors, even individual’s names, particularly if you’ve got a relationship with somebody who trusts you, likes you, thinks you do a great job.

And I would actually second this sort of tapping into the, if you want to consider all the search fund people part of this Grousebeck ‘network’. I mean, you’re not going to raise a dime from me, but - I’d love to give it to you, but - in terms of, once you’re out there looking at industries, I’ve come up with many great ideas that research guys before me have looked at and you learn more in a half hour conversation with them than you learn in two weeks trying to research it.

Yeah, that’s your network, when you’re sitting alone in your office. I had a search funder call me up on Friday. He says, what’s new with you, Gene? I just lost my deal. And, you know, that’s who you commiserate with. So we’re going to go hit some golf balls after this.

Anything else? I’ve never written a letter of intent. Joe sent me one.

It was pretty good, wasn’t it?

Well.

It wasn’t good because it didn’t work.

I called somebody else to send me one. I know a little bit about the structuring of the deal. People can rattle it off after they book one deal a lot quicker.

It’s all the cripitty crap of setting up your corporation.

It’s even helpful after running a company. I know some of the folks, like Jamie and Patrick and so forth, we’ve exchanged things - how are you doing, how are you structuring your employee stock options, how are you looking at executive count, how are you doing some of these things. We trade stories back and forth, I tried this this way and it was terrible, I tried this this way ...

Question: Any thoughts on specifically, when you were raising money, what worked well or things that you’d never do again, badly or those things that stand out in your mind?
That's a hell of a sales approach to just say, hey, they're not the right kind of investor, they're not the person that you are.

**Question:** Is it necessary when you're raising your fund to put your own money in?

No.

**Or did you all split it?**

Yes. You're required by law to actually invest a little bit. I think we invested 350 each or something like that. But that wasn't in until we had everybody else lined up.

It's pretty nominal. We had no funds. No funds.

In fact, our lawyers wanted us to invest 500 and we had to talk them down to 350, because...

Somebody had to borrow it, had my girlfriend put it on her credit...

**Question:** Where do you get ideas on what specific industries you go out and research? Is that just like the Holy Grail.

...read a lot. We subscribe to every single business magazine out there.

You drive around in your car and if there's like a telephone pole, you go, wow, what's a value chain behind that telephone pole? I'm not kidding, I'm serious. That is the intellectual capital of search fund, in my opinion, is coming up with those kinds of ideas.

Take the business to business yellow pages, and go through there and just look at all those ads that are in there.

But Dale mentioned something that, in passing, that I think is actually pretty darn valuable and that is getting deal books from brokers just sent over to you can be a real catalyst to getting your mind thinking about - well, maybe not this, but - everything connected to that. I mean, that was my approach, in what's all connected to that and where does it lead.

We actually got ideas from guys, people in our class, who are in investment banks, who either buy out firms or stuff that they looked at but the deal was really too small. Actually, Jeff Stevens got his transaction that way, from somebody who said, geez, this is really below our radar screen, hey it might be something that you're interested in. So if you get a group of friends you feel close enough to that are even working on bio funds or working on the merchant banking side of the bank or somebody who's looking at those kind of transactions, you can get leads in terms of industries or even specific transactions. 

Tell everybody you know, even if it's a dumb idea, to tell you. And if it is a dumb idea, you say, hey, that's great, I'll look into it, and just because they might come up with a good one eventually.

There was an industry that I ended up passing on but it looked really good for a while. I got it from an old, one of my old golf teammate's fraternity, it's his roommate's girlfriend's brother, or something like that. They were sitting around talking about this crazy thing I'm doing and she said, hey, well what about this business? He called me up, I looked into it, and I said geez, this is a pretty good idea. You've just got to tell everybody what you're going to.
David Dodson, who’s on our board, who was a casewriter, did two search fund acquisitions and just sold his company about a month or two ago, says basically that he has two criteria. One is, if you assume, first of all, that companies that are in business are making money, first assumption. He looks at industries where there are enough companies for sale, that there are enough companies that it’s worth your time. And secondly, that those companies are selling for a price that’s within your range — it’s a specific deal size and a reasonable multiple. And he uses those; I don’t know how hard he stuck to them, but really those as his two criteria. And outside of that, an industry that’s 40,000, there aren’t enough. The deals aren’t big enough. If you look at an industry that’s got 4 players, you spend all this time learning the industry, you strike out on your first one, you’re done, or your second one, you’re done.

I had that happen.

You’ve got to go back and start all over again.

And it’s so tough because you’ll set these criteria down that look so smart on paper. And then you start doing it. And you’re like, this industry really looks good, I’m going to push a rope, I’m going to make something happen. But the fact is it doesn’t fit the criteria and you put the criteria there for a good reason and you know, you can squirt away 6 to 8 weeks on something.

That’s why deals take a year and a half, two and a half years to do, because you spend - it varies, but - you spend six or twelve months learning stuff, making mistakes. That’s what I did, for sure. I’m going to spend a couple more years making mistakes.

**Question:** Does it have to be that the search process is a full time job or is something you can do as you work somewhere else? How about managing that risk so that you don’t spend two years that could end up in nothing?

You can do it, but I can’t think of an investor who would invest in somebody doing the search part time.

I think it’s also hard to really search. I mean, think about trying to find another job while you’re working at a job. It’s difficult to put aside that time and you’re doing something that’s a lot harder than just finding a job. But people have tried it; people have done it, too.

You could raise your money while you’re doing something else.

**Question:** You guys, we talked earlier, a lot earlier about multiples creeping up. I’m curious, how were people who were looking are about kind of getting into a deal and ending up buying high and then having multiples drop. How important does that look in terms of financials? Could that kill all your worth in the deal and can you mitigate that?

I worry about it.

**Question:** Can you mitigate it by industries?

It’s one of those things, on the one hand the multiples are high and on the other hand, you can get airball cashflow financing at one to two times where you couldn’t get anything two years ago. So, do you worry about it? Yeah. What do you do about it? I don’t know.

One, you can look at industries that are out of favor, I guess, and the multiple should be lower in that. But then you’ve kind of got to ask yourself, well, if the industry’s not up there, why am I in there?

I worry about where we are in the business cycle. I think everybody’s worried about that. You know, is this the right time to be doing this? I think banks are getting to the point where the guys, they have to be out there ___ deals. I think credit committees are concerned, you know. They’re concerned.
Question: How do you go up from here?

It's on everybody's mind.

If a company's got really good growth potential, then maybe, just maybe, that seller's expectations are not higher. It is on their mind because of the company's great growth potential.

I think it's very, very deal specific. It's all in - like selling the search fund - it's what you can sell. I mean, it's your conviction about it, how good the whole story comes together. I think the last thing you want to do is over sell something you don't believe in. Because the only thing worse, I think - and I have not been in that situation but have talked to a couple others who are - I think the only thing worse than looking at not running a company is buying something you don't want. And being stuck with it. I've talked to a couple guys who say, everyday I go to work and I hate it. Because the good thing is, you're at the top of the pyramid. You do make your own decisions. The other side of that is you're the person who's accountable and when stuff goes wrong, it's your fault. It doesn't matter who it is that worked for you. So it's as much as what you believe in and what you can sell.

The only other thing I'd add is this old adage, you name the price and I'll name the terms. So they might have a seven times multiple and as long as you hit that multiple, you can make them take a seller's note or something that stretches out that price over a number of years so that it works for both parties. And the only other thing I'd say is that there's a lot of talk about how much money's out there, how much competition's out there, etc. You know, that's not going to change, unless you're willing to sort of put off a search for five years, these funds have raised so much capital that they're not running out of capital in the next five years. So you kind of have to live with that and we have to live with it. It's not going to get better in the future, I don't think.