Search Fund Panel
Transcript of Discussion
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Kevin Taweel, GSB '92
Scott Bekemeyer, GSB '93
Tim Briglin, GSB '95
Nick Mansour, GSB '96

Note: Minor edits have been made for greater clarity.

Contact the Center for Entrepreneurial Studies at 650-723-0887 with any questions.
Panelists: Peter Kelly, Kevin Taweel, Scott Bekemeyer, Tim Briglin, Nick Mansour

Peter: My name is Peter Kelly, Class of '89. I bought a company 5-1/2 years ago. It’s a home health care company, home respiratory services. The first couple years were rough, the last few years have been good. We’re still going strong; the outlook looks pretty good. Our original investor group is still together, but that doesn’t mean we didn’t have lots of interesting problems along the way. Next to me is Kevin Taweel.

Kevin: My name is Kevin Taweel. I graduated in '92. My partner, Jim Ellis, couldn’t be here. He’s class of ‘93. We bought a roadside assistance company almost four years ago. We OEM our product to the wireless companies of world and they sell our roadside assistance product to the end subscribers. In January of this year, we bought another company that provides insurance for cellular phones. Now we’ve got two enhanced services to the wireless industry and sell them ride-by-side in most retail locations across the country. We bought our company back in '95 for about $8.5M. We’ve been very fortunate to have ridden the wireless wave, and the company has grown a reasonable amount in that time. I guess that’s where we are now.

Peter: His company is Mr. Rescue. Anyone who has a cellular phone bill, go home and look at it. There’s a good chance it’s on there.

Kevin: There is a good chance it’s on there, and you have no idea. That’s how we make our money.

Scott: I’m Scott Bekemeyer. I closed a fund about 16 months ago and have been searching for a company. I’ve not bought a company yet. In fact, I think I’m the only one here on the panel who is still looking. Some of the industries I’m interested in are general business services as well as some light manufacturing opportunities. So I can comment more on the raising the money side, the search process, and some of the strategies there. You can rely on these guys for some of the transaction stuff.

Tim: My name is Tim Briglin, and I am not part of a search fund; I’m a partner in a firm called Green Mountain Partners. We’re trying to elbow our way onto the search fund landscape. In the last six months, we funded one individual who graduated from Harvard Business School about a year ago who was searching for a company. And we’re in the process of working with two other individuals, one who has raised a search fund and another who is deciding whether or not to raise a search fund.

The reason I’m here today is that Green Mountain Partners is interested in working with people who fit the search fund profile. We’re want to help them fund an investment once they find a company they want to acquire. Or possibly offer an alternative to people who
are thinking about raising a search fund but might want more independence than they get working with an investor group of 10-15 individuals.

What Green Mountain Partners does is we provide all the capital to make an investment instead of raising roughly 20% of the capital from your investor group and then raising the rest of the capital from mezzanine investors and senior lenders or from a seller. We write one check for the company. We’ve found it to be a very streamlined way to work with first-time investors which most search fund entrepreneurs are. It’s a terrific way to buy a company, and we have great partnerships with the early career LBO-types who we’ve worked with in the last six months. We’re in search of other entrepreneurs to work with.

Peter: Just curious. How many people here are first years? How about second years? Anybody from outside the business school? Great.

Scott: Is everybody clear on the search fund concept or would it help to review that? The search fund basically is for entrepreneurs who want to go out and find an existing business. I think the concept was for folks who didn’t necessarily have a lot of industry expertise or any money to go and find a group of investors who will support your efforts to search and then acquire a company.

Usually it’s a two-part process. I’m talking about the traditional model and not the one that Tim just described which also has a number of advantages. But traditionally we’ve gone to a group of investors who’ve put in anywhere from $20-30K for a unit. That unit usually carries the right of first refusal to invest in the eventual acquisition in exchange for their giving you money for that unit up-front. Typically the search funder will give them a stepped-up carried interest in the eventual acquisition.

In my case, I sold $25K units. One unit would have a stepped-up valuation in the ultimate acquisition of $35K. I’d automatically give that value to the investors for each unit. Then they’d also have the right to invest on a pro-rata basis on all the equity that’s required to complete the transaction.

I’m not quite sure what’s typical, but I think it’s been the experience of search funders that it’s anywhere from 1-4 years out there looking for a company. Then you stay in touch with your investors pretty well. At the time of the acquisition you put together an opportunity memorandum and get the equity that you need from them. Also do a leverage transaction where you have the senior financing and also mezzanine financing.

Question: ....discussing the search fund concept. How do you get investors interested in this kind of deal? Is it more effective now that there are success stories?

Scott: Yeah, I think it used to be a lot harder before you could demonstrate that the model had been successful. One of the benefits that I had going out raising money was that somebody who graduated from the ‘94 class of the GSB had done a study of investor
returns. I believe that it was a 40% IRR if an investor had invested an equal amount in all the search funds that had come out of Harvard and Stanford, maybe one out of Wharton as well.

So there is 1) you are sort of pitching the concept. 2) you are pitching yourself and there has got to be some element of your experience or your enthusiasm that lends itself well to this model.

Usually these guys have some affinity for somebody who wants to do something. They are excited by entrepreneurs who have energy. You go in there with a well-thought out case, identify opportunity areas, why you think you can do well in those opportunity areas, and just present your case. You are going to be turned down by your share, and your share of folks are going to say yes as well.

Kevin: As Scott pointed out, there are really two risks: the investment vehicle concept risk and the person risk. Ideally if you can find somebody who has invested in this concept and knows you, that’s the perfect candidate. But if you can’t, and I certainly didn’t in my case, you start with people who know at least one of the two and are comfortable with at least one of the two. People who have invested in it before, or people who know me. I think I ended up with the 13 investors of the initial round, I think 12 of them either had covered one of the two.

Peter: People didn’t know me and I did it early enough that most people didn’t know the investment vehicle. Two people did. So people who didn’t know it, didn’t invest, but I was more successful with people who knew someone that I’d worked with closely and someone who could recommend me as a good, hard-working, honest person. Then they drew conclusions about whether I was going to be effective or not.

Especially now I think, there is a lot of money that people want to put to work out there and not enough places to put it. So if they find someone like you who they think will find a good investment and has a good chance of running it, and they can risk a little bit of money up-front to fund your full-time search.

$20-30K for a lot of investors (the kind you are looking for) is not that much. They don’t have to commit the big money until they see what you actually find. When they see what you find, by that time they’ve gotten to know you a little bit because you’ve presented a couple other opportunities to them perhaps. Then they get to see it, touch it, kick the tires (in Kevin’s case, really kick the tires) and they will be a lot more comfortable.

It really does make sense for investors...there are three stages of risk: raising the money, finding and completing the deal, and then running the company afterwards. I think the first one is the least difficult, the least risky, especially today.
Tim: Did you guys look for a particular industry? When you were seeking investors, did you say you were looking for a health care company and you were looking for a roadside assistance company?

Peter: We had four industries we were looking at when we were pitching investors. We looked at them and didn’t buy a company in any of them.

Kevin: I actually ditched health care at the time. That was sort of the thing I wanted to be doing, but never came close to it. Once I got more deeply into healthcare, I didn’t like it.

Question: How much of the equity do you give to investors and how much do you keep?

Peter: Enough so it looks like they’ll get a good return and enough so that you feel comfortable that you are going to make enough money to be satisfied. I think it varies. What do you think, Kevin?

Kevin: Yes, it varies. In our case, there are two of us and we ended up with 27%. I’d say the more recent ones, if there is a single individual, are closer to 20%.

Peter: We were 30% with two of us.

Kevin: It seems to have come down over the years, unfortunately.

Peter: If it’s a smaller company, there may be a bigger carry rate. It depends... if it’s a very, very large company, it would probably be a smaller percent, but I think a typical transaction size, an average one is maybe $15M. Ours was actually $6M. I know several around $20M.

Kevin: That’s where they end up. You back into that number, right? You’ve got the company and you’ve got these projections. What you really target is the 35% IRR to the investors. Really, whatever is left over is yours.

Peter: You have to be happy with whatever is left over, or you are not going to want to do it.

Question: What kind of IRR do investors expect?

Peter: We told them that we’d look for above average returns for this sort of investment. At the time, we were looking for about 40%. It’s somewhere around there.

Nick: I’m Nick. I’m still in a search fund right now. I’ve been looking for about a year and a half. Sorry I’m late, I got hung up on 101.
My partner and I were close to doing a deal back in roughly the December time frame that was a larger deal, a much larger deal. It was about a $65M purchase price at the time. On that size deal we estimated roughly 18-20% between the two of us at the 35% IRR.

We’ve since looked at some smaller deals as well in a typical range. I’d say 25-30% is probably what we’d get between the two of us, although the weighting people typically use is about 1/3 at close, 1/3 investing, and 1/3 for performance based. I think the weighting has come down in terms of how much you get at close; it’s skinnier. And how much is performance-based has gone up.

Tim: We’re actually probably a little less sophisticated in that the deal sponsors and the “search funders” that we’ve worked with, we pretty much negotiate a flat amount of equity up-front. That amount is usually in the 25-35% of the common equity in the deal. We’ll have a incentive equity piece if the deal achieves a certain IRR. I think we’re probably a little more generous than the search fund.

Question: How much of the financing is equity?

Tim: Roughly a quarter, 25%.

Nick: In our deal, about half was equity.

Kevin: Ours was about half as well. It was structured 1/2 common stock and 1/2 subordinated debt. The subordinated debt was all taken by the investors.

Nick: Actually, let me clarify. 25% was investor capital and then that was structured as half subordinated debt to the investors and half is equity. So the equity itself is about 12.5%.

Question: There’s a revolution going on -- right now we have the tremendous opportunity to get funding and start internet companies. What would you do if you were graduating now?

Scott: Kevin came up to me and said he’d just spent a couple hours on the phone talking about internet ideas this afternoon.

Kevin: I was a case writer for Irv for a year, so I had a year to think about it. I think it really depends on the person obviously and what their risk profile is like. I really wanted to start a company, but at that time had no particularly good idea or particular expertise with which to start a company. If I were coming up now, I’d certainly be on the bandwagon of the Internet, no question about it.

Nick: We’ve been looking for 1.5 years. The Internet bandwagon was big when we got funded and it’s gotten huge since. So I think I’m not quite sure what I’d do. It would be a
tough decision. I think I would take a much more serious look at it now than I did at the time.

I think part of the trade off you have to make is what you want to do, at the end of the day. My last roommate started an Internet company and has done phenomenally well. I think this guy in his second year is close to 100 employees now. The ramp is huge. Now, how much longer he’s going to be the CEO of that company, I’m not sure. So to me that’s a big part of the decision - how much control you want to have. I think you have to weigh off how important that is to you as well.

Question: What about the pros and cons of the partnership approach? I thought I heard a lot of you say you had partners.

Kevin: Jim (my partner) and I practically live together. Nick has a partner and Peter had a partner. It’s actually a pretty good mix. For myself, I have to say I started out alone and wasn’t looking for a partner. Jim was the case writer after I was and we got to know each other.

It just so happened that the opportunity that I was looking at during the summer of ‘94 happened to be something that lent itself to two people as opposed to one. It was really a roll-up opportunity. It was a roll-up of the roadside assistance industry which has been done a couple times over.

So we happened to know each other. We felt we worked well with each other. Then this opportunity of the company we bought worked out of that. Although I didn’t start with the idea of having a partner, it’s been a tremendous experience for us. It’s really worked out. We got to know each other over a longer period of time. We’re at the same stage of life -- we wanted the same things. It’s been very positive.

I think we did end up building a bigger company than we would have if it had just been one of us.

Peter: I think it’s a personal decision. Other people who have done it have said they’d never do it with a partner. They absolutely would do it by themselves. I did it with a partner. It didn’t work out after we bought the business and he ended up leaving. In retrospect, I respected him tremendously. I would have probably have chosen him again if I was in the same situation, but I much prefer to run the company on my own. If I did it again, I’d do it by myself. But it can work out great. Higher highs, lower lows with a partner.

Nick: Lower lows?

Peter: I think so.
Nick: I think that one of the benefits of a partner is the lows aren’t quite as low. But Peter doesn’t give that impression.

Peter: My situation was unusual.

Nick: Hopefully the highs are higher. The emotional support is a big thing. But if that’s the only reason you want a partner, then it’s probably not the right reason to do it. My partner and I have very complimentary skills. We look at the world almost in completely different ways. So that creates some tension that at times decisions get more difficult and things take longer. At the same time, there are probably a million opportunities that I would have said no to that he’s saying yes to that we probably should be saying yes to and vice versa.

Peter: I should say I’m not sure we would have bought the company if we weren’t a partnership when we did. I don’t regret doing it the way I did it, but next time I would do it myself. The “next” meaning if I sell this company and go buy another, I’ll absolutely do it myself.

Scott: Just to lend some balance, I am doing it alone. It can get lonely out there. It’s nice that there is a sort of community of other people whether they are alone themselves or have partners that you can rely on and commiserate with. But I would reiterate Nick’s comment that if it’s just for companion-ship, you don’t want a partner. Really make sure that you guys work together well and you have something complimentary to offer one another. I would have been happy for a partner if there was somebody who met that criteria.

Question: Tim, what do you look for when you invest in search funds? What is the profile of the typical search funder? Are there commonalities of backgrounds?

Tim: It’s actually pretty simple from our perspective. There are two things that all these folks share that we’re interested in working with: 1) the ability to find and manage a company and 2) lack of capital.

Kevin: Your standards are very high! (Laughter)

Tim: Not exactly. Green Mountain Partners has traditionally worked with deal sponsors who are more ex-M&A banker types. They are all interested in doing deals. They find nice companies to invest in but they haven’t raised an equity fund. They bring those deals to our attention. That’s historically what we’ve done.

We’ve kind of shifted our model more to working with management-types, people who are interested in actually running the company once the deal is consummated. But again, they haven’t raised pools of capital that they can invest. They basically use Green Mountain Partners as their equity fund.
Kevin: Why did you switch your focus?

Tim: We found that in small companies there is always a pothole that you are going to run into. With a deal sponsor who has management experience, who can step in and augment the current management team, or wants to run the company from day one, it’s a much greater degree of comfort for our investor group. It’s been a very smooth transition.

Question: Has anyone failed to close a deal?

Scott: That’s happened. Some folks, if they run out of money, will raise subsequent money after their fund expires or some people just won’t continue. They’ll go find a job.

Kevin: As a matter of fact, that’s happened recently. A couple funds have folded up in the last few months. They’d been looking for a couple years and for whatever reason, different personal reasons, they decided not to continue. I only know of one gentleman; he’s actually a private investor with an investment fund now.

Question: Do they pay any part of the money back?

Kevin: Of the original amount? I don’t think anybody expects them to.

Nick: I know one of the guys who did return the money to his investors...I shouldn’t say “did”. They certainly didn’t make enough during the search fund to be able to turn around and pay it all back, but he plans to. I know that his investors did not expect him to do that. So that was his personal decision.

Question: Do some people have a regular job and do this on the side?

Peter: I think the success rate is much higher when you commit 100% of your time. I think investors are starting to recognize that.

Kevin: I think it would be difficult to convince an investor to give you the money if you weren’t going to spend all your time...

Peter: Some people have done it because it may require less money to do it, but it’s hard enough to do with all your time.

Scott: The purpose of the fund is so you can dedicate yourself 100%. You are not going to take a market salary, but you can get enough to live on and really dedicate yourself to the search.

Peter: You are getting enough to live on then? (Laughter)

Tim: As an alternative, there is a guy that Green Mountain Partners just backed -- for the 18 months after this fellow graduated from business school, he basically did small
company consulting. Basically through a lot of his client work, he looked for a company at the same time.

In taking that route, he chose not to raise a search fund and paid for the groceries through this consulting business. If you asked him about it, I think he’d say it’s a much tougher route to go, but at the same time he really got his hands into some businesses which helped him find the company he eventually acquired and is running now.

Question: Where do the deals come from?

Peter: It’s different for different people.

Scott: That’s a great question. I’m struggling with it right now. There are a lot of different ways deals come in. From a lot of different angles. I think probably all of us had industries that we identified as target industries. You can get information on targets and go out and contact them yourself and try to generate deals that aren’t represented by a broker. There is a large broker community out there as well which is happy to sell you a company. Typically it’s going to be more of an auction environment where it’s sold at the higher end of the price range.

I think people historically have done well going either route. There can be an opportunity out there under any rock. That’s been my personal philosophy. I’ve been trying to source deals as well as work with a broker community. I guess I don’t think there is a right answer necessarily.

Peter: Two ways people have tried is to use a network of professional contacts like lawyers and attorneys to get into companies that they just know are really good and work their network more. The approach we took more was research which was to identify an industry and really delve in and try to understand it and understand who is in it and talk to people, but process a lot and talk to a lot of companies through volume and find the right opportunity for us. It’s tough.

What I hear lately is it’s gotten maybe a little tougher, a little more competitive because there is a little more money chasing smaller deals. I talked about this before: the risk of raising the money, the risk of finding the deal, and the risk of running a company. Finding a deal sounds like it’s the toughest thing to do now.

Question: Nick, is that how you look for companies?

Nick: Yes, we prefer more the former. The way Peter did it which is do a lot of research, find industries we like, and go out and talk to companies. We probably spend about 80% of our time doing that and about 20% finding deal brokers or going through deal brokers, investment banks. We have tried a lot of methods within that. Everything from almost straight cold calls to companies which you are going to get a lot of “nos” to...one way is a hybrid.
We find an industry we like and early on try to identify a broker who specializes in that industry or a consultant who only works in that industry. Someone who basically knows everybody in that industry and has some credibility in it. We get them to represent us. They get some fee if they bring us a deal.

It has two advantages: 1) they have more credibility when they knock on the door and say, ‘I’m representing this group,’ than you do sort of calling them out of the cold and saying, ‘Hey, do you want to sell your company?’ 2) Believe it or not, your scarcest resource is still your time. So you can almost say this guy is working on this industry and he’s going to bring me deals. I’m going to go start spending more of my time looking for other deals while he’s calling you every other day and saying, “Hey, this company looks good.”

Tim: To add to Nick’s answer a little bit, we’ve been talking to a search fund in Denver that is interested in the animal health industry. Similar to that strategy what they’ve done is they’ve identified two folks in the industry that they call river guides which I thought was an interesting moniker. Basically these guys are old hands in the industry who now are semi-retired and do some consulting. But basically they took these guys under their wing because they were young entrepreneurs and they were interested in what they were doing. These guys have really opened a lot of doors in the industry for them. They’ve taken them to national trade shows and introduced them around to specific types of companies that they are interested in. I think that opened a lot of doors for them.

Question: Is knowing Professor Grousbeck the key to getting investors? And, how important are your investors?

Nick: They are huge. I’m going to skip the Grousbeck question for a second. Yes, we draw heavily from our investors. We’ve got roughly 18 investors which is probably more than you need. But we do have 18. They come from roughly two areas of the world. About 1/3 are professional investors themselves; guys and women who have done this for a living since before I was born. (Definitely for some of them.) The other 1/2 to 2/3s are men and women who are entrepreneurs, actually running the companies.

We call on probably 5-6 of them with a fair amount of frequency. You pretty quickly realize who is more responsive and who adds more value and where their strengths and weaknesses are. Some of our investors are adding more value now when we are looking at opportunities whereas some of the others are going to be a lot more valuable once we are in the company. One guy is great at reading sellers and trying to figure out how bought into the selling process they are. I don’t have much more to say on that.

Kevin: We found that our sponsor group some of the folks were helpful when we were actually acquiring a company. You are going through this for the first time. A lot of it is very new. Certainly you will hire your attorneys and your accountants to help you through, but having some folks alongside you who have done it is a tremendous asset.
Since running the company, our board is made up of all of our investors. They are a tremendous asset. We have quarterly board meetings, but we call on them all the time for advice and help. The way we look at our folks is (and this is one way to contrast with Tim’s situation) is it’s really a lifelong relationship. If you can (you can’t always do this) you’d like to develop a group of investors or sponsors that are people that you can work with for many years to come. This is only the first step in the process. The way we’ve always treated it is if you are working with these people and you do a good job for these people, whether or not you actually find a company or get to run a company, if you work well with these folks there are going to be plenty of opportunities in other ways to work with them in the future even if it doesn’t work out this time. We see that as our most valuable asset.

Nick: I think we should answer the Grousebeck side of it because it often comes up. I’ve heard it termed sort of the Grousebeck Mafia. I was a case writer. Kevin was a case writer. Irv (Professor Grousebeck) has been a big help to my partner and I in raising the search fund and a big help in looking at opportunities, and there is no doubt that having him give me and my partner a good reference has been very beneficial to this whole thing.

While I say that, there is no such thing as a Grousebeck Mafia. Anybody he ever introduced me to is a very sophisticated investor. If they didn’t want to back us, believe me they would say no. But, there’s no doubt that he’s a great resource; he’s seen the search fund more than anybody else has. If you are really thinking about it, I would recommend building a relationship with him. That said, plenty of people have done it without knowing Irv. It’s not going to make or break your search fund.

Question: What do your families think about what you’re doing?

Peter: Are you talking about our spouses?... Yeah, it can be difficult. There are tough times, but they’ll support you if it’s something that you are compelled to do.

Kevin: If you do have a spouse, you don’t want to go into this alone. As with everything, you want to make sure you are on board together. In my case (and I think it’s happened in a number of cases) you don’t get (particularly during certain processes) a lot of money up front, so it helps if your spouse is working. Fortunately my spouse was a classmate and she went to work at BCG, so she was able to fund us. She was also totally on board, loved the idea, and backed me 100%.

Peter: I didn’t have a spouse who was working and times can be tight, but the economics have to work so you can get by.

Nick: I think spousal support is huge. My wife, who was just my girlfriend at the time, was telling me she was behind my decision. She is getting her Ph.D. right now, so she’s probably worse than me being on my own. I’m the big bread winner right now (Laughter), but she’s been great.
My family...people have no idea what you are doing. They are kind of scratching their head. This is the way I perceived it anyway...my cousins and all these people say, ‘you are trying to do what? And you’ve never run a business.’ You kind of get over this hurdle where after six months they just quit asking you what the heck is going on.

My parents, I think, have a vague idea of what I’m trying to do. They keep describing me as a venture capitalist, which is giving me more credit than I deserve. I’m more concerned personally about what my wife’s parents think about what’s going on. Because, if my parents think I’m crazy, they raised me. But to her parents, I’m supposed to be supporting her...whatever! I’ve actively made sure everybody felt OK with what was going on. I think you have to do that to make it work.

Question: Has the search fund been successful on the international market? What differences will come out? Like with Asia, do investors seem a little more cautious giving a young, smart person large amounts of money? What do they think about that?

Kevin: I know of one gentleman who graduated a couple years ago who focused his search in Puerto Rico and I don’t know...do you guys know? Did he ever buy something?

Nick: He was in my class; he’s still looking. That’s the only international try at this point.

Tim: There’s been one done in England.

Peter: Successfully?

Tim: Still looking. Trying to raise a fund.

Peter: I’d say the Puerto Rico one may be too small a focus. Maybe not. I shouldn’t say that because they are kind of into that focus too. Are you saying do you think international investors would do it? Or, do you think you’d actually buy a company? I think you have to break it down into the risk. Can you find it? Will they do a deal with somebody who is young and looks young and inexperienced to them? Or can you get money from international investors? I don’t know about the first. The second, I think yeah. I mean it’s tough, but first, you’re selling yourself. Then you’re just selling yourself in a different way to someone who wants to get rid of their company.

Nick: I can give you the guy’s name who was doing it in Puerto Rico and his number. He’s happy to talk at any rate. I think you have to sell your investors on why you are good for wherever you are looking at and on that market as well.

He probably ended up with a mix of roughly half people who were living in Puerto Rico (half Puerto Rican investors) and half U.S. investors. You could probably do that in other instances as well. You have to be prepared to move to wherever you want to go. I think it would be hard to try to do a search fund from San Francisco looking at opportunities in Asia. It wouldn’t be very practical.
Scott: One obstacle which I discovered looking at an opportunity in Canada, which you’d think would be fairly common, and I know Nick had looked at one there as well, was just the availability of financing on the same sort of traditional terms that are in the U.S.

I was at an investment bank that was interested in supplying the senior and some additional portion. I kept discussing mezzanine and mezzanine-like returns. And it became obvious during the conversation that they’d never heard of mezzanine. This whole mezzanine industry which has really grown in the U.S. really didn’t exist in the same way, even in Canada. There are a lot of tax reasons why it exists here in the U.S. So it’s just a lot of little things that add up to make it a little more difficult, I think to do it in the same traditional way. Not to say that it couldn’t be done in a different way though.

Nick: Actually, to build on Peter’s point, the guy from Puerto Rico does feel at times that they picked a little bit too small a market. The benefits are there are not many other people doing what he’s going. You can quickly learn who the key people in the market are. You can also probably pretty quickly figure out all the companies that are your targets too.

Question: First question, with this group of investors it almost seems like you have a captive audience who you are pitching to on a little road show. I am curious how often you might present an idea that maybe a significant portion is interested in and a significant portion isn’t. Do you just drop that business until you get everyone on board or just take that group of interested investors and go look for other funding? How do you decide how big your original search fund is going to be? Do you do a budget? What about a salary for yourself? How do you handle that?

Peter: Your first question, I know these guys each have key people, advisors that they trust and people who, I don’t know if they’ve invested more than anybody else, but just advisors they trust, they depend on who other people also look to for some leadership.

If you feel that you are getting momentum with an idea, you just go with it. Hopefully, everyone else will go with it. It’s a consensus building process along the way. You are distributing information to everybody, trying to get everybody going in the right direction, knowing that one or two or three might not do it. But if it is a good idea, it should get funded. Did everybody invest in yours?

Kevin: Almost everybody except for a couple of small funds, I think what you’ve got to do is if you really like the idea, you’re going to probably move forward if the key folks that you look to for support and that you really want to come with you in your investor group are going to go with you. If a few folks don’t (and for many different reasons, some people will not) you are going to go ahead anyway. If you can’t get the support of people you feel are your key investors, then you will probably back out.
Peter: Everybody but one invested in our deal, but we built consensus pretty well. There was one deal that I really liked that we thought about doing, but a couple key investors just couldn’t get comfortable with it. We didn’t want to do it at that point, because we really trusted and respected their opinions.

Nick: Like I said, we had 18 investors. A deal that we were close to doing, three people wouldn’t have invested in it. None of which were the more active handful of people. I think one of them is a pretty active guy, but he didn’t invest for personal reasons, not for the deal. I think it’s great if you can get everybody. When you have 18, we expect somebody to not like a deal or not want to do it for whatever reason.

In terms of the budget, yeah, we absolutely tried to sit down and certainly showed what our salary was going to be and tried to figure out what we thought office expenses and travel etc. were going to be. Then we worked back from that.

Kevin: I wouldn’t waste a lot of time on that one. I’d look at some of the search fund documents that have been created. Start with those and then talk to a few more recent people who’ve been out there and get a sense of what truly were the costs of searching. What you’ll find is your burn rate can be pretty low, but as soon as you start looking more deeply into a deal, then it goes up pretty fast.

Scott: One thing also to keep in mind with regard to the investors and the investor group dynamic is just how familiar all the investors are with one another. If there are clear opinion leaders going, then one person may lead a number of people’s opinion. If you get 10-12 people who really don’t know each other at all, then at some point you are going to be herding cats trying to get everybody together. But you also have some protection there in case somebody really doesn’t like it, it’s not going to poison a larger group.

Question: What happens if you’re oversubscribed on the deal? Do you pick and choose which investors you’ll go forward with?

Kevin: In our transaction, we were in the fortunate position we were oversubscribed and we had...it wasn’t a particularly fun process. We ended up sort of rationing the available equity among the shareholders.

Peter: You could just cut everybody back?

Kevin: We didn’t cut anybody out entirely.

Nick: We were oversubscribed. We didn’t do the deal, but we were oversubscribed. If it’s a good deal, you will find that raising the money is not a problem, especially now.

Question: Do you focus on industries that have things that you enjoy doing or more in things that are profitable to turn around and sell in a couple of years?
Peter: In my case, it was the latter first, but the former is really important. You need to be happy there. We didn’t look at the mortuary business at all, for instance. Seriously. I did this because I didn’t feel compelled to start a company, but I really wanted to run a company. I thought this was a less risky way to be running a company and have a good return, but have a great job too. There weren’t a lot of other things I was excited about doing. So it’s got to be something that you like doing.

There are probably a hundred industries I would have been interested in doing and 50 that I’d have been perfectly happy...I like this one. It’s health care. We do our jobs well every day. People are happy and you see a lot of return on that. The people who work at your company get a lot of psychic benefit from that. So that’s important, but I don’t think you can say you are only going with certain industries.

Kevin: I was more interested in running a company as opposed to the specific industry. I would have been happy, probably not in the mortuary industry, but happy in most industries. We certainly focused more on the latter. Really, our criteria got whittled down over time. We had all these great sets of criteria and then at the end it came down to, all right we’re looking for industries with profitable companies that have at least more than 50 in the price range we’re looking for. That was about it. You want to know that at least if you are going to invest the time in that industry, you are not going to waste it by making three phones calls and finding out that nobody is interested in selling.

Question: What did you tell your investors about the time frame of your exit?

Peter: We told them we were shooting for 5-7 years, because we wanted to take people who were patient. It’s a good thing we did. Actually, in our position now after you’ve been in it for awhile it’s sort of a yearly decision. What do you really think the future is? Do you think you can get better returns in this business or in a new one with your money and with their money?

Some industries there will clearly be no public option to go because of liquidity. I think an IPO is not really a liquidity option here. It’s just a step in that direction. It just depends on the industry, but I think selling the company, in general in the industries we were looking at, it made sense because they were consolidating industries. That was always one you could say, well we could always sell it but we’d like to maybe go public. If we can achieve this, then maybe we can go public.

Scott: Because an increasing proportion of the entrepreneur’s equity is tied to performance, I think you are going to have an eye on the IRR meter. That’s going to judge also when your exit is. So probably a five year exit is what you project. You can also re-capitalize the company in addition to selling it. You have a number of options as well.

Question: But if I was an investor who wanted to get out early, what could I do?
Peter: Sell your shares for whatever the market value is. If there is not a real market value for it, how bad do you want to exit? If someone came to Kevin today, he might judge his market value to be $X M, but it's not very liquid. He might say, if you want out I'll pay you 70% of X. See if one of the other partners will buy it for 75% of X.

But most of the time I think they're saying it's five years. Think five years out when you first buy a company. Selling, maybe public or a good chance would be re-capitalization to take out some of it. I know a number of people who have done that.

Kevin: Remember when you are actually running the company, there is going to be a board. More than likely the board is going to be made up of your investors. They are going to be looking out for what is the best interest of the entire group of shareholders. So it's not going to be your sole decision. It's not as though one investor is going to come to you and look to you personally as being responsible for getting liquidity to him. There is really a board that's going to be responsible for that.

In our case right now, we're actually providing a liquidity event in a couple months. We're very simply going to our senior lender and we're going to raise $10 M from them and we're asking our shareholders if they want to sell shares back to the company.

Peter: One of the nice things about having a good board (and it's very important) is that you don't need the board when you are looking for a company necessarily. Some people have, but I think most people have not formed the board until they've bought the company. They just had an informal group and you sort of see who emerges as somebody who is a good advisor for you and someone you trust.

Question: So the investors have the right to invest, to put up the money to buy the company. What benefit do they get for having funded you for the first three years compared to those who invest later? What advantage do they have for funding you $25 K up front as opposed to someone has a great idea?

Kevin: The investor is essentially buying an option. If you don't invest in the first round, you do not have the right to invest in the second round.

Nick: There is a chance that you won't need any more money from outside investors, so if you don't invest in that first round you won't get another chance. The other thing they also get is that $25 K usually gets stepped up into some value in the company. The typical number I think is a 50% step-up. I invest $25 K today and whenever the company is bought, that $25 K converts into $37.5 K just like any other money.

Peter: We had people say that when you find a company, come back. We say, thank you but we plan not to come back. For our investors, this is their own private venture capital fund that's going to have great returns and this is why it's going to have great returns. But if you don't invest, you don't get a chance.
Nick: I think that unless you do a really big deal you probably are not going to need too many outside investors, unless people in your investor group don’t want to do the deal. In which case, you have to think really hard about doing it yourself.

Kevin: If there is a big deal, then it’s likely you will look for institutional capital before going to specific individuals. In your case, did you contact institutions?

Nick: No. Well...what do you call Housatonic Partners? No, we had at least three very deep-pocketed investors that prefer to put in more than $1M in whatever deal it is. We were going to raise $15M dollars and even then we were cutting people back.

Peter: I’ve been out of touch for a little while, except with my current partners, but I think for someone who wants to invest $100-500K in a deal like this directly, there are not that many opportunities to have someone go and find them a great deal. They may have friends or contacts here and there, but that’s sort of a random process who may bring them a good deal. But to have someone who is really like their own venture capital firm, one-time deal to find a great opportunity for them is somewhat rare.

Even at that level, I’m not sure that all of them can invest in venture capital funds. I think the stated minimum for most venture funds now is $1M and they’ll let other people in below that sometimes, but not always. So this is really a window for them. If they like you and are compelled by what you are trying to do, then it’s really an exciting thing. It really makes sense if you are going to find a good deal. It makes sense for a lot of investors to want to do that. The question is do they think you are going to find a good deal and be OK with it.

Anybody on the verge of doing a search fund, raising money?

Answer: (A couple hands raised.)

Peter: Good. It’s doable. It’s scary but fun.

Comment: My wife’s not so sure it will be fun. (Laughter)

Nick: You know the biggest hurdle with your spouse is going to be the whole relocation thing. My wife’s expectations got set pretty low early on. My apologies to anybody who is from Tulsa. A friend of ours was looking at a deal in Tulsa when I was making the decision. That’s kind of where her sights got set, but even today the first question whenever we look at a deal is, she doesn’t care what it’s doing, it’s ‘where is it going to be?’

Kevin: When we bought our company, we had to move to Houston for a year. My apologies to all the Texans, but Houston is not a fun place to live.

Peter: It was just a year, right?
Kevin: That’s true. We moved to Houston for a year and we were able to move back after a year. We’re very fortunate. We’ve run the company for four years, three of those years have been from right here. There are only three of us in the office in San Mateo, and we’ve got 400 employees scattered between Houston and Nashville and other places, but we get to live here. It worked out, but we did have to do a year of penance.

Peter: I moved to Bakersfield for three years (3+) and convinced my girlfriend at the time to follow me there. We got married while we were there, but it wasn’t the best thing – it was in the bottom 10 of the places we probably would have chosen. But also, for a year you are working pretty hard and it’s just at that really exciting time. So it’s not that difficult for you, but for your spouse the question is how can s/he handle it.

Question: I have a question on the international side. I have a friend who’s from Spain. I think his company did $5M and he raised money in the U.S. What do you give in exchange for the investment?

Peter: They have partnership shares in our case or they buy stock in the company. The agreement pretty much says you are going to do your best to look for a company and if you don’t find it and spend all their money they don’t get anything. They get shares, common equity in your company.

Question: But how do you make business people trust you? Pay you a million up front or whatever for equity in a company you haven’t found yet?

Peter: I think they invest $25K per unit now. So it’s not a million. They are less concerned with it, but $25K is still a lot. They come to trust you personally.

Most of our success was raising money from people who knew people we knew. We really didn’t raise much from people we knew very well. But people who knew people that we worked with for the most part, who could say ‘those guys worked hard, they are bright guys, they are good people, I know them well, you can trust them.’ Then a lot of it is on faith.

Kevin: I don’t think you are going to have a problem. With the investor group you are going to be looking at, you probably are not going to have a problem with them trusting you and whether you are going to take off with their money. Your big challenge is going to be convincing them that there is something special that you have that you can do in Spain that makes sense.

Peter: It’s amazing how quickly these people make the decision. At least when we were raising money, it sort of happens in a half hour or it doesn’t.

Nick: We had a 20 minute meeting, and he was one of our first investors. I didn’t really insult him, but I came close to insulting him, let’s put it that way. I certainly stuck my
foot in my mouth. He kind of looked at us, not based on me sticking my foot in my mouth, but after we gave our whole spiel and he said, "You know, I really believe that you should know the industry you are going to get into and this is the exact opposite of that philosophy. But this sounds interesting, so you can count me in."

We sold our second unit to that guy. He took it on a flyer. So it can be that quick, but we had some people who said give me a couple weeks and I'll let you know. That was probably the longest window - two weeks. People are going to decide quickly.

Peter: You want people who can invest. Our minimum threshold was $100K. We said, however many units you take, we want you to be able to invest at least $100K in the deal. We didn't want people whose lifestyles would change if they lost the money for instance. We just wanted people who were sophisticated investors.

Question: How many people do you talk to? Just to get an idea of how you work out the number of contacts you have to make?

Kevin: For the investors?

Comment: Yeah

Kevin: Obviously there is no formula. We can all talk about our individual experiences. I have one group of friends who cold-called hundreds of people before getting their investors.

Our hit rate was very good. Going along with what Nick said a little while ago, having worked for Irv really helps a lot in raising the money. My hit rate was better than 50%. It was probably 60-65% and it was pretty quick. I'd worked for Irv, and I went to those people who'd invested in a search fund before. All they had to do was call Irv and presumably I did a good job for him, so he said good things about me.

Peter: I didn't work for Irv; I took his class. He knew some people that I'd worked with and I think back, I think raised maybe 25%. We had some more places we could go at the end, but you have no idea how many people can and would be interested in investing in us. There are a lot more than you probably can think of right now. But you have to come up with a plan that you are so confident in that when you go out you go to everybody and you'll find the people.

Scott: Your hit rate also really increases as you get the first couple. For me it was hard to get the first couple. I wasn't a case writer and my prior experience was with a failed business, an airline that I co-founded. I'm starting out not really knowing anybody either as well. After getting the first couple, it really was easy from there. I don't know what my overall percentage was, but it was probably under 25%. But it can be done, whether or not you've been case writer and have a close relationship with Irv or not.
Peter: There are people who you think, this person should invest. And they won’t. And other people, you don’t think will and you go meet them and it just clicks.

Nick: Our hit rate was probably around 50% as well. But that said, we had a long list of people that could have... If our hit rate had been 10%, I’m sure we would have eventually contacted them.

The last few units, you are basically very careful. We were very careful about which people we were talking to because you don’t really want to get into the situation where you pitch somebody, they say, yeah. Then you say, well sorry but I’ll come back to you later or whatever. So we were honing down at the end and we pretty much hit it right on.

Kevin: You really are selling something. You would not believe how things change once you let people know that if you are raising say 12 units, ‘we’ve got our seventh unit and there are about 10-12 people out there vying for the last five.’ You would not believe how much excitement that creates. The hump for us was probably at 5-6. The last ones just go within a week.

Question: How many people already understand the concept?

Peter: For the longest time, most people didn’t know about it. I think I was the 3rd or 4th to do it. Fewer people laugh at you than you think.

Kevin: Not to your face!

Peter: You and your peers probably have less confidence in yourselves than you should. And less than older people do. That was true when I came out of the business school. Believe some of the things people say about you; as a group, you are going to be tremendously successful. There are people out there that it will just make sense to.

For us, it was really ex-entrepreneurs or current entrepreneurs. Maybe they saw something of themselves in us. The venture capital people, some of whom I knew very well, it didn’t make as much sense to, but the entrepreneurs really clicked. Maybe they saw the same thing except 20 years later.

Nick: They were about 50% of the people who had invested in search funds before and people who didn’t have any idea what they were.

Kevin: We were a little bit higher. We were 60-70%.

Scott: Having a tie to the GSB was helpful for a lot of my investors, either they knew somebody or they graduated from the GSB. That strengthened my case because the model really came out of here or a lot was done out of here. They had that affinity going in. That was helpful.
Nick: I think the guys that cold called hundreds of people actually got a GSB alumni book and cold called people out of the alumni book.

Kevin: Yes, they did.

Tim: I think the concept is a lot more widespread in the last couple of years. In the last year I’ve gone to 5-6 different business schools to talk to entrepreneur clubs about search funds and this type of investing.

Five years ago no one at other schools would have heard of a search fund. Now there are people in the last couple classes who have raised them. I think that’s going to continue in the future. I think the community is definitely growing in terms of the people who are raising them and also in terms of the investor base out there.

Nick: There are a few investor groups out there that look toward search funds that you should try to get in touch with. There is a group of lawyers (I don’t know if they are all lawyers, but some of them are) in Santa Barbara that have thrown their money together into a partnership which is called the Stanford GSB Search Fund Partnership. You can guess what they are looking to invest in. There is some organized capital looking to do this sort of thing and interested in meeting with people trying to do it.

Peter: Deal flow is the harder thing. Especially now, there is just so much more capital out there that it makes deals harder than raising the money. Maybe now is a really good time to go internationally because maybe the idea is filtering over there enough that it will make sense to people.

- End -