



A PRIMER ON SEARCH FUNDS

A PRACTICAL GUIDE TO ENTREPRENEURS EMBARKING ON A SEARCH FUND

INTRODUCTION

There are multiple ways into the world of entrepreneurship, including buying an existing business. For prospective entrepreneurs who are motivated by the desire to build and manage their own business, but who may lack an idea or the desire to start a company from scratch, acquiring a small business may be an excellent option to consider.

In 1984, H. Irving Grousbeck pioneered a new investment vehicle, commonly termed a “Search Fund,” with the aim of allowing young aspiring entrepreneurs the opportunity to search for, acquire, manage, and grow a company. “It’s the most direct route to owning a company that you yourself manage,” Grousbeck said.

In the past several years, the search fund model has gained popularity. When the Center for Entrepreneurial Studies (CES) at the Stanford Graduate School of Business conducted its first Search Fund Study at the end of 1996, it identified 20 first-time search funds. The number had grown to 258 by the end of 2015. While originally popular among newly minted MBAs, the search fund model has captured the interest of many mid-level managers, with anywhere from one-third to one-half of new “search funders” raising their funds 2 to 10 years after leaving business school. The entrepreneurial aspect, the challenge of growing an existing company, and the independence of ownership draw people to the search fund model, as do the 36.7 percent internal rate of return (IRR) and 8.4x multiple of investment (as of the 2016 Study). The search fund model is not without risks, however. More than one in four search funds have not acquired a company despite the principal(s) spending 24 months in this pursuit.

This *Primer on Search Funds* is intended for those seriously considering the search fund route. It attempts to answer the most frequently asked questions raised by people embarking on the process. The *Primer* aims to provide an unbiased view of the benefits and challenges, explain the model from the entrepreneurs’ and the investors’ perspectives, and share operational and execution tips provided by search fund entrepreneurs. In preparing this guide, we have spoken to and drawn from the experience of numerous entrepreneurs, GSB and HBS faculty, and search fund investors.

The document is divided into several parts:

- Part I introduces the search fund model, provides data on previous search fund entrepreneurs and investment returns, and asks the readers to question whether the search fund model is appropriate for them.
- Part II addresses fundraising.
- Part III explains the economics of a search fund.
- Part IV explores setting criteria as a framework for finding suitable acquisitions and evaluating industries.
- Part V explores the process of searching for acquisition candidates.
- Part VI discusses evaluating acquisition opportunities and the acquisition process.
- Part VII focuses on the transition of ownership and management once an acquisition is completed.

- Exhibits 1-25 provide sample memos and other documents.

Please note for simplicity we refer to “search fund entrepreneurs” as singular, even though many search funds are undertaken in a partnership by a pair of entrepreneurs.

Peter Kelly, Lecturer, and Sara Rosenthal, Senior Case Writer, oversaw this revision, drawing extensively on previous versions and the input of many searchers and search fund investors. Coley Andrews (GSB 2009) and Lecturer David Dodson contributed significantly to this update. Elad Benjamin created the original version, and the law firms Choate, Hall & Steward LLP and Perkins Coie LLP contributed memos and the sample legal documents found in the Exhibits to this *Primer*.

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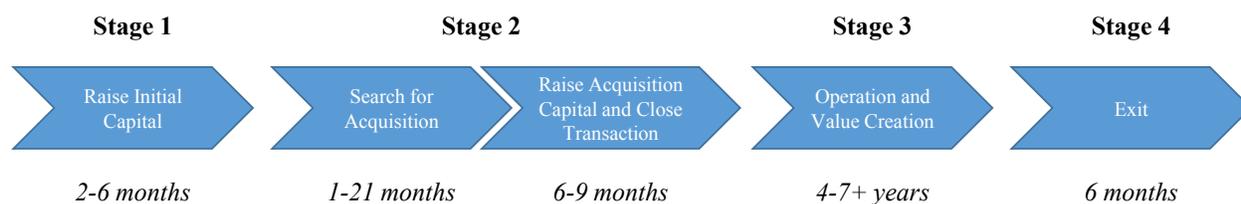
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PART I: THE SEARCH FUND

BACKGROUND¹

The search fund concept originated in 1984 and has become increasingly well known among business schools and private investors. A search fund is an investment vehicle that allows aspiring entrepreneurs to search for, acquire, manage, and grow a company. As shown in the following chart, the search fund process consists of up to four stages: fundraising, search and acquisition, operation, and eventual sale or other event providing shareholder liquidity.



The timeframes shown above are estimates for each stage; the time spent on each phase can vary widely.

STAGE ONE: RAISING INITIAL CAPITAL

Search funds are usually structured as limited liability companies. See **Exhibits 2-7** for an overview of limited liability companies and the relevant legal documents involved with the creation of such entities.

In a search fund, the money is raised in two stages: (1) to fund the search (“search capital”) and (2) to fund the acquisition of a company (“acquisition capital”). The search capital is used to cover a modest salary and administrative and deal-related expenses over a two-year period while the entrepreneur searches full-time for an acquisition. Once a target acquisition is identified and negotiated, the search fund entrepreneur raises the capital to purchase the company.

To formally begin the fundraising process, the search funder composes an Offering Memorandum (also called a Private Placement Memorandum) to provide to potential investors, presenting the investment opportunity. This document typically includes several sections:

- Executive summary
- Overview of the search fund model
- Outline of the search methodology to be employed, including resources to be utilized
- Potential industries and/or geographies of interest

¹ Much of the content in Part I is taken from Mu Y. Li, “Search Funds – 2003, What Has Changed Since 2001,” June 24, 2003; Sean Harrington, “Search Funds – 2007: Selected Observations,” *Stanford University Graduate School of Business*, January 15, 2008; and Aimee LaFont Leifer and Tjarko Leifer, “Search Funds – 2009: Selected Observations,” *Stanford University Graduate School of Business*, July 21, 2010.

- Specific criteria to screen acquisition opportunities
- Detailed timeline with expected completion dates for specific activities
- Detailed budget for the uses of the search capital
- Proposal of the form of the investment for the acquisition capital (e.g., subordinated debt and/or equity and the associated coupon/preference)
- Financial model showing potential investment returns under various scenarios of an illustrative acquisition
- Outline of the potential exit alternatives
- Summary of the personal backgrounds of the principal (and allocation of future responsibilities if more than one principal)

See **Exhibit 3** for a sample Private Placement.

Aspiring search fund entrepreneurs usually engage experienced legal counsel during fundraising. Qualified legal counsel can help the entrepreneur avoid violating securities laws; assist in creating and documenting the appropriate legal entities for the fund; and help the entrepreneur propose legal, tax and financial structures to potential investors for the acquisition capital as well as the entrepreneur's earned equity. Searchers are well-advised to rely on recent searchers or investors for fundraising and PPM guidance.

Principals today can tap a wide network of potential investors to raise a search fund, including experienced individual and institutional search fund investors as well as business associates, business owners and executives, and possibly friends and family. Typically, ten or more investors purchase one or several units of the initial capital of the search fund, at about \$35,000 to \$50,000. The median amount of initial search capital raised by the 81 new search funds in the 2016 study was \$420,000, approximately the same as reported in the 2013 study. These funds will cover the salary and administrative and deal-related expenses (office space, travel, legal fees, certain due diligence fees on deals, etc.) of the search fund for two or more years of raising capital and searching for a company to acquire. In exchange for the initial search capital, each investor receives (1) the right, but not obligation, to invest pro-rata in the equity required to consummate the acquisition and (2) conversion of the search capital, typically on a stepped-up basis (e.g., 150 percent of the actual investment), into the securities issued as the acquisition capital.

Most search fund principals solicit investors who also can serve as high-quality advisors. Ideal investors can offer expert guidance and advice in deal evaluation, deal execution, and company management; provide support to the entrepreneur during the ups and downs of the search process; assist in generating deal flow; and provide leverage with lawyers, accountants, and bankers. In many cases, investors are drawn not only to the potential financial returns of a search fund, but also the psychic benefits of being involved with a young entrepreneur.

Part II of this *Primer* addresses fundraising in more detail.

STAGE TWO: IDENTIFYING AND MAKING AN ACQUISITION

Compared to raising the initial capital, searching for an acquisition target and completing the transaction is typically more time-consuming—the process has ranged from 3 to 87 months for search funds, with a median of 19 months. The general economic environment, industry characteristics, sellers' willingness to sell, and regulatory issues are among the factors that can prolong or derail an acquisition process. Depending on the complexity of the deal, it can take 3 to 12 months or more from the time the opportunity is uncovered until the deal closes.

Those search funders who focus their search, as well as developing and adhering to a systematic approach of creating deal flow and analyzing deal opportunities, have a higher likelihood of identifying and closing an acquisition. Parts IV and V of this *Primer* address the search process in detail.

In order to mitigate operating and investment risks, search funders generally target industries that are not subject to rapid technological change, are fairly easy for them to understand, and are in fragmented geographical or product markets. Within the preferred industries, companies are targeted based on their sustainable market position, their history of positive, stable cash flows, and opportunities for improvement and growth. Search funders and their investors tend to prefer healthy, profitable companies over turn-around situations. Adhering to a disciplined list of acquisition guidelines reduces some of the risk of investing in a company run by entrepreneurs who often possess little operating experience.

When a target is identified, the search funder must simultaneously undertake several efforts:

- Negotiate the company purchase with the seller(s) – addressed in Part VI
- Perform due diligence on the company – addressed in Part VI
- Arrange for the senior debt and subordinated debt from third parties (if any)
- Negotiate the structure of the acquisition capital and secure commitments from the original search fund investors – addressed in Part III
- Secure additional equity commitments if needed
- Finalize the searcher's earned equity allocation and performance targets with the investor base – addressed in Part III
- Plan the transition for when the acquisition closes and the entrepreneur assumes management of the company – addressed in Part VII.

In addition to the follow-on equity investment from the original group of investors, the funds for the acquisition can come from a combination of other sources: seller debt, seller equity rollover, earnouts, traditional senior and subordinated loans, and equity financing from new investors. The capital structure, and therefore equity requirement, can vary widely by industry and the current lending environment.

The acquisition is expected to be at fair market value. The purchase prices of search fund-acquired companies have ranged from less than \$1 million to \$71 million, with a median of \$9.5 million, with 49 percent in the \$4 million to \$12 million range. Ideally, the acquired company would provide adequate cash flow and not be highly leveraged, so that the short-term survival of the company does not rely on immediate, significant improvement in company performance.

If the initial search capital is exhausted before an acquisition is completed, search funders may choose either to close the fund or to solicit additional funding to continue the search.

STAGE THREE: OPERATION AND VALUE CREATION

Upon completing the acquisition, search funders will establish a board of directors for the company, which often includes substantial representation from the investor base. In the first 6 to 18 months after the acquisition, search funders typically make few significant changes to the existing business, opting instead to gain familiarity with its inner workings and finer details. After becoming comfortable operating the business, search funders then make changes as they see fit. Search funders can create value through revenue growth, improvements in operating efficiency, appropriate use of leverage, organic expansion, add-on acquisitions, or multiple expansions upon exit. These means of creating value are not mutually exclusive; ideally, more than one will apply to a search fund investment. When a growth plan is executed successfully, the search fund principal shares in the increase in equity value through personal earned equity.

STAGE FOUR: EXIT

Most search funds are established with a long-term outlook, generally greater than a five-year time horizon, and often longer. Even so, investors and principals share a desire to realize returns at some point; consequently, principals evaluate exit alternatives throughout the life of the business. Liquidity events for investors and principals can occur in a number of ways: companies can be sold or taken public; investor debt may be repaid; investor equity may be sold to other investors or bought by the company; or the company can issue dividends.

THE PERSONAL PERSPECTIVE

HOW DO I KNOW IF A SEARCH FUND IS RIGHT FOR ME?

Embarking on an entrepreneurial career, whether through a search fund or starting a business, is a very personal decision. There is significant risk in undertaking a search fund. Individuals contemplating this route should carefully consider their short-, mid- and long-term goals and understand what such a path entails before embarking on it. Those who raise search funds often share two common motivations:

- A desire to take an entrepreneurial path to running a company – Search fund principals have the drive to lead a company in which they have autonomy, accountability, and a meaningful economic stake. That drive is stronger than the need to develop an idea in a specific industry or to start the company from scratch.
- A desire to realize high financial upside – For the effort, a search fund principal generally receives the potential for a 20 to 30 percent equity stake in the acquired company. Many search funders have acquired small companies and have grown them successfully, resulting in outsized returns for their investors and for themselves. Although not the only motivation for many search fund principals, large financial returns are possible for those who raise search funds.

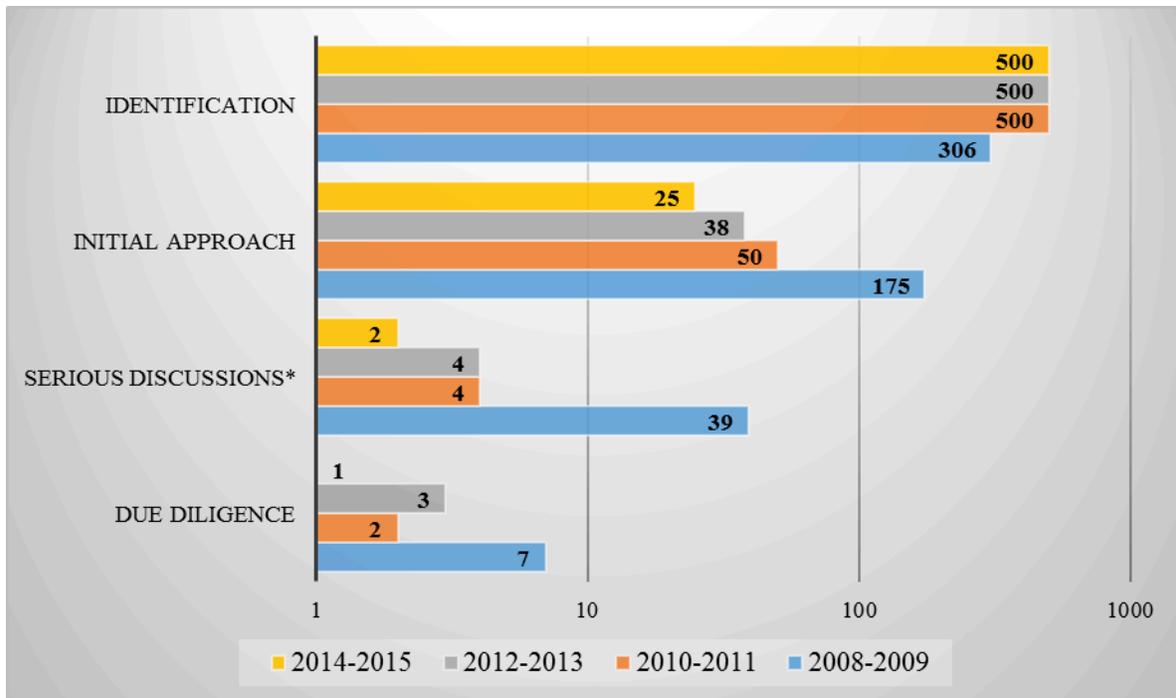
In addition, successful search fund entrepreneurs tend to share a number of common characteristics. The following list is neither prescriptive nor exhaustive, but a self-check on some of these characteristics may help to determine if pursuing a search fund is a strong personal fit.

Attention to detail – The process of searching for an acquisition target requires a keen focus and a systematic approach to reach a successful outcome. Likewise, once the acquisition is consummated, the principal begins an intensive period to manage and grow the business. Success in the transition phase often depends upon the entrepreneur mastering the nuanced details of the business, then evaluating the best ways to make changes and attack a growth plan.

Perseverance – In general, the search process can be long, tiring, and full of rejections. A successful search is often seen as a “numbers game,” in which a searcher may contact 1,000 companies, visit 50, submit a letter of intent to 10, and undergo due diligence on perhaps 1 to 3 companies before an acquisition is consummated. Much of the search phase involves “cold calling” companies in an effort to reach the owner to discuss a potential sale. Even with introductions from “River Guides” (River Guides, discussed in greater detail in the section on **Sourcing Opportunities**, are typically retired CEOs or trade association presidents in the target industry, who are tasked with providing the searcher with introductions to acquisition opportunities), brokers, or other personal contacts, a searcher will face frequent rejection from potential sellers. With the search taking around 18 months, and up to four years or more in some instances, a searcher must continue to be relentless in uncovering and pursuing acquisition targets regardless of repeated rejection.

On the upside, via the daily exposure to multiple industries, many have found the search intellectually rewarding. Furthermore, at the end of the process, searchers find it quite satisfying to find a company they are confident they can turn into a successful enterprise.

See the following graph for funnel statistics.



*“Serious discussions” were not further defined in the 2009 study and defined as “Number of Companies under Letter of Intent (LOI)” in the 2011, 2013 and 2015 surveys, which may account for the delta between 2009 and 2011-2015.

Note: The numbers from each respective year reflect the median number reported by survey respondents who answered this question.

Source: GSB search fund surveys, data from previous search fund studies.

The exact reasons for the shift in the funnel from 2009 to 2015 remain unclear, as are the implications of this shift, if any, for search fund principals. One contributing factor to the shift may be a heavier reliance on business brokers. In the 2007 study, only 4 percent of all searchers reported relying on business brokers. That figure rose to 30 percent in the 2009 study and remained high in 2011, 2013, and 2015. Business brokers may increase the volume of opportunities reviewed by search fund principals, and decrease the need to contact businesses directly in the early stages of learning about a potential acquisition. However, they are unlikely to replace the high-quality deals to be discovered outside of the open market.

Ability to build relationships and networks – At the outset, a search fund entrepreneur must establish credibility and trust to secure an initial investment from 10 to 15 people or firms. Some investors are familiar with the search fund model, while others must be sold on the model; regardless, principals must sell all investors on their abilities as entrepreneurs. Once the search phase starts, the search fund entrepreneur must build strong relationships and networks with potential deal sources, including intermediaries and professionals in the industries of interest. Many company owners may greet the search funder with skepticism, wondering how a young and relatively inexperienced entrepreneur could secure the financial backing and have the competence to take over the company and lead it successfully. Convincing a potential seller to do a deal with the search fund entrepreneur, especially when search

fundors do not tend to pay high multiples, is often one of the biggest challenges faced during the process. Once a company is acquired, the relationships built by the search funder—particularly with the investors and other advisors—can be leveraged to provide further guidance and support while running the company.

Belief in one's leadership ability – Search fund entrepreneurs must have an unyielding belief in their ability to lead a company to prosperity. At every turn—from fundraising to searching to running the company—search funders will be asked why they believe they can successfully be the senior executive of a particular company. Investors will test the entrepreneur's confidence during fundraising, intermediaries will judge this before making introductions, sellers will challenge this when making their decision to sell the business, and employees will look for this reassurance as the transition is made. Without a long track record of success as an executive to point to, the search fund principal will need to project a convincing message to instill trust in all stakeholders.

Willingness to seek, and heed, advice – Most search fund entrepreneurs are relatively inexperienced in at least one critical phase of a search fund, i.e., searching for an acquisition, structuring and closing a transaction, or operating a company as CEO. Therefore, search funders must be willing to call upon their own networks of investors and personal and business contacts, soliciting and parsing advice from those who are more experienced investors and operators. Many search fund investors see this piece of the search fund puzzle to be as critical as raising capital. If the searcher does not have good counsel, it will be tough to succeed.

Flexibility – During the initial fundraising process, the principal will establish industries of interest and criteria for potential acquisitions. However, principals are unlikely to find a company that meets all the criteria for an acceptable price. Thus begin the trade-offs to be made by the entrepreneur, who must also have the capacity to deal with unknown, unfamiliar, and stressful situations. Principals must be mentally agile—thinking and acting on ideas quickly. Once an acquisition is made, the search fund principal must deal with every single aspect of the business, generally with limited resources and experience. This means shifting regularly between everyday management—motivating employees, setting short-term and simple priorities, and solving problems with customers and vendors—to developing the strategy and growth trajectory for the business.

Adaptable and modest lifestyle – In recent years, search funders have generally pursued industry-focused and opportunistic searches rather than regional searches. This means the principal must be willing to move to wherever the acquired company may be located. Further, the search fund principal should realize that the paycheck during the search period will remain modest, particularly relative to other career options. Likewise, during the first years of running the acquired company, the principal often receives modest compensation, so as not to unduly burden the company. As the company grows, the compensation generally increases, but the principal should recognize that true economic benefit comes from the ownership in the company—and is not realized until there is a liquidity event for the investors.

The process of searching for a company is arduous, and running and growing a small company can be filled with challenges. However, many search funders have found the search process itself rewarding because they gain experience valuable to other paths, immerse in multiple industries in a short time, and earn the chance to operate a company early in their careers.

HOW MUCH AND WHAT EXPERIENCE IS NECESSARY TO RAISE A FUND?

There is no specific answer to this question as there has been great variation among those who have raised search funds. The following charts, taken from the *2016 Search Fund Study*,² show a comparison of search funder profiles.

Entrepreneur Age at Start of Search Fund

	Pre-2001	2002-2003	2004-2005	2006-2007	2008-2009	2010-2011	2012-2013	2014-2015
Minimum	26	28	28	27	26	25	24	24
Median	30	31	32	32	30	30	30	32
Maximum	35	60	47	50	51	51	46	54
Under 30	N/A	12%	30%	33%	35%	39%	49%	24%
30-35	N/A	64%	53%	47%	40%	30%	36%	49%
36-40	N/A	12%	10%	10%	16%	14%	11%	20%
Over 40	N/A	12%	7%	10%	9%	17%	4%	7%

Number of Post-MBA Years before Search Fund

Minimum	N/A	0	0	0	0	0	-1	-1
Median	N/A	2	1	1	4	2	0	1
Maximum	N/A	10	18	16	20	17	10	26
No MBA	N/A	N/A	0%	13%	16%	14%	20%	18%
<1 year post-MBA	N/A	N/A	47%	33%	18%	42%	49%	35%
1-3 years post-MBA	N/A	N/A	17%	27%	20%	17%	20%	24%
4-7 years post-MBA	N/A	N/A	23%	20%	22%	17%	7%	12%

² Susan Pohlmeier and Sara Rosenthal, "2016 Search Fund Study: Selected Observations," *Stanford University Graduate School of Business*, June 27, 2016.

Gender

	Pre-2001	2002-2003	2004-2005	2006-2007	2008-2009	2010-2011	2012-2013	2014-2015
Male	96%	100%	100%	100%	100%	94%	100%	95%
Female	4%	0%	0%	0%	0%	6%	0%	5%

Source: GSB search fund surveys, data from previous GSB search fund studies.

Search Fund Principals' Professional Backgrounds

	Pre-2001	2002-2003	2004-2005	2006-2007	2008-2009	2010-2011	2012-2013	2014-2015
Management Consulting	26%	23%	10%	26%	7%	14%	16%	11%
Investment Banking/Finance	23%	10%	16%	27%	20%	11%	22%	11%
Sales	12%	1%	3%	7%	4%	6%	4%	6%
Venture Capital	8%	3%	5%	1%	0%	0%	2%	0%
Line/General Management	5%	27%	7%	15%	11%	19%	2%	12%
Marketing	5%	2%	4%	0%	4%	0%	0%	0%
Law	4%	0%	2%	0%	0%	0%	7%	3%
Operations	4%	7%	16%	1%	7%	8%	7%	5%
Entrepreneur	2%	13%	8%	7%	13%	6%	4%	3%
Accounting	2%	0%	3%	0%	0%	0%	0%	2%
Engineering	2%	0%	5%	2%	0%	6%	2%	1%
Military	2%	1%	8%	1%	0%	0%	2%	9%
Insurance	2%	1%	0%	2%	0%	0%	0%	0%
Private Equity	1%	5%	11%	4%	27%	28%	31%	27%
Other	0%	7%	2%	8%	7%	3%	0%	11%

Source: GSB search fund surveys, data from GSB previous search fund studies.

SHOULD I HAVE A PARTNER?

The decision to undertake a search fund alone or with a partner is a highly personal choice. Some people prefer to operate by themselves, relying upon their network of investors and professional and personal contacts to provide advice, guidance, and support. In general, a solo searcher may end up with a higher equity percentage of the company (20 to 25 percent), while a partnership may share a combined 25 to 30 percent stake.

Others prefer to have a partner to share the ups and downs of the search process and running the company. Also, some prefer to have a trustworthy person with whom they can discuss ideas and issues as they arise. And many entrepreneurs feel that someone with complementary skills will make the whole package more attractive and will allow them to better succeed in managing the company. Many search fund pairs will split the various roles to be filled by a CEO; for example, one may lead sales, marketing, and human resources while the other tackles operations, finance, and accounting. Establishing a successful partnership is no small feat, however, and requires continual work to ensure its longevity.

Having said all this, an analysis of the data underlying the *2016 Search Fund Study* shows that while there was a nearly even split between funds operated by a single searcher versus a partnership, average financial returns between the two categories appear to be different (We acknowledge that the decision of whether to form a solo search or a partnership is a personal one that depends on many factors, and that statistical returns do not indicate that partnerships are always the best choice for searchers forming a new fund). Among solo searchers, 41 percent who had acquired companies achieved returns greater than 2x, while 60 percent of partnerships achieved 2x returns. Additionally, 32 percent of solo searchers incurred a partial or total loss of capital, as compared to 21 percent of partnerships. The median return on investment (ROI) for solo search funds and partnerships, excluding unsuccessful searches, were 2.3x and 1.4x, respectively, while the average ROIs were 4.2x and 2.8x, respectively.³ It is unclear whether these results reflect superior decision-making about acquisitions, better management of the acquired companies, market timing, or some combination of factors.⁴

WHAT ISSUES DO WE NEED TO DECIDE OR DOCUMENT UPFRONT?

As in any partnership, the relationship within the partnership needs to be clearly defined. Roles and responsibilities, the decision-making process, the equity positions, conflict management and resolution—all these issues should be discussed prior to embarking on a search. Also, it is important to talk about issues such as what motivates or discourages each partner, how each interacts in a team, what each expects from the experience, what their values are, and whether these values are congruent or in conflict with each other.

People who have had trouble with a partnership later on in the process commonly say that it might have been mitigated had they flushed out more issues in the beginning of the process, instead of glossing over them because they were uncomfortable discussing the matter, or the issue seemed irrelevant at the time.

³ Average calculations exclude one search fund partnership that acquired a business returning over 200x to its investors.

⁴ Susan Pohlmeier and Sara Rosenthal, “2016 Search Fund Study: Selected Observations,” *Stanford University Graduate School of Business*, June 27, 2016.

- What are the specific roles and responsibilities of each partner in the search fund post-acquisition?
- Does either partner have any “non-starters” with regards to industry or geography?
- How will reporting to the board be structured (i.e., both partners, one partner)?
- How would decisions be divided into “yours,” “mine,” and “ours”? Use specific examples to discuss the issues.
 - In the case of an “ours,” if we can't agree, what would be some possible processes to get the decision made?
- What are core values of the partnership?
- What are your personal values and life goals?
- How would we handle the equity economics if one of us wants to leave and pursue other opportunities?
- What is each partner’s core skill set, and what does each partner really enjoy?
- What is each partner lacking with regards to skill set, and what does each partner not enjoy?
- Who was your favorite manager and why?
- Have you had any poor managers? If so, what made them poor managers?
- What is your management style and what kind of a manager do you want to be?
- How much money do you need to earn to feel successful? How do you define success?
- What does the sale scenario need to look like for each partner to be ecstatic?
- How many hours per week is each partner anticipating to work?
- Why do you want to run a company?

WHAT TYPE OF COMPENSATION AND EQUITY SHOULD I EXPECT?

The answer to this question naturally has large variations depending on specific situations and deal structures. During the initial fundraising, the search fund principal raises search capital to cover salary, basic benefits, and administrative and deal expenses for a two-year period. As shown in the *2016 Search Fund Study*, the median amount raised per principal in the 2014-2015 period was \$385,000, up from the median of \$262,500 in the 2012-2013 period. Generally, principals budget a salary of \$80,000-\$120,000 per year. Once a company is acquired, salaries vary widely depending on the size and growth of the business; however, many search fund principals report maintaining modest salaries, not dissimilar to amounts during the search process, during the first several years of ownership.

The majority of the economic benefit of a search fund comes through the principal's earned equity. Again, the amount and structure of the equity varies widely. Typically, the entrepreneur/pair receives a 15-30 percent equity stake in the company, received in three equal tranches:

- Tranche 1: Received upon acquisition of a company
- Tranche 2: Vests over time (~ 4 to 5 years) as long as the principal remains employed by the company.
- Tranche 3: Vests when performance benchmarks (e.g., IRR hurdles) are realized. The typical IRR hurdle range starts at a 20 percent net investor IRR and ends at a 35 percent net investor IRR.

Part III contains additional information on the earned equity for search fund principals and the economic impact to the entrepreneur and investors in various outcomes. It is important to note that the investors commonly receive some type of preference over the search fund entrepreneur. The preference allows search fund investors the ability to ensure their investment is repaid, usually with a return attached, before the search funder entrepreneur receives any equity value.

WHAT ARE THE RISKS OF PURSUING A SEARCH FUND?

The risks of undertaking a search fund are similar to the risks of starting a business. As shown in the *2016 Search Fund Study*, the returns of the search fund asset class are an impressive 36.7 percent IRR and 8.4x multiple of investment. However, removing the three best performing funds (out of 142) reduces the IRR to 28.8 percent and multiple of investment to 3.1x. These returns are equivalent to the returns of other alternative asset categories (private equity and venture capital being the most analogous). The top-performing funds saw meaningful gains for the investors and search fund entrepreneur: 53 percent of the funds at least doubled the investors' capital, and 24 percent returned 5x or more the investors' capital.

Additionally, as most search funders do not have prior experience running a company, there is a risk that they will not fully enjoy the work once a company has been purchased. The last major risk is that some search funders end up buying a company that limps along and never allows for a graceful exit.

WHAT IF I FAIL?

Approximately one in five search funds end the search without acquiring a company. In this case, many of the searchers close their funds and find jobs in a variety of fields (not dissimilar from what they would have pursued coming out of business school), bringing with them two to three years of search experience. The systematic and analytical approach, familiarity with certain industries, and contacts made during the search process can be beneficial, depending on the job. Savvy investors recognize the risk of a searcher not finding a suitable acquisition, and will often help find another opportunity if they believe the searcher performed admirably and used appropriate discipline in the search process. While winding down a search fund prior to an acquisition results in the loss of investor capital, the loss of the search capital is small relative to the potential loss of capital if a sub-optimal acquisition is made.

Acquiring a company that ultimately fails under the leadership of the search funder is far more problematic. The search funder likely spent many years between the search and running the company, with few positive results to show. Also, investor capital has been lost. Entrepreneurs still maintain respect from their investors by acting admirably and placing the return of capital as the top priority. Failure is defined by how one fails, and handles oneself during the process. Examples abound of

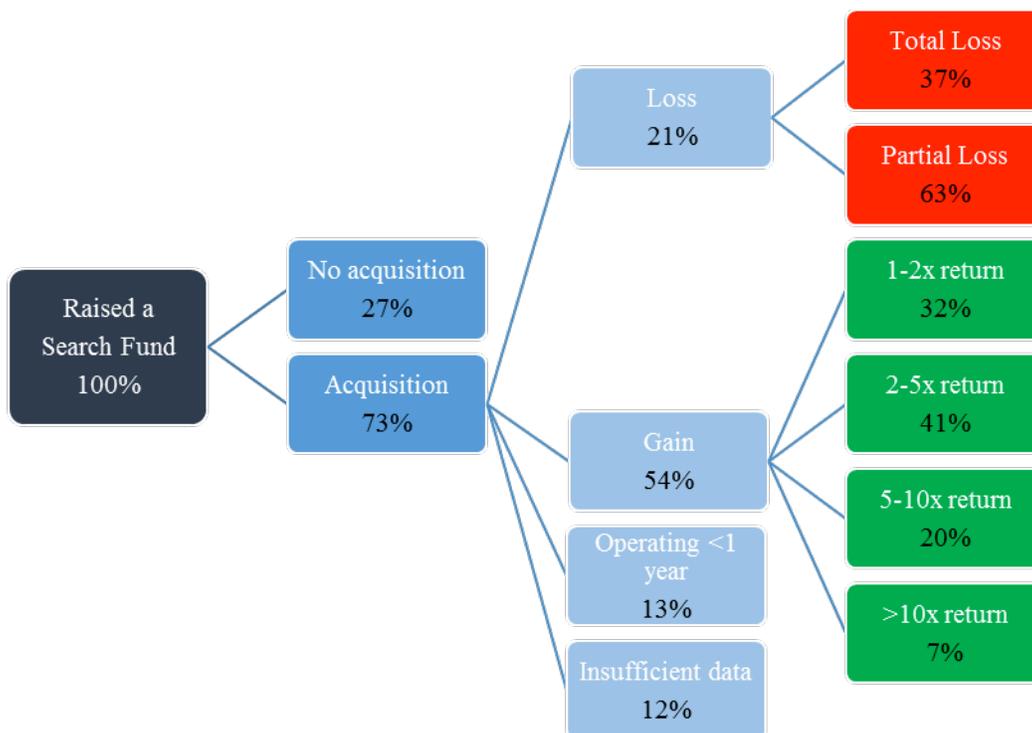
entrepreneurs who lost investor capital, communicated well and worked hard to protect investor interests, and later embarked on new ventures with some of the same investors. However, the potential career setbacks should not be minimized, and younger entrepreneurs need to consider carefully whether they have a compelling industry, solid company, and many of the right personal characteristics to manage a company successfully.

THE NUMBERS: HOW WELL HAVE SEARCH FUNDS PERFORMED?⁵

The demographic sample in this study includes 258 first-time search funds formed since 1983. Keeping with precedent, we excluded funds raised by principals who had previously raised a search fund. The focus of this study is to understand the returns from investing with a new entrepreneur with limited prior experience in that particular industry.

As of December 2015, search funds have achieved an ROI of 8.4x and an IRR of 36.7 percent. The performance of individual search funds has varied widely over the years. Distribution by ROI ranges from greater than 10x for highly successful companies to total loss of capital. Distribution by IRR ranges from greater than 100 percent to negative; in cases of a total loss of capital, IRR cannot be calculated. The figure below reflects the percentage of search funds in each phase of the search fund life cycle, as well as return characteristics for terminal funds.

Percentage of Search Funds in Each Phase of the Search Fund Life Cycle⁶



⁵ Susan Pohlmeier and Sara Rosenthal, “2016 Search Fund Study: Selected Observations,” *Stanford University Graduate School of Business*, June 27, 2016. (See **Exhibit 1** for full document.)

⁶ Percentages may not add to 100 percent due to rounding.

Source: GSB search fund surveys, data from previous GSB search fund studies.

This study calculated financial returns from the perspective of investors of initial search capital. Two measures of return were used: return on investment⁷ and internal rate of return.⁸ Both ROIs and IRRs were calculated on a cash flow basis, including both equity and debt invested as initial search capital and as acquisition capital. As in prior years' studies, the timing of the cash flows for each search fund was adjusted to a common start date.⁹

All returns were calculated on a pre-tax basis using data provided by the principals of the funds. We assumed that the searchers' share of equity had fully vested,¹⁰ that all debt was repaid, and that funds were distributed in proportion to the investors' share of equity and subordinated debt.

We have made every effort to provide accurate returns. It is also important to note that precise information for all cash infusions and distributions over the life of each fund is difficult to obtain, especially for funds with long operating histories and complex capital structures. Readers should keep this in mind when considering the ROI and IRR figures presented in this study.

⁷ Return on investment (ROI) represents the multiple of initial cash invested that is returned to investors. For example, if the group of initial investors invested \$5 million and received back \$10 million, this would be described as a 2.0x ROI. A return of \$1 million would be a 0.2x and so forth. A complete loss of capital is an ROI of 0.0x.

⁸ Internal rate of return (IRR) represents the annual compounding rate derived from the adjusted dates and actual amounts of search and acquisition capital invested and returned by an investment. For investments returning nothing, or only a fraction of the investors' original investment, IRR is not a meaningful metric.

⁹ The IRR for search funds as an asset class was calculated by shifting the dates of all cash flows such that all funds appear to have raised initial search capital on the same "day one." Subsequent infusions from, and distributions to, search fund investors occurred at the same intervals reported by each fund. Thus, the asset class IRR is a hypothetical return an investor would have realized if all funds had started at the same time and the investor had participated in each fund in proportion to the amount of capital raised by each fund.

¹⁰ This assumption gives investors a more conservative IRR since funds typically include both time-based vesting and performance hurdle rates that must be exceeded before the searchers vest at least a portion of their equity. Also, most investments in the search phase include downside protection for investors in the form of preferred returns or liquidity preference.

**Return on Investment (ROI) to Original Search Fund Investors,
Including Search and Acquisition Rounds¹¹**

Study Year	2009	2011	2013	2015
Individual ROI				
Minimum	0.0 x	0.0 x	0.0 x	0.0x
25th Percentile	0.0 x	0.0 x	0.0 x	0.0x
Median	0.5 x	0.8 x	1.0 x	1.0x
75th Percentile	1.9 x	2.1 x	3.1 x	3.2x
Maximum	>200 x	>200 x	>200 x	>200x
Distribution of Individual ROI:				
0.0 x (total loss)	30%	29%	25%	30%
< 1.0 x (partial loss)	29%	27%	26%	14%
Exactly 1 x (return of capital)	3%	2%	2%	2%
1.0 x - 1.5 x	10%	10%	15%	13%
1.5 x - 2.0 x	3%	6%	3%	4%
2.0 x - 5.0 x	13%	14%	17%	20%
5.0 x - 10.0 x	5%	6%	8%	13%
>10.0 x	7%	6%	5%	4%
Aggregate Blended ROI:	13.5 x	11.1 x	10.0 x	8.4 x

Source: GSB search fund surveys, data from previous GSB search fund studies.

¹¹ Return on Investment data was first reported in the 2009 study, with ROI calculated on a cash flow basis, including both debt and equity that was invested as initial search capital and as part of the acquisition. In all calculations of returns, we assumed that all debt was repaid, that the searchers' share of equity had fully vested and that funds were distributed in proportion to the investors' share of equity and subordinated debt. All returns were calculated on a pre-tax basis. Figures in this exhibit include searches that shut down without acquiring a company.

Internal Rate of Return (IRR) to Original Search Fund Investors¹²

Study Year	2001	2003	2005	2007	2009	2011	2013	2015
Individual IRRs:								
Minimum	NM							
25th Percentile		NM						
Median	18%	NM	NM	NM	NM	NM	NM	5%
75th Percentile		22%	25%	25%	11%	26%	26%	35%
Maximum	98%	85%	215%	189%	189%	189%	189%	189%
Distribution of individual IRRs:								
Not meaningful (NM)*			53%	49%	60%	57%	52%	42%
0% to 25%			22%	25%	19%	17%	22%	26%
26% to 50%			14%	18%	14%	18%	16%	22%
51% to 75%			4%	2%	3%	4%	7%	8%
76% to 100%			2%	2%	2%	1%	1%	0%
>100%			4%	5%	2%	2%	2%	2%
Aggregate blended IRR	38%	32%	37%	52%	37%	34%	35%	36%

* Not meaningful (NM) is reported in situations of partial or complete loss of capital over a period of years where the IRR metric is not useful.

Note: Internal Rate of Return (IRR) figures are reported in aggregate for all search funds that had acquired a company (including those that were operating, had exited, or were shut down) or had concluded without making an acquisition. Funds that had acquired a company less than one year prior to the end of the respective study period were not included, nor were funds still searching for an acquisition.

Source: GSB search fund surveys, data from previous GSB search fund studies.

¹² IRRs were calculated on a cash flow basis, including both investor debt and equity that was invested as initial search capital and as part of the acquisition. As in prior years' studies, the timing of the cash flows for each search fund was adjusted to a common start date. In all calculations of returns, we assumed that all debt was repaid, that the searchers' share of equity had fully vested and that funds were distributed in proportion to the investors' share of equity and debt. All returns were calculated on a pre-tax basis. Figures in this exhibit include search funds that shut down without acquiring a company.

Selected Statistics for All Search Fund Acquisitions

Total Number of Months From Start of Search to Deal Close	All Acquisitions
Minimum	3
Median	19
Maximum	87
<11 months	11%
11-20 months	44%
21-30 months	26%
31+ months	18%

Purchase Price Statistics	All Acquisitions
Minimum	\$0.6 M
Median	\$9.5 M
Maximum	\$71.0 M
<\$4 M	12%
\$4 M to \$8 M	25%
\$8 M to \$12 M	24%
>\$12 M	39%

Additional Statistics for All Search Fund Acquisitions	Minimum	Median	Maximum
Company Revenues at Purchase	\$0.4 M	\$7.1 M	\$103.0 M
Company EBITDA at Purchase	-\$1.6 M	\$1.8 M	\$12.0 M
Company EBITDA Margin at Purchase	-18.5%	22.9%	83.3%
Purchase Price / Revenue	0.2x	1.3x	6.7x
Purchase Price / EBITDA	NM	5.3x	114.0x
EBITDA Growth Rate at Purchase	-56.0%	12.0%	300.0%
Company Employees at Purchase	4	45	740

Source: GSB search fund surveys, data from previous GSB search fund studies.

PART II: RAISING A FUND

BUILDING AN INVESTOR BASE

THE VALUE OF THE RIGHT INVESTORS

In an ideal world, investors should bring advice, counsel, and credibility as well as the financial support for the search and acquisition. Given that most search fund principals are relatively inexperienced in at least one aspect critical to the success of the search fund (e.g., deal sourcing, transaction negotiation, or management and operations), building a diverse base of investors with deep and varied experience is crucial. Beyond providing the capital to fund the search process and acquisition, the right mix of investors can serve many purposes:

- Act as a sounding board for the search funder
- Provide introductions and leverage with professionals such as lawyers, bankers, and accountants
- Provide introductions to sellers of companies, industry contacts, and intermediaries to boost deal flow
- Provide personal support through the ups and downs of the search and operation of the company
- Serve on the board of directors of the acquired company
- Provide valuable guidance in early operations
- Provide introductions to other search funders and entrepreneurs for a peer network

FINDING INVESTORS

Search fund principals often segregate the universe of potential investors into four groups: (I) those who know them personally or professionally but don't know the search fund model; (II) those who know search funds but don't know the search fund principals; (III) those who know the principals as well as the search fund model; and (IV) those who know neither the principals nor the search fund model.

Most successful fundraisers generally approach the following people as investors, in no particular order:

- 1) Professional search fund investors
- 2) High net worth individuals, particularly those who have invested in other search funds
- 3) Former business associates
- 4) Business owners, entrepreneurs, and executives known to the searcher
- 5) Friends and family

There are many considerations for a search funder when deciding which potential investors to present with the investment opportunity.

A number of professional search fund investors have now emerged (some are listed below, and are defined as investors who focus exclusively or almost exclusively on investing in search funds). These small funds typically were formed by former search fund entrepreneurs or investors who understand the search fund entrepreneur's path, the risks of investing in search funds, and the support that a skilled investor and mentor can provide to a search fund.

When approaching individual investors, the search funder should consider the total assets and risk profile of the investor. An investment in a search fund falls into the alternative asset class, which typically comprises 5 to 15 percent of an individual's investment portfolio. A search funder should aspire to raise the search capital from investors who have the financial means to participate in the acquisition capital. Therefore, the question is not whether the investor can risk the \$35,000 to \$50,000 to purchase a unit in the search fund, but whether that investor can risk an additional \$100,000 to \$1,000,000 in the deal. It is not in the best interest of the search funder to bring in an investor who will be "stretching" to make the investment, as the personal situation of the investor can put undue pressure on the searcher.

Raising money from friends and family is a difficult decision for some search fund entrepreneurs. As addressed earlier, more than half of all search funds have not provided a positive return to the original investors. There is always the added risk that a loss of money might cause irreparable damage to a friendship or familial relationship. A search funder should feel comfortable that the individual can afford to lose the money (both the initial unit and the larger investment in the company) and is fully aware of the risks of such an investment.

There are still many reasons to approach family and friends. First, they tend to be a sympathetic audience, giving the entrepreneur the opportunity to practice the search fund pitch and answer a variety of questions which will arise from people who may be unfamiliar with the search fund model. Second, many other investors consider it a good signal if search funders have a vote of confidence from those who know them best, and are prepared to invest their money in the search fund.

Individuals who regularly invest in search funds can bring many benefits: they are comfortable with the search fund model and the risks; they can provide perspective and guidance on how to run an efficient search; they have a network of deal sources and other professional contacts; and they are often a patient source of capital. The potential downside, however, is they may lack the bandwidth to provide as much guidance to the searcher as hoped, particularly if they have jobs and/or have invested in a large number of search funds.

Many search funders approach executives, entrepreneurs, and business owners known to them. While these individuals are often savvy businesspeople, the search fund model may be new to them, and they need to be educated on the process. These people tend to invest in search funds not just because of the potential economic returns but because it provides them a way to stay involved in an exciting new business venture and to help a younger entrepreneur.

Speaking with search fund principals who recently raised funds is perhaps the best way to gain insight into the current fundraising climate. However, each search fund principal brings specific experiences, networks, and areas of interest to the process and should approach fundraising strategically. Successful search funders strongly suggest contacting potential investors through a personal introduction.

Many investors will test a potential searcher for persistence, tenacity, and a willingness to push forward, requiring a respectful, but dogged, approach to fundraising. The universe of investors who have involved themselves in multiple search funds is small and close-knit, and many follow the lead of key individuals or funds in deciding whether or not to invest. Also, some contacts, even if they don't invest, will refer a searcher to other potentially interested investors.

Before accepting an investment from an individual or professional search fund investor, the search fund principal should investigate the reputation, available resources, and motivation of the investor as well as the role they have played with other entrepreneurs (if applicable). Are they hands-on or passive? Do they require economic and/or voting control? Do they take a seat on the board of directors? In which areas are they most helpful? What and when is their need for liquidity? Is the search fund's timeline the same as the investor's? Having answers to these questions will allow the searcher make good choices when selecting investors.

Firms that have invested in multiple search funds include:

- Anacapa Partners
- Cambria Group
- Pacific Lake Partners
- Peterson Partners
- Relay Investments
- Search Fund Partners
- TD Investments
- Trilogy Search Partners

THE RIGHT NUMBER OF INVESTORS

The number of investors depends on the amount of funds to be raised and the tradeoff of control versus ease of managing the investor base. How much is raised for the search phase varies widely; pairs obviously require more than solo searchers. However, the amount raised per principal between 2004 and 2015 ranged from \$106,250 to \$750,000. The number of investors per fund ranged from 1 to 28, but the median in the 2014 to 2015 data was 15.5. (In recent years, more investors have been taking "half units," in part due to the expectation of larger equity raises upon acquisition.) Having more investors means each of them will have less control, leaving the entrepreneur with more influence than if there were only a few major investors. However, it may be more challenging to communicate with and solicit advice and decisions from every investor. Regardless of the number of investors, legal documents will be negotiated to delineate the rights of all investors equally on a variety of matters. Experienced legal counsel can advise the search fund principal on these issues.

Attracting investors

First, it is important to remember what investors will be "buying." Some investors must be sold on the search fund investment vehicle, and all investors must be sold on the search fund principal(s). Most

former search funders said it was difficult, and often impossible, to attract investors who knew neither the search fund model nor themselves. When approaching potential investors, the following guidelines are useful: understand the investor; prepare thoroughly for the meeting, and respond quickly to information requests; ask for a commitment; and remain open to alternate possibilities.

Understand the investor

As in any important sales situation or job interview, a prospective search funder should attempt to uncover as much information as possible about the investors and their motivations and concerns:

- Why are they investing?
- Have they invested in a search fund before? As angel investors? As private equity investors? Which search funds or companies have they backed?
- What is their investment style? What role do they like to take in their investments?
- How much do they typically invest in a deal? If they invest in search funds, have they declined to participate in the acquisition round of any of the funds? Why?
- Are they interested in specific industries or business models (e.g., services businesses, manufacturing, distribution) in preference to others?
- What is their personal situation (if it's relevant to the investment)?
- What are they looking for in an entrepreneur?
 - Personality
 - Experience
 - A certain approach to business or people

While a searcher may not be able to answer all of these questions prior to meeting each investor, it's a good idea to attempt to do so—especially before key meetings where the searcher plans to ask for money (as opposed to introductory meetings). Perhaps the best way to glean this information is to speak with other search funders or entrepreneurs who have received investments from the investor. It can also be instructive to talk to those who pitched the investor but were declined. Beyond this, the searcher should avoid monopolizing the time during meetings with the actual pitch, and be sure to listen to the investors discuss their prior experiences and investments, paying keen attention to the questions the investors ask.

Many investors will view a meeting with a prospective searcher as a field test for how well the searcher will do in connecting with and convincing owners to sell their company, convincing customers to buy the company's products or services, and building relationships with employees.

Prepare for the meeting and respond to answers quickly

Generally, a prospective search funder will send the Private Placement Memorandum (see Part I of this *Primer* and **Exhibit 3**) in advance of the meeting, so the investor has a base level of information on the search fund concept, the principal's planned focus for the search (e.g., industries, geographies, types of company), and the principal's background.

Depending on their background and experience, entrepreneurs may spend more or less time on two key elements to a successful search: *finding* and *running* a business. The searcher should be prepared to answer questions on each topic, such as the following:

- What is the strategy, in detail, to find a company? Which industries are of interest? Which geographies are of interest?
- What are the major parameters for screening acquisition targets? What attributes must the company possess? What attributes must the company NOT possess? Where is there flexibility?
- If it's a partnership, what are the planned roles for each principal? How will decision making occur? How will the equity be split?
- What are the points of differentiation between this fund and other search funds or other people trying to buy a company in the target industries?
- Why will this entrepreneurial venture succeed?
- Why should the investor invest in the principal?
- Why is the search funder pursuing this route?
- What is the search fund principal committing to pursue this endeavor (not necessarily money)?
- What terms is the entrepreneur seeking, especially for the earned equity? What potential equity structure? What IRR or other hurdles exist for earning equity?

If the investor asks specific questions to which the search funder does not have an answer, the search funder should be honest about not having the answer, but follow up as quickly as possible with a concrete response.

Ask for a commitment

This is the most important, and surprisingly often forgotten, punch line. A search funder's objective is to raise funds, and rather than skirting around the subject, the searcher should be direct in asking for an investment at the appropriate point in the process. When doing so, it is helpful to provide the investor with a term sheet and/or subscription document that outlines the amount and terms of the investment.

Remain open to alternative possibilities

Some investors may not invest in the initial phase of the search fund, or may be precluded from doing so, but will tell the searcher to contact them once an acquisition is identified and the equity is being raised. Beyond keeping a list of these investors, a searcher should *keep them informed* of the search process as it progresses. Providing periodic updates allows these potential investors to track the searcher's progress and gauge the effectiveness of the searcher; it should also reduce the decision-making time if the investor is updated on the acquisition target, deal terms, due diligence, etc.

SECURING AND DOCUMENTING THE INVESTMENT

As discussed above, the first written communication investors receive typically is the Offering Memorandum. After the search fund principal has met with potential investors and secured sufficient commitments, the next step is to send a Limited Liability Company Agreement, a Subscription Agreement, and an Accredited Investor Questionnaire to finalize the investment. **Exhibits 2 to 7** provide samples of the documents needed in the fund formation and search phase. The search fund principal will need to set up appropriate bank accounts in the name of the fund to receive the investments and to run the operations of the fund. Search funders should be prepared with an adequate accounting system to record all capital infusions and all cash outflows, as the fund will need to produce financial statements and tax information for the investors.

PART III: SEARCH FUND ECONOMICS

OVERVIEW

This section addresses the basic economics for the entrepreneurs and investors in search fund investments.

The two key components impacting the split of proceeds in a search fund are the structure of the investor capital and the search fund entrepreneur's earned equity (referred to as "Manager Equity" in this *Primer*; also often called "Carried Interest").

The search fund acquisition is often structured as a participating preferred equity investment. This means that the investors receive a return of their initial capital (and often with a modest preferred return) before the searcher begins to participate in equity appreciation. Thus investors receive protection in downside scenarios. Manager equity is usually issued as common equity; as such, only once some or all of the investor capital has been returned does the search fund entrepreneur begin to realize value in a personal equity stake in the company.

This section on economics is intended to emphasize that the primary drivers of economic return are the performance of the company and the absolute dollar gain on the investment. However, it also illustrates that the form and structure of the investors' capital can impact the split of proceeds between investors and search fund entrepreneurs.

INVESTOR CAPITAL

Search fund investor capital is provided in two stages: (1) to fund the search (the "search capital") and (2) to fund the company acquisition (the "acquisition capital"). Upon an acquisition, the search capital converts into the same securities issued for the acquisition capital investment; typically, this conversion is done at a stepped-up value, often 150 percent of the original investment, to compensate investors for running the risk on the search.

Once an acquisition is completed, the post-closing capital structure will include some or all of the following:

- Traditional debt (e.g., revolving line of credit, senior term debt, and, potentially, mezzanine debt)
- Seller financing (e.g., seller notes or earn-out)
- Preferred equity (e.g., one or more senior instruments)
- Common equity

Investor capital can come in various forms, including, but not limited to, those addressed here:

Preferred equity – There are many variations, and therefore room for creativity, in structuring preferred equity. Preferred equity is junior to all debt securities but senior to common equity. In search funds, preferred equity is often issued as participating preferred stock, although in Europe and some other countries "participating" securities work quite differently than in the United States.

- *Preferred stock* offers the holder the right to BOTH (a) the initial value plus accumulated and unpaid preferred dividends (if any); PLUS (b) 100 percent of the common equity, less vested Manager Equity (described below) upon sale or liquidation. Preferred stock can be issued as redeemable preferred stock or non-redeemable participating preferred stock:
 - *Redeemable preferred stock* can be redeemed in whole or in part prior to a sale, recapitalization, or liquidation. Once redeemed, the redeemable preferred stock has no further participation.
 - *Nonredeemable participating preferred stock* cannot be redeemed prior to a sale, recapitalization, or other liquidity event as defined by the terms of the agreement.

For the sake of simplicity, the following analysis focuses on two potential structures of investor capital:

- Structure 1: For every \$1 of Investor Capital, \$1 buys nonredeemable participating preferred stock with preferred return (often ~5-8 percent).
- Structure 2: For every \$1 of Investor Capital, \$0.50 buys redeemable preferred stock and \$0.50 buys nonredeemable participating preferred stock.
 - Series A - Redeemable Preferred Stock (~10-17 percent coupon)
 - Series B - Nonredeemable Participating Preferred Stock with No Coupon (~0 percent)
 - i. Manager Equity comes in the form of common shares that participate with the Series B Nonredeemable Participating Preferred Stock

Structure 1 and Structure 2 can be substantially equivalent at certain interest rates and preferred returns.

It should be noted that the two structures described in this section, “Preferred Equity” and “Split of Redeemable Preferred Equity and Nonredeemable Participating Preferred Stock,” apply only to U.S. investments. In the United Kingdom, for example, the bulk of investor capital goes into a redeemable preferred share, not participating preferred stock. In these instances, a very small amount of capital (sometimes only 1-2 percent) goes toward purchasing ordinary shares. As a result, there is no need for a participating feature within this structure since there is no conversion. Two advantages of this structure are that most of the capital can be repaid out of retained earnings and option awards can be made to key employees at quite low exercise prices. (An alternative is to use debt instead of preferred shares for the large amount, which can be repaid at any time.) Searchers in foreign countries should consult with their local investors and advisors on the appropriate structure for their acquisition.

So, why choose one structure or the other? Historically, as traditional private equity funds that did both search fund deals and traditional control buyouts moved into the search fund space, they preferred Structure 1. However, many high net worth individuals or professional search fund investment firms with extensive search fund investment or operating experience preferred Structure 2. Recently, approximately 75 percent of deals have been done with Structure 2, at the election of the search fund entrepreneur.

The advantages/disadvantages of each structure for the investor and the entrepreneur are depicted in the following chart.

	Structure 1 Preferred Equity Usually 6-8% coupon	Structure 2 Split of Redeemable Preferred Equity and Nonredeemable Participating Preferred Stock 15-17% Series A, 0% Series B
Investor	<p><u>Pros</u></p> <ul style="list-style-type: none"> • Maintains uncapped returns on entire investment <p><u>Cons</u></p> <ul style="list-style-type: none"> • In a middling outcome, the preferred return can become onerous and lead to misalignment of incentives between the entrepreneur and investors • May promote excessive risk-taking by searcher to create outsized growth in equity 	<p><u>Pros</u></p> <ul style="list-style-type: none"> • Focuses managers on cash flow generation and early return of capital • Early return of capital allows for reinvestment in other opportunities • Investor still maintains 100% of the upside • Provides opportunity to take “chips off the table,” and therefore opportunity to reinvest redeemed capital in other growth investments while still preserving upside potential <p><u>Cons</u></p> <ul style="list-style-type: none"> • The searcher has a better chance at redeeming the high coupon debt quickly, therefore driving down returns
Searcher	<p><u>Pros</u></p> <ul style="list-style-type: none"> • More commonly known structure outside the search fund community <p><u>Cons</u></p> <ul style="list-style-type: none"> • 100% of the investor equity investment has a coupon attached, therefore significantly more cash generation and return to investors is required in initial years to stop coupon accretion • In mid-growth scenarios, significant accretion of the preferred equity can lead to misalignment of incentives and be demotivating to entrepreneur 	<p><u>Pros</u></p> <ul style="list-style-type: none"> • Allows pay down of expensive component of capital structure more quickly because only half of the total investor equity investment is accreting • Early redemption of Series A Preferred creates economic value to entrepreneur, similar to paying down third-party leverage • Early return of capital can boost IRR and allow for early vesting of performance-based carry <p><u>Cons</u></p> <ul style="list-style-type: none"> • In middling outcome of greater than 5 years, significant accretion of Series A can become onerous

Some investors warned that Structure 1 could be “massively de-motivating to managers” and could have “a devastating effect on the entrepreneur.” These negative consequences are more acute in low growth outcomes without significant free cash flow generation. In these cases, the original investor capital plus the preferred coupon may prohibit the entrepreneur from participating in any meaningful equity gain. Ultimately, investors all noted that the equity capital should be structured to align the interests of investors and entrepreneurs.

MANAGER EQUITY

A typical search fund entrepreneur(s) will vest into 20 to 30 percent of the common equity (“Manager Equity”) of the acquired company in three equal tranches:

- Tranche 1: Upon acquisition of a company;
- Tranche 2: Over time, as long as searcher remains an employee of the acquired company (commonly, a 4 to 5 year vesting schedule); and
- Tranche 3: By achieving performance benchmarks (e.g., IRR hurdles).

Partnerships typically earn 30 percent of the common equity while solo searchers earn 20 to 25 percent.

Performance benchmarks most commonly start at 20 percent IRR net to investors and max out at 30 to 40 percent IRR, net of Manager Equity (but may occasionally be based on ROIC). Performance vesting can be on a sliding scale or in increments upon achieving minimum thresholds (e.g., 20 percent, 25 percent, and 30 percent IRR hurdles). Neither IRR nor ROIC are flawless measures of performance, and very generally IRRs have been preferred for holding periods under five years and ROICs have been preferred over five years. Some search funds have been structured with either declining IRR ladders over time periods greater than five years or a switch to an ROIC table after 5 to 7 years in order to align investor and entrepreneur interests over long periods (i.e., an investor might prefer a 20 percent IRR on a 10-year investment over a 35 percent IRR on a 2-year investment).

In some instances, the entrepreneur can request a third-party valuation of the company if a liquidity event has not occurred after five years. The IRR calculated at that point can be used for purposes of vesting the performance equity. In many instances, investor agreements allow the Board of Directors to decide how to handle these issues, and others, best. This is another reason to have an engaged and experienced Board.

In search funds with international investors, the question of in which currency to denominate the entrepreneurs’ performance vesting arises. Choosing either currency has notable advantages and drawbacks.

One recent solution has been to use local currency and to adjust for inflation differences between the local country and the currency of a major group of investors (often from the United States). For example, if the deal were in Mexico and inflation in Mexico was 5 percent, compared to 1 percent in the United States, over the earned equity vesting period, then the effective table would be 4 percent higher (say 20 percent - 35 percent would turn into 24 percent - 39 percent). This specifically adjusts for what some call the “free” return* created by inflation, the associated price increases, and the mathematical devaluation foreign investors will step into as a result of this inflation difference.

* “Free” return is at best a term of art as there is nothing about the return generated that will be free, rather it will be due to the effort and talent of the entrepreneurs, industry, deal terms, company, and perhaps luck.

VALUE CREATION

There are three primary levers used to create equity value in any company:

Operations

- Revenue growth through sales and marketing efforts or strategic initiatives (e.g., sales improvements, new products/services, geographic expansion, pricing)
- Margin expansion through cost reduction or operating leverage
- Add-on acquisitions to enhance scale, product/service offerings, or capabilities

Finance

- Capital structure decisions
- Cost of capital
- Capital intensity reduction – fixed assets, working capital, and/or capital expenditures

Valuation Multiple

- Buy at lower multiples, sell at higher multiples

Of these three levers, managers can influence operations and finance directly. It is useful for a search fund entrepreneur to analyze potential acquisition opportunities by considering the “calculated bets” to drive equity value creation. For instance, an acquisition opportunity may have incredibly high growth potential but also a high valuation multiple. Does the entrepreneur believe it is possible to hit the growth targets necessary to justify a high entry valuation multiple? Alternatively, another investment opportunity may have slower growth but high fixed asset intensity. Does the entrepreneur believe capital requirements can be reduced enough to generate a cash-on-cash return to be attractive to all involved?

There is no right or wrong answer to these questions. Rather, entrepreneurs should match their personal risk/reward profiles and operating strengths with the characteristics of the investment.

HYPOTHETICAL EXAMPLE OF SEARCH FUND ECONOMICS

To illustrate the potential economics of a search fund investment, we will take a representative search fund transaction and manager equity package and apply two different options for investor capital. To see the impact on returns to investors and searchers, we’ll run three different operating scenarios:

Summary of Operating Scenarios

	Optimistic	Base Case	Pessimistic
Revenue Growth	20.0%	12.5%	--
Annual EBITDA Margin Expansion	0.50%	0.25%	--
Exit Multiple	7.0x	5.5x	4.0x
Increase in Net Working Capital	20% of Revenue Growth		
Cash Tax Payments	40% of Earnings Before Taxes		
Depreciation & Amortization	\$500K in Year 0; fixed margin throughout		
Capital Expenditures	\$250K per Year		

The representative transaction, with the capital structure at closing, follows.

Transaction assumptions:

- \$15 million in sales and \$3.0 million EBITDA
- 5.0x EBITDA purchase multiple (\$15 million purchase price)
- 1.0x traditional Senior Debt
- 1.5x Seller Debt

Acquisition Capitalization

	\$000s	EBITDA Mult.	% of Total
Senior Debt	\$3,000	1.0x	19.4%
Seller Financing	\$4,500	1.5x	29.1%
Investor Capital (a)	\$7,950	2.7x	51.5%
Total (b)	\$15,450	5.2x	100.0%

(a) Includes search capital of \$300K at 50% step-up.

(b) Ignores transaction costs.

We will analyze the differences in returns to both investors and searchers under two different structures for the investor capital:

- Structure 1: 7% Nonredeemable Participating Preferred Stock
- Structure 2: 50/50 split of:
 - 16% Redeemable Preferred Stock
 - 0% Nonredeemable Participating Preferred Stock

Regardless of the structure of investor capital, the search fund principal will receive the following Manager Equity package:

- Potential of 30% of Common Equity
 - 1/3 (10%) vests at acquisition
 - 1/3 (10%) vests over 4 years (also commonly vests over 5 years)
 - Up to 1/3 (10%) vests according to net investor IRR performance hurdles
 - Straight line vesting is most common between 20% IRR and 35% IRR – i.e., 0% vesting at 20% IRR, 50% vesting at 27.5% IRR, and 100% vesting at 35% IRR

Following is a summary of the results in each of the three operating scenarios described above depending on whether Structure 1 or Structure 2 is used for Investor Capital:

Summary of Returns (\$000s)

	Investors		Seacher	
	<u>Structure 1</u>	<u>Structure 2</u>	<u>Structure 1</u>	<u>Structure 2</u>
Optimistic Case	\$ 46,877	\$ 49,077	\$ 11,909	\$ 12,813
Base Case	\$ 26,481	\$ 27,108	\$ 5,110	\$ 5,400
Pessimistic Case	\$ 11,150	\$ 11,235	\$ -	\$ -

As illustrated, the greatest driver of economic returns to investors and searchers is the company's operating performance and total gain on the investment.

Note that the economics to the searcher would be split in a partnership scenario.

The following two tables provide more detail on the results of the three operating and two financing cases described. Financial models with more detail on each scenario can be found in **Exhibit 12**.

SUMMARY CASH FLOW MODEL & RETURNS - INVESTOR CAPITAL STRUCTURE 1*(US\$ in 000s, except where noted)*

	<u>Optimistic Case</u>	<u>Base Case</u>	<u>Pessimistic Case</u>
<u>Operating Assumptions:</u>			
Annual Revenue Growth	20.0%	12.5%	0.0%
Annual EBITDA Margin Expansion	0.50%	0.25%	0.00%
Exit Valuation Multiple	7.0x	5.5x	4.0x
Year 5 Sales	\$ 37,325	\$ 27,030	\$ 15,000
Year 5 EBITDA	\$ 8,398	\$ 5,744	\$ 3,000
Exit TEV	\$ 58,787	\$ 31,592	\$ 12,000
Less: Net Debt	-	-	972
Total Equity	\$ 58,787	\$ 31,592	\$ 11,028
Redeemable Preferred Equity	\$ -	\$ -	\$ -
Non-Redeemable Preferred Equity	11,150	11,150	11,150
Value of Common Equity	\$ 47,636	\$ 20,442	\$ -
<u>Returns:</u>			
Investor Redeemable Preferred Equity	\$ -	\$ -	\$ -
Investor Non-Redeemable Preferred Equity	11,150	11,150	11,150
Investor Common Equity	35,727	15,331	-
Total Return to Investors	\$ 46,877	\$ 26,481	\$ 11,150
Original Investment	\$ 7,950	\$ 7,950	\$ 7,950
Return on Invested Capital	5.9x	2.4x	1.4x
Investor IRR	44.8%	28.8%	7.0%
Manager Common Equity Ownership %	25.0%	25.0%	20.0%
Manager Payout	\$ 11,909	\$ 5,110	\$ -

SUMMARY CASH FLOW MODEL & RETURNS - INVESTOR CAPITAL STRUCTURE 2

(US\$ in 000s, except where noted)

	<u>Optimistic Case</u>	<u>Base Case</u>	<u>Pessimistic Case</u>
<u>Operating Assumptions:</u>			
Annual Revenue Growth	20.0%	12.5%	0.0%
Annual EBITDA Margin Expansion	0.50%	0.25%	0.00%
Exit Valuation Multiple	7.0x	5.5x	4.0x
Year 5 Sales	\$ 37,325	\$ 27,030	\$ 15,000
Year 5 EBITDA	\$ 8,398	\$ 5,744	\$ 3,000
Exit TEV	\$ 58,787	\$ 31,592	\$ 12,000
Less: Net Debt	3,558	6,017	7,247
Total Equity	\$ 55,229	\$ 25,575	\$ 4,753
Redeemable Preferred Equity	\$ -	\$ -	\$ 1,647
Non-Redeemable Preferred Equity	3,975	3,975	3,975
Value of Common Equity	\$ 51,254	\$ 21,600	\$ -
<u>Returns:</u>			
Investor Redeemable Preferred Equity (a) (b)	\$ 6,661	\$ 6,933	\$ 7,260
Investor Non-Redeemable Preferred Equity	3,975	3,975	3,975
Investor Common Equity	38,440	16,200	-
Total Return to Investors	\$ 49,077	\$ 27,108	\$ 11,235
Original Investment	\$ 7,950	\$ 7,950	\$ 7,950
Return on Invested Capital	6.2x	3.4x	1.4x
Investor IRR	47.4%	30.7%	6.5%
Manager Common Equity Ownership %	25.0%	25.0%	20.0%
Manager Payout	\$ 12,813	\$ 5,400	\$ -

(a) Includes Investor Capital dividends during duration of investment.

(b) Cash from operations pays down Redeemable Preferred Equity over 5 year hold period.

PART IV: SETTING CRITERIA AND EVALUATING INDUSTRIES

SETTING SEARCH FUND INVESTMENT CRITERIA

Over the years the “search fund community” has developed and refined a list of criteria targeted at balancing risks and rewards for this particular investment vehicle. While the criteria are not absolute, they represent a collective history augmented by the successes and failures within the search fund model. However, it has become common for many search funders to simply accept the list without thinking about *why* each of the criteria exists. In general, the criteria aim to reduce a search fund entrepreneur’s key risks:

- Risk of finding a suitable company to acquire
- Risk of completing an acquisition
- Risk of managing and growing the company to provide an attractive return

The purpose of setting investment criteria is to create a framework for the search process and for evaluating acquisition opportunities. The criteria do not resonate equally with each entrepreneur or investor, and search fund principals should customize their target criteria based on their own skills and deficiencies, interests, and personal preferences. The criteria should maximize the chance that, within a reasonable amount of time, the searcher finds a good business that can be financed and acquired from a willing seller—and a business that the searcher can run successfully despite having limited to no experience as a CEO.

Having a defined set of criteria provides a framework of ideal circumstances, not absolute restrictions. No potential acquisition will meet all the criteria, requiring tradeoffs between the incremental risk being assumed and the potential reward. It is worth noting that many of the companies acquired by high performing search funds fell outside the standard “acceptable” criteria shown above in at least one substantial dimension. A key challenge facing search entrepreneurs is to know “when to take a train,” lest they never leave the station by waiting for opportunities that fit all the criteria perfectly. However, searchers and investors can recognize that the common criteria exist in the search lexicon for a reason, and when an opportunity falls outside of these guidelines, there is reason to assess carefully what risks are increased and what corresponding rewards may be gained.

Establishing acquisition criteria up front also helps align the searcher’s and equity investors’ expectations for the general nature of investment opportunities that are likely to emerge from the search effort.

The classification of the following criteria as applying to an industry or a company is simply a matter of practicality. Many searchers take an industry-focused approach, so a logical starting point is to articulate desirable and undesirable characteristics of that particular industry. It is clear that many companies (though not all) share many of the macro attributes of the industry, and therefore classifying criteria as specific to the industry or company can be arbitrary.

	Desirable	Undesirable
Industry	<ul style="list-style-type: none"> • Fragmented industry • Growing industry • Sizable industry – both revenues and number of companies • Straightforward industry operations • Relatively early in industry lifecycle • High number of companies in target size range • Healthy and sustainable profit margins (ROTC* >20%)¹³ 	<ul style="list-style-type: none"> • Highly consolidated industry • Declining industry • High competitive intensity/limited barriers to entry • High customer pricing power • Unpredictable exogenous factors
Company	<ul style="list-style-type: none"> • Competitive advantage • High recurring revenue**¹⁴ • History of cash flow generation • Motivated seller for non-business reasons • Fits financial criteria, e.g. \$10 million to \$30 million in revenues and greater than \$1.5 million of EBITDA • Multiple avenues for growth • Solid middle management • Available financing • Reasonable valuation • Realistic liquidity options in 3-6 years 	<ul style="list-style-type: none"> • Turnaround situation • High customer concentration • High customer churn • Small company – less than \$10 million revenues or \$1.5 million EBITDA • Limited or no management bench strength • Competitive auction • Public to private transaction

¹³ ROTC = Return on Tangible Capital

¹⁴ Recurring revenue can be defined as regular monthly, quarterly or annual payments for services received every month or quarter from customers who stay for at least 18 months.

REDUCING RISK

This section will consider the potential industry and company criteria listed above in terms of the three major risks of a search fund. Many of the criteria apply to multiple categories of risk. For example, any attribute that reduces the risks for the search fund entrepreneur in managing and growing the business will, for that very reason, make the opportunity more attractive to debt and equity financing sources and therefore reduce the risk of completing the acquisition. To reiterate, the industry and company criteria discussed here are not meant to be exhaustive or proscriptive. Search funders should calibrate target characteristics to their personal skill sets, potential weaknesses, deficiencies, and preferences, as well as the expectations of their investors.

Risk of finding the right company to acquire

Searching for a company to acquire can be a “numbers game.” A search fund principal has limited time and resources to pursue acquisition candidates. Setting criteria such as the following can help a searcher structure this process to increase the pool of potential opportunities and to leverage learning about certain industries against a larger group of acquisition candidates. By definition, fragmented industries will have numerous smaller players serving narrow customer segments or geographic regions. This can provide more targets for acquisitions and more avenues for growth through product/service or geographic expansion. Likewise, sizable industries, both in terms of the number of participants and overall revenues, are more likely to have companies that fit the search fund’s financial criteria (e.g., \$10 million to \$30 million in sales). Further, other downstream buyers will consider the overall size of the industry, and a large industry will be more attractive to strategic and financial buyers, thus enhancing exit options.

On the flip side, highly consolidated industries are likely to have strategic acquirers willing to pay premium valuations, leading to the possibility that the best companies have been “cherry-picked” by the strategic buyers.

Risk of completing an acquisition

To complete a deal, a searcher needs to identify companies that have a willing and motivated seller who is selling for reasons besides deterioration in the business. Ideally, the seller is ready to transition out of the business for retirement or personal circumstances, or has other professional plans.

The searcher must also identify acquisition opportunities that have available financing (equity and potentially debt) to buy the company. Obtaining debt for the company is not a requirement, although financing a deal solely through equity makes it much harder to obtain a suitable return on equity for the investors and searcher. Some search fund target companies may have sufficient fixed or current assets to obtain asset-based lending; however, many (e.g., services business) will only be able to obtain cash-flow lending. In general, debt and equity investors are attracted to growing industries with straightforward industry operations they can easily understand, particularly in situations where management is transitioning due to a change in control. In addition to being in attractive industries, companies favored by lenders and equity investors typically are growing and have sustained healthy margins and a history of free cash flow generation. These attributes reduce the company’s risk profile and will drive the company’s ability to service its debt payments, de-lever the business in a reasonable time frame, and create equity value. While not required, a recurring revenue model is attractive as it provides a higher degree of comfort about the company’s projected performance. Finally, most lenders and investors favor companies of a certain size, usually at least \$10 million in sales and \$1.5 million in EBITDA, and preferably larger. A larger company with more cash flow makes it easier for the new manager to hire

highly qualified (and more expensive) new team members, access more debt, and invest in systems required to scale the business.

On the other hand, attributes that lenders and investors find undesirable include high customer concentration (e.g., any customer comprising >30 percent of sales), as the loss of a big customer or major reduction in price to that customer can impact the company's ability to service its debt and can greatly impact margins. Many investors also avoid situations where the sales and earnings base is volatile or where there is limited visibility into the revenue and earnings pipeline, such as when there is high customer churn.

Industries with unpredictable exogenous factors (i.e., factors that cannot be controlled or mitigated) are unattractive due to the potential risk of macro changes that could adversely impact the financial profile of the entire industry. Examples of unpredictable exogenous factors include regulatory risk, payment risk (e.g., health care), technological change, environmental risk, litigation risk, commodity exposure that cannot be hedged efficiently or cost-effectively, a heavily unionized work force, high cyclicality or seasonality, and subjectivity to trends/fads (e.g., certain consumer segments).

Even if a company is situated in a favorable industry and possesses many of the desirable company criteria, it must be available at a reasonable valuation to provide satisfactory returns to the stakeholders. If the company is for sale in a competitive auction, potential buyers are competing on both price and execution. Private equity firms and strategic acquirers, with their committed capital, proven deal execution capabilities, and incumbent lender relationships, generally have a relative advantage to search funds in auction situations. Further, strategic buyers often have a greater understanding of industry profit drivers and the ability to pay a higher price due to operating synergies or lower return hurdles. The larger the company, the higher the likelihood that it will be sold in a competitive situation. Typically, search fund entrepreneurs have had the most success looking for companies with between \$1.5 million and \$5 million of EBITDA.

Searchers should consider avoiding public-to-private transactions, which require substantially higher legal fees and for which, due to a diffuse ownership base, they will have a lower likelihood of successfully reaching an agreement with selling shareholders.

Risk of managing and growing the company to provide an attractive return

In general, most search fund principals have limited or no experience managing a company at the CEO level. Certain industry and company characteristics provide new CEOs with a greater margin of safety as they transition into the business, as well as a greater probability of obtaining future growth and robust exit options.

Choosing a growing industry with a "tailwind" allows companies to grow without stealing market share or entering into aggressive price wars. Therefore, new managers have the opportunity to learn the business in a more favorable competitive environment. Straightforward industry operations allow new managers to scale the learning curve quickly so they can identify the fundamentals of the business and levers for growth and profit improvement. Industries with low product or service obsolescence and long product or service lifecycles prevent the new CEO from having to make early bets on product development. Highly fragmented industries are less likely to have a dominant "800-pound gorilla" that can distort the competitive environment (e.g., aggressively pricing competitors out of the market), giving the search fund CEO more breathing room to operate and grow the company. Fragmented industries also may provide the CEO with more growth opportunities to expand the product/service offering or expand geographically to provide a "one-stop shop" in certain customer verticals or geographic regions.

Industries with high competitive intensity and limited barriers to entry tend to lead to competition on price, eroding margins and making sustainable growth more difficult. Industries with high customer or supplier concentration may have dominant customers or suppliers who can exert significant influence in the value chain, turning industry participants from price-makers into price-takers and limiting industry profit potential.

Historically, search funds have not done well “being the best house in a bad neighborhood”; declining industries often deteriorate into a zero-sum game, increasing competitive pressure as companies compete primarily on price. A single company, particularly one in the search fund target’s size range, is unlikely to turn the industry tide, and achieving growth may require fundamental changes to strategy or operations, which an inexperienced CEO may not be poised to accomplish.

Ideal companies will be growing and have a competitive advantage (e.g., product/service differentiation, cost advantage, barriers to entry to its core business model), making them more likely to generate healthy and sustainable profit margins. Growth and high margins provide the new manager with a cushion in the event of unforeseen macro-headwinds (e.g., economic downturn) or other inevitable bumps in operating the business. EBITDA margins greater than 15 percent can provide a reasonable margin of safety. Even better are companies with multiple avenues for growth; for example, potential growth through improvement in sales and marketing, product/service extensions that do not require substantial investment, or geographic expansion. A company with a recurring revenue model gives an inexperienced CEO greater visibility into revenue pipeline, backlog, and conversion, making it simpler to match operating expenses and capital investments. This also allows the new CEO to take the time to understand the business fully and make incremental changes to improve a solidly performing base.

While size is an important factor in search fund acquisitions, the statistics around the top-performing funds have shifted over time. Prior to 2015, the common consensus was that smaller companies (e.g., less than \$10 million in sales and \$1 million in EBITDA) had a thin margin for error and may not have had sufficient profits for the CEO to invest in growth or recruit experienced managers. Further, as one former search fund noted, “Even big growth on a small number still results in a small number.” On the other hand, companies that are too big (e.g., greater than \$30 million in sales and \$5 million in EBITDA) are still considered to have the capability to overwhelm an inexperienced manager. Data from the *2016 Search Fund Study* challenges previously held notions about smaller companies. Specifically, the top quartile search fund performers bought companies with median sales of \$7.8 million and a median purchase price of \$8.5 million. Further, the median EBITDA growth rate of the companies acquired by the top quartile performers was 20 percent and the median EBITDA margin was 22.7 percent for the top quartile.

It remains true that smaller companies have fewer debt financing options. They also have less money with which to recruit middle or senior management talent and invest in growing the business (e.g., capital projects, marketing, working capital build).

Further, turn-around situations, which require a specific skill set and provide much less margin for error, are not generally considered appropriate for the search fund model and are unlikely to attract debt or equity financing.

Companies with limited or no management bench strength tend to put more pressure on the new CEO to “do it all,” and will ultimately require an investment in hiring and training an appropriate layer of middle management, thus reducing profits. Also, if the seller maintains the key customer and supplier

relationships, rather than allowing them to be spread throughout the management team, there is increased risk in the transition process.

Companies with high customer churn provide an inexperienced CEO with much less room for error when budgeting operating expenses or capital investments. In addition, the company may have high customer acquisition costs.

Companies with low profit margins, whether due to being in fundamentally poor industries or having pursued a flawed strategy, are not generally good candidates for search fund acquisitions. Warren Buffet reinforces the sentiment: “When a management team with a reputation for brilliance tackles a business with a reputation for bad economics, it is the reputation of the business that remains intact.” Experience in the search fund industry has shown principals have been better off paying a full price for a good company than getting a “bargain” for a bad one.

The final criterion for a company is that, assuming the manager is successful at operating and growing the business, there are logical opportunities for liquidity in 3 to 6 years.

In summary, searchers should be thoughtful about developing and applying criteria to industries and individual company opportunities. There is (and should be) tension between finding an ideal business and realizing that no opportunity is 100 percent perfect. One experienced searcher and investor noted, “A searcher’s hierarchy of outcomes is (1) buy a good business, (2) don’t buy a company, and (3) buy a bad company.”

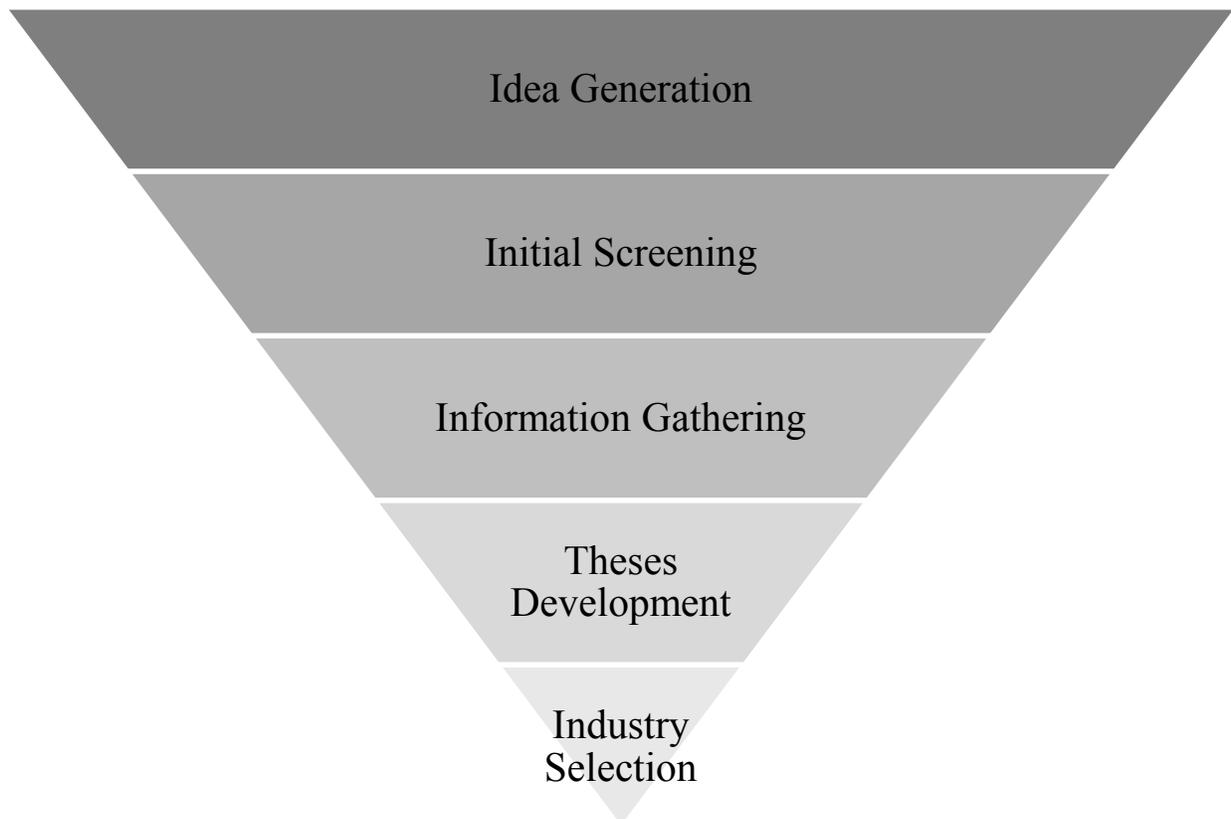
EVALUATING INDUSTRIES

Searchers and investors recommend analyzing industries and companies through the criteria developed by the searcher (described in the prior section of this *Primer*). When searching for investments, there are two general avenues to finding deals: by targeting specific industries or by sourcing deals from intermediaries in an industry-agnostic or opportunistic approach.

Neither the industry approach nor the opportunistic approach has proven to be consistently better than the alternative. Most searchers blend the two approaches. For example, searchers might spend 75 percent of their time searching in a few particular industries, and 25 percent of their time reviewing deals from brokers, deal intermediaries, and service providers to small companies. This mix will fluctuate according to the searcher's highest return on time and personal preference and style.

If a searcher follows an industry-focused approach, a big component is selecting several industries to pursue that fit those criteria. Search funders have used a variety of tactics to select target industries.

Generally, industry selection follows a multi-stage funnel process, as depicted below:



Idea Generation

Search funders have generated industry ideas using a variety of methods—some use a very wide funnel and some very narrow. If using a wide funnel, a search principal must balance exploring a breadth of industries against time constraints. If using a narrow funnel, a searcher should be cautious of being too focused and risk missing other attractive opportunities. Four typical methods of idea generation are:

- Top-Down
- Mega-Trends
- Historical Experience
- Opportunistically / Ad-Hoc

These approaches are not mutually exclusive.

The top-down approach starts with a wide funnel and narrows down in a systematic fashion by applying just a couple of overriding criteria. Searchers who use this approach generally start by looking at lists of industries and companies to spark ideas. Sources such as SIC and NAICS codes, Yahoo Finance, Thomson Financial industry listings, Inc. 5000 companies, public stock OTC or NASDAQ lists, and even the Yellow Pages can provide starting points. The goal is to create a sufficiently large, yet manageable, list of industries that pique the interest of the searcher (one former searcher advocates generating an initial list of approximately 75 industries via this process).

Some searchers take a more moderate approach and target industries likely to be buoyed by a mega-trend. For instance, by focusing on services to aging baby boomers, a searcher could analyze the industries and specific industry sub-segments of healthcare services, eldercare, in-home care, assisted living, etc. with the intent of selecting industries that have high growth potential in the near to mid term. Historical search funds have capitalized on mega-trends such as specialty insurance, business process outsourcing, professional employer organizations, and outsourced legal services.

Other searchers have taken a narrower approach by leveraging their prior professional experience, searching primarily in industries in which they have worked and have an established knowledge base and network. These searchers may have a relative advantage in their particular industries from a network and credibility perspective, compared to other investors who are learning about the industry for the first time.

Lastly, some searchers generate ideas opportunistically by reaching out to brokers for investment opportunities, talking to advisors, or speaking to professionals in investment firms. Often, a specific investment opportunity, such as a brokered deal, can educate the searcher on an industry that was not previously under consideration. Even if the deal does not go through, assuming it was not due to macro trends in the industry, the searcher can subsequently leverage industry learnings across additional opportunities within the same industry. Similarly, the searcher's advisor or professional network may yield promising ideas.

Initial Screening of Industries

Once an initial list of industries has been developed, searchers typically evaluate industries against the criteria they developed at the inception of the search fund. This process can be formal or based on gut instincts, and the process will be driven in part by the number of industries being evaluated.

Historically, searchers who use a more formal approach create a scorecard or forced ranking of industries against ideal criteria. The following chart provides an example of how a searcher might create an industry scorecard:

Sample Industry Scorecard

(Ranking 1 to 3, Low Fit with Criteria to High Fit with Criteria)

Industry Criteria	Potential Industries			
	Professional Employer Organizations	Medical Billing Services	In Home Eldercare	Consumer Credit Collection
Fragmented Industry	2	3	3	3
Industry Growing	3	3	3	2
Recurring Revenue Model	3	3	3	1
Sizeable Industry (# of companies and \$)	3	3	3	3
Healthy and Sustainable Margins	3	2	2	1
Straightforward Industry Operations	2	2	2	2
High Barriers to Entry	3	2	2	1
Low Customer Concentration	3	3	3	3
No Consolidation Trend	3	3	3	3
Low Exogenous Risk <i>(e.g Payment, Regulatory, Technology, etc.)</i>	3	2	1	1
Industry Score (out of 30)	28	26	25	20

The points assigned to each criterion are based on the searcher’s intuition and cursory high-level research, such as reviewing company websites, research reports, or filings of public companies in the industry. See **Exhibit 13** for an example of a more detailed industry scoring system.

Some searchers advocate an even simpler industry screening approach by looking only for two or three “super-priority” industry criteria. For instance, they only consider industries that have recurring revenues, ability to scale, and at least 20 potential targets—all other industries are immediately eliminated.

The screening process is based on personal preference and is intended to be quick. Search funders liken this step to using a blunt instrument to pare down the list of industry targets to a small number, usually between five and ten promising industries, to investigate more thoroughly. This process can take one to two months.

Information Gathering

With the list of industry targets reduced to a manageable number, searchers start gathering more detailed information to narrow the list of target industries from approximately ten to the top three—the industries that the searcher believes have attractive economic and competitive dynamics and align with the target criteria. It is common at this stage for searchers to perform a basic strategy analysis on the industry (e.g., Porter’s Five Forces).

Gathering key information on industries quickly can be difficult. Some industries may have public companies with equity research reports and annual reports containing details on market size, growth, and margin benchmarks. Other industries can be researched using databases with information on private companies such as Capital IQ, Hoover’s, Dun & Bradstreet, and One Source.

Searchers often rely upon primary methods such as calling an industry insider (e.g., business owners, trade association members, sales or business development professionals) to gather information. In addition, industry trade associations and specialty investment banks or advisory firms that service the industry often have general industry research and/or white papers that are publicly available. Trade associations also typically post lists of member companies that are a good screen to determine if there are a reasonable number of industry participants. Some searchers recommend using undergraduate and MBA interns to assist in gathering information.

Theses Development

In the process of detailed industry analysis, some searchers develop a brief white paper or industry thesis to make the case for or against pursuing an industry. The purpose of creating a thesis is to codify the accumulated knowledge and compare opportunities across a common set of metrics in order to make an objective go/no-go decision.

Searchers have also used this exercise to pitch each other (if a partnership) or investors and advisors on industry ideas. In addition, this industry analysis is often an integral component of the final investment memo for a transaction.

The following information can be useful in structuring industry theses:

Category	Specific Topics
Industry Description	<ul style="list-style-type: none"> • History and evolution of industry • Products/services provided • Primary customers, suppliers, and competitors
Industry Size	<ul style="list-style-type: none"> • Total industry revenues – past, present, and expected • Industry revenue growth rate and macro trends • Number of players • Industry volumes and pricing trends • Addressable market potential
Industry Players	<ul style="list-style-type: none"> • Qualitative assessment of competition – e.g. mom and pop, fragmentation, professionalism, etc. • List of industry competitors by revenues • Estimated market share by competitor
Business Model Review	<ul style="list-style-type: none"> • Detailed review of product/service offerings and distribution channels • Revenue model – e.g., recurring revenue model • Assessment of operational complexity and capital intensity • Unit economics – back-of-envelope estimates for average transaction size, profit per transaction, length of contracts, contribution margin by product or service, etc. • Product/service cycles, R&D or capital requirements

Category	Specific Topics
Strategic Assessment (Porter's Five Forces)	<ul style="list-style-type: none"> • Suppliers – number and pricing power of suppliers, cost trends • Buyers – number and types of customers, concentration of customers, customer stickiness, pricing power of buyers • Competition – level of competitive intensity, pricing environment, sophistication of product/service offerings • Barriers to entry – structural, capital, contractual, or regulatory barriers to new entrants • Availability of substitutes – competing products or services, assessment on risk of technological, off-shoring or other business model displacement
Exogenous Variables	<ul style="list-style-type: none"> • Cyclical, seasonality, technology, political or regulatory environment • Roll-up potential
Mega Trends	<ul style="list-style-type: none"> • Aging population, energy efficiency, business process outsourcing, etc.
Final Assessment	<ul style="list-style-type: none"> • Coherent and summarized thesis on a go/no-go decision based on the above factors

Time management during this step is important. Spending three days each on ten industries can easily result in a month of effort.

Industry Selection

Once several industries are targeted, the search fund principal may talk to the investor base to validate the attractiveness of the industry and solicit support to commit time and resources to the industry and help in sourcing deals.

The next step is to budget the time to become an industry insider. Searchers commonly attend tradeshows, meet with business owners in the industry, interview customers and suppliers, and develop “River Guides.” River Guides, discussed in greater detail in the section on Sourcing Opportunities, are typically retired CEOs or trade association presidents in the target industry who are tasked with providing the searcher with introductions to acquisition opportunities. River Guides have proven to be very effective at helping searchers establish credibility in an industry.

PART V: “THE SEARCH” – SOURCING ACQUISITION OPPORTUNITIES

OVERVIEW

As seen in the *2016 Search Fund Study*, the median number of months from start of the search to closing a deal is 19 months, although the range is vast:

Total Number of Months From Start of Search to Deal Close	All Acquisitions
Minimum	3
Median	19
Maximum	87
<11 months	12%
11-20 months	44%
21-30 months	26%
31+ months	18%

Whether a searcher sources potential acquisitions using an industry-focused approach or opportunistically, key ingredients to a successful search process include a relentless drive and discipline, creativity in finding sellers, and organization in tracking and planning all activity.

Search funds often track data for both acquisition opportunities and fundraising using CRM software (e.g., Salesforce, Zoho, or Sugar CRM) or another database product. Many searchers recommend investing in the software/database before commencing the fundraising effort to track all potential investor contact information, meetings, communications, and commitments. Once the deal sourcing process is underway, the software/database is used for many purposes, including:

- To collect, classify, and centralize contact information on individuals and companies in an easily searchable format
- To capture data on target acquisitions
- To record all communication with each contact (company owners, intermediaries, industry resources, other executives, investors, etc.)
- To analyze the searcher’s activity and results (e.g., number of companies contacted, number of meetings, Letters of Intent submitted, sources of opportunities, etc.)
- To assist in planning future search activity

A critical step in the deal sourcing process is “qualifying sellers,” that is, determining if the company is truly an attractive target and if the seller is willing to sell in the near term. With limited resources, a

search fund cannot afford to spend time, money, and energy getting to know a company, only to find out the owner is not truly committed to a sale, but is rather looking for a free valuation service from a smart MBA investor.

Past search funders recommend being up front with business owners about financial criteria and valuation ranges as early as possible. While a business owner will rarely share sensitive information freely, searchers can solicit information creatively. For instance, a searcher might say, “I’m an investor looking for companies between \$10 million and \$30 million in sales and \$1 million and \$5 million of bottom-line earnings. I’m willing to pay 4 to 6 times EBITDA based on my research on this industry. I don’t want to waste your time, so if you don’t fit this profile, I can let you go.” Ascertaining the business owner’s age, succession plan, and motivations for selling can be helpful in determining the owner’s true intentions and timeline to sale.

Indications of seller seriousness include a willingness to share sensitive business information, allowing the searcher to meet other company employees, announcing the sale process to employees, stating a price for the business, signing an exclusive LOI, and spending their own money on lawyers or other service providers in anticipation of a sale.

INDUSTRY-FOCUSED SEARCH

If pursuing an industry-focused search, once an industry has been selected, the next task is to generate lists of target companies within that industry that fit the search fund’s company criteria. One method for finding lists of companies in a target industry is to find the relevant trade association, which will commonly have a list of member organizations on the website or an offline directory, sometimes with contact information, links to the companies’ websites, and general information on the company’s size (e.g., sales, employees, products, etc.). In addition, a searcher may look at the list of trade show exhibitors from an industry trade show or search databases such as Capital IQ, Dun & Bradstreet, Hoover’s, or OneSource by industry codes. Recent searchers have also used outsourced services, such as hiring overseas help using oDesk or other BPO platforms, to generate lists of companies and contact information.

Once a robust list of companies has been developed, a search funder can use the above databases and Internet searches to find information to screen for appropriate targets. Key metrics include approximate revenues, age of CEO/founder, and number of employees. Caution must be used when collecting this information; many of the databases rely upon self-reported numbers, which small private companies are often reluctant to provide or may embellish. Also, a company that may appear too large or too small for a search fund target may still be worth contacting as a source of information or additional introductions. Some search funds have used interns or other outsourced providers to “scrub” the list of all participants in an industry, to help narrow down the subset of target companies to be contacted.

There are various ways to make contact with business owners. Search funders have used techniques like sending targeted letters, cold calling, e-mailing, getting warm references from industry insiders or other personal and professional contacts, and meeting at industry conferences and tradeshows. Professionals at private equity shops with outbound calling efforts estimate that they often leave 10 to 20 voicemails before receiving a call back. Some searchers have reported better results due to the size of the companies they target and the fact that they are the managing principals of their funds calling the business owner, versus PE funds that generally use junior associates to make cold calls.

A successful seller outreach effort is an art, not a science. A “warm” introduction is always preferred to a “cold call.” To this end, getting an introduction from a “River Guide” (addressed in more detail below) can be highly effective. If no introduction is possible, sending a letter prior to the call can be more effective than a pure cold call in which the searcher is trying to offer an introduction as well as explain the reason for the call. Search funders note the importance of making sure the call immediately comes across as useful, credible, or relevant to the business owner. Techniques for accomplishing this can include mentioning other CEOs in the industry; mentioning a supplier, customer, or industry association; and talking first to a lower-ranking executive (e.g., VP of sales) who then refers the search funder to the CEO. At the seller outreach stage, the search funder has already completed deep industry analysis based on other research and conversations, which should increase the search funder’s credibility.

Tradeshows can be a critical source of deal flow. To be an effective use of time, a search fund principal should plan well in advance of attending the show by calling the list of relevant targets to schedule meetings or to let the CEO know when to expect a visit at the company’s booth. It’s always a good idea to map out the exhibition hall and plan a route that includes the maximum number of possible. One searcher recommended creating an information card on each target that contained key statistics such as estimated sales, key personnel, and an opening pitch. Tradeshows can also be an effective place to make other useful contacts with industry consultants, service providers, and executives.

Searchers emphasize that every conversation can be valuable. Many employees within a company can help qualify a target company by providing information on number of employees, customers, products, services, etc. If a particular owner is not willing to sell, searchers recommend asking if the owner knows someone who is planning to sell. Using a CEO’s name in future conversations with other prospects can also help build credibility.

A search fund principal can engage a “River Guide”—typically a retired CEO or head of the industry trade association—to broker introductions to potential sellers. River Guides are commonly compensated with a deal success fee (typically 0.5 to 1.0 percent of total deal size, often with a modest cap) as the incentive for them to make the introductions of the search fund to business owners and generate proprietary deal flow. The River Guide’s main role is to call prospective sellers and ask them to take a call from the searcher. Some searchers have also used River Guides to provide them with an insider’s view to the industry and the competitive landscape.

Search funders who have successfully utilized River Guides recommend clearly defining the rules of engagement, e.g., length of agreement, how the fee will be calculated and when it will be paid, and if specific companies are already known to the searcher. It is also important to clarify the search fund’s investment criteria, and how the fund should be represented to potential sellers (e.g., the purpose of the fund, its interest in the industry, and its capital resources). The searcher may provide the River Guide with marketing materials on the fund to be distributed to the potential seller and provide the River Guide with talking points. **Exhibit 14** offers an example of a contract with a River Guide.

There are a growing number of service providers and “buy-side” brokers who can help searchers generate proprietary leads with business owners by conducting outbound direct mailing and calling efforts to business owners in the fund’s target industries. These parties typically receive a monthly retainer and a deal success fee.

In addition to direct seller outreach, many searchers look for intermediaries such as boutique investment banks, accounting firms, and legal practices with practices dedicated to specific industries. A searcher

can market the fund to these firms and establish credibility as an investor who has completed substantial analysis and developed a network within the target industry.

OPPORTUNISTIC SEARCHES

Opportunistic searches rely on third parties such as business brokers, investment banks, accounting firms, and law firms to refer companies that are actively for sale. The following chart lists potential sources of brokered deals and representative transaction sizes:

Sources of Deals by Size

Sources	Deal Size						
	\$500K	\$1MM	\$5MM	\$10MM	\$20MM	\$35MM	>\$50MM
Independent Brokers	██						
Professional Brokers		██					
Venture Firms			████████████████████				
LBO Firms			██				
Personal Contacts	██						
Investment Banks					██		
Other Professional Services Firms <i>(e.g. banks, CPAs, lawyers, etc.)</i>		██					

The broker community is extremely large and fragmented; there are over 10,000 members of the Association for Corporate Growth (ACG) and more than 1,800 members of the International Business Brokers Association (IBBA), industry trade associations dedicated to small business M&A. The quality and sophistication of brokers varies widely.

Marketing to business brokers, boutique investment banks, and other deal intermediaries requires intensive effort. Searchers have spent multiple weeks and sometimes months generating lists of contact information for business brokers. Contact information can be generated through Google searches, attending an ACG or IBBA conference, or getting access to a database such as the ACG or IBBA member directories. In addition, accounting, law firms, and regional banks are often involved with the sale of companies, although this list may be harder to assemble and generally results in fewer leads. Again, some searchers are using interns or “off-shoring” the development of broker and intermediary lists to organizations in India and elsewhere.

Once a database of contacts has been developed, search funds market themselves to brokers in various ways. Some searchers send a mass e-mail to the entire list of brokers (up to thousands), with the hopes of being added to a business broker’s general e-mail list. For instance, one searcher compiled a list of nearly 1,100 brokers, and sent a simple e-mail describing the search for companies that were greater than \$10 million in sales, had at least \$1 million in EBITDA, and were in growing industries. Over the following months, the searcher received over 100 deal opportunities, one of which led to a successful acquisition. Many searchers continue to send periodic marketing e-mails to their list of intermediaries to remain “top of mind” as new companies emerge for sale.

Other searchers cultivate relationships with a handful of buy-side brokers and provide incentives to them to search on the fund’s behalf for a negotiated deal fee and perhaps a retainer.

Sophisticated intermediaries, including boutique investment banks, often require greater marketing efforts from search funders. Investment banks are more likely to show promising opportunities to private equity firms who have committed capital sources or investors with whom they have a prior relationship. Accordingly, searchers can market the strength of their investor base and ability to execute on an acquisition to gain access to the investment bank's deal flow.

The advantage to brokered deals is that the seller is usually actively seeking liquidity. In contrast, an industry-focused search often yields conversations with business owners who had not yet considered selling their companies. In addition, brokers can be good for generating investment ideas by bringing opportunities in industries that had not been considered before.

While brokers may bring actionable deals, their ultimate goal is to secure the highest price possible for a good deal fee. Search funds may end up competing with private equity funds on price and ability to execute. One investor noted it appeared that search funds only saw brokered deals when credible private equity investors with committed capital had already passed on the deal, leading to an adverse selection problem.

In addition to brokers and service providers, search funders also typically "make everyone an agent" on their behalf. Searchers commonly broadcast their basic criteria (e.g., company from \$10 million to \$30 million in sales seeking management transition), and agree to a standard deal fee for anyone who introduces them to a company that is acquired by the search fund. One entrepreneur was referred to a deal by his mother-in-law, who saw an ad in the local newspaper.

REGIONAL SEARCHES

In the past, entrepreneurs have raised search funds for the purpose of focusing the search on a region of the United States or a specific country. For the most part, these have been formed for personal reasons, or reflect limitations in the searcher's ability to relocate. Naturally, this has to be disclosed and explained in a satisfactory manner so the investors believe the restrictions do not hamper the probability of finding an acquisition target.

A possible advantage of doing a regional search fund is that it may offer a head start to a searcher who has relationships with the intermediaries, sellers, and companies that are relevant in that region. The downside is that the pool of potential acquisition targets may be severely limited if the search is too localized. One point to remember is that approximately 20 percent of search funds never make an acquisition.

LEVERAGING YOUR INVESTORS

Search fund entrepreneurs should seek to leverage the experience of their investors and advisors during the entire search process. Many search fund investors were either searchers themselves or have invested in multiple search funds, so they can identify with many issues that may arise. Investors can offer personal advice to help searchers through the difficult journey and professional advice to ensure smart opportunities are pursued.

It is also important to stay in regular contact with investors to ensure their support when the searcher finds the ideal company to purchase. Regularly communicating with the investor base and calling upon specific investors for assistance during the search process will help the entrepreneur identify what investors care most about and ensure that their "hot buttons" are included in the list of priorities. If this is

not done effectively, the searcher runs the risk of not being able to raise sufficient equity to purchase the acquisition target.

A NOTE ON TIME MANAGEMENT

Time and money are the two most valuable, and scarce, resources a search fund possesses. Many searchers report that the clock starts ticking loudly the day the fund is closed. With approximately 2 years of funding, and the median search lasting 18 months, each month that passes increases the anxiety level of the searcher and the willingness to “settle.” Although the time pressures are very real, if the searcher has not closed a deal for the right reasons and maintained an open and forthright dialogue with investors, extending the search fund may be a viable option by raising additional funds from investors. However, conversations with recent investors indicate there may be a growing unwillingness to extend existing funds.

Therefore, the searcher should carefully monitor and track process against time-based benchmarks (e.g., making a certain number of calls per week and a certain number of company visits per month). If in a partnership or using interns, searchers can hold internal “competitions” on deal sourcing efforts. Solo searchers could set their specific quotas or performance benchmarks. Most searchers send regular updates to their investors on the progress of their search, including data on their recent efforts as well as cumulative effort through the life of the fund. Committing to a level of measurable activity (number of calls, meetings, company visits, etc.), and then reporting on the actual results, ensures accountability; it can also help create a sense of accomplishment in what can be a grueling and otherwise binary process.

Given the time constraints, searchers should seek to hit the ground running as soon as the search capital is funded. Opening an office, developing marketing materials, contacting brokers, and doing industry research can quickly eat into a search fund’s limited time. Raising a search fund is generally not a full-time job, even less so for two people. Significant downtime exists while meetings are being scheduled and documents distributed. This is an opportune time for an enterprising fund to get ahead of the game and begin laying the groundwork for full operations. By setting up a website and creating marketing materials, for instance, a fund can begin generating deal flow prior to closing.

To leverage their time, some search funds use undergraduate and graduate school interns to help with their search processes. Solo search funders in particular advocate using interns, who often work for a success fee if a deal they sourced ultimately closes. Often, interns can receive class credit for their work. Interns have typically been effective at developing lists and contact information for companies, brokers, and industry intermediaries as well as organizing mass mailings. Some searchers have also used interns to help gather information for industry analyses or to help with the initial calling effort (depending on the experience and maturity of the intern.) Feedback on the best ways to use interns most effectively is mixed. Results are dependent on the quality and sophistication of the interns as well as the search fund’s willingness to invest time training them.

In addition to interns, as mentioned earlier, various organizations can tackle tasks such as developing lists of target companies or intermediaries, or undertaking direct mailing and calling efforts on behalf of the search fund. There are tradeoffs between cost (most will require a retainer as well as performance fee), pure manpower, and quality of results that each search fund must evaluate with respect to its overall search process and goals.

ADDITIONAL THOUGHTS ON DEAL SOURCING

Maintaining a robust deal pipeline

It is not uncommon for a time-consuming deal to fall apart after weeks or months of effort. Experienced search fund principals and investors advise searchers to continue actively sourcing new deal opportunities until the day the closing documents are signed. This scenario is especially true for solo searchers who may be drawn into detailed due diligence at the expense of mining new opportunities. Interns may be a good resource for generating a pipeline while the search fund principal is allocating close attention to a particular deal.

Involving lenders early

Debt can be an important component to funding a deal and generating attractive equity returns. However, the debt market for microcap buyouts is highly cyclical. One way for a searcher to improve the odds of securing appropriate debt is to establish relationships with senior and mezzanine lenders (often via the investor group) and involve them early in the deal process. By showing a potential deal to a lender before making an offer, the principal can avoid wasting time on an un-financeable deal, as well as get the lender comfortable with the manager and the company over time.

Remaining flexible with the deal structure

Often, the structure and terms of a transaction and other non-financial concerns are as important to the seller as the price paid. By listening carefully to the seller, a search fund may be able to offer more flexibility than a private equity or strategic buyer and win the bid despite paying a lower price. For example, one search fund principal was the third-highest bidder on a company, but won the deal based on meeting the seller's desires, such as not relocating the company and leaving the owner with a small equity position.

PART VI: EVALUATING TARGET BUSINESSES

OVERVIEW

Every acquisition process is different; however, to generalize, a search funder will go through three levels of evaluating an acquisition opportunity before the deal closes:

- “First Pass” – When the opportunity is first presented, the searcher will typically evaluate very limited and high-level information about the company and industry to determine if the particular opportunity warrants more time and resources.
- Valuation/LOI stage – In this stage, the searcher will qualify the owner as having a genuine intent to sell the company; perform a more detailed analysis of the industry; conduct sufficient analysis on the business to submit a Letter of Intent, which will include a non-binding valuation (or valuation range) and major terms; and prepare a list of items to be explored in a comprehensive due diligence process.
- Comprehensive due diligence – Generally, once a company is “under LOI,” the searcher will conduct a more thorough vetting of the company’s organization, products/services, operations, customers, suppliers, assets, liabilities, financial results, prospects, and legal aspects.

Each deal will unfold on its own timeline, largely driven by the seller’s motivation and responsiveness in sharing information (or the availability of information within the company), but it is not uncommon for the entire deal process to take 4 to 12 months from the first introduction to closing. Each subsequent stage requires a larger commitment of both time and money and therefore an escalating commitment by both the seller and the searcher.

Regardless of the stage, search funders should be guided by several principles when evaluating target businesses:

- Be smart and efficient with resources, bearing in mind a searcher has limited time and money, and therefore faces a real opportunity cost in pursuing any given transaction.
- Clarify the key goals in each stage of evaluation and structuring the work to meet those goals.
- Establish clear priorities in each stage, and recognizing that perfect information on every aspect of the business is an unrealistic goal. The list of potential items to explore can be long and never fully exhausted; however, searchers are advised to keep a list of prioritized items that will really impact the go/no-go decision. One serial search fund investor emphasized the need to “separate the ants from the elephants,” with the “elephants” being the issues that would cause the searcher to “kill the deal.”

- Adhere to a process. The evaluation of a company, especially in the latter stages, can be very complex with multiple parties involved and overwhelming volumes of information. Successfully completing the evaluation requires discipline in the process and a keen attention to detail.
- Identify the potential risks to the searcher's ability to close the transaction and operate the business successfully; and ways to mitigate the risks.
- Maintain a positive and open relationship with the seller. The evaluation process is not just for the buyer to become comfortable with acquiring the business, but for the seller to be comfortable selling the business to the buyer. Communicating throughout the process in a constructive way that is respectful of the seller's limited resources greatly enhances the probability of closing the deal and having a successful ownership transition.
- Lastly, take the time to step back from the process to evaluate the opportunity anew. Many acquisitions evolve and change through the evaluation, negotiation and due diligence stages. Former searchers warn of the risk of tunnel vision—becoming so focused on the process that one ignores the cumulative effect of all the small, incremental changes that occur along the way—and counsel building in time with advisors and investors to step back and assess the opportunity objectively.

For many sellers, this is the first (and only) time going through a company sale, and a mismanaged evaluation process can easily cause the relationship between the buyer and seller to sour, potentially derailing the entire transaction. For an owner-entrepreneur with intimate knowledge of the business, the questions and analysis can seem tedious, unimportant, or overly intrusive. A searcher can lose the seller's trust by being too demanding or insensitive to the incremental workload these questions create. Therefore, it is critically important for the searcher to maintain good communication with the seller, keeping the seller informed of how the process works, the buyer's broad and specific goals at each stage, who will be involved, and what help is needed from the seller and management team. The searcher should respectfully remind the seller that meeting the deadlines for closing the deal is contingent on the seller offering appropriate and timely information and access. The searcher should also communicate to the seller what the expectations of other parties will be throughout the process; for example, lenders and equity investors often complete a parallel due diligence process, and may have their own requests for information.

Even a relatively benign due diligence process can be a tremendous distraction to the seller and key managers, causing company performance to suffer. Beyond responding to data requests, the seller may also be engaged in time-consuming acts such as negotiating the LOI or the purchase documents, planning the personal transition process, and doing tax and estate planning, while still running the company. At all stages of the evaluation process, especially the latter stages, the searcher needs to prioritize requests around the truly important issues and weigh the trade-off of receiving detailed information versus the extra workload and distraction these requests place on the business.

Further, a search funder (as well as the investors) must remember companies acquired by search funds are typically smaller businesses with less formal and less sophisticated systems. Often, the companies have relied on the founder's sixth sense and business instincts. This is not to suggest that the existing managers do not understand their businesses; rather, they have often developed their own heuristics and understanding that serve the purpose of detailed business analytics. Much of the desired information is

not likely to be prepared in advance, or even readily accessible. Rather than asking a battery of questions or making data requests, searchers can share what they are trying to learn, and a cooperative seller may be able resolve the issue in a way that is less intrusive or demanding of company resources. It is not uncommon for a due diligence list to request specific analyses that could take a great amount of resources to perform, while a slightly less robust set of reports already exists that could provide adequate coverage of the issue. Likewise, there may be creative ways to shortcut the information collection; for example, it might seem ideal to interview hundreds of end users of a consumer product, but the searcher may be able to spend far less time and money by interviewing a dozen major store buyers who could provide the same input and reassurance.

Finally, many sellers are simply unwilling to provide the requested information and purposely prohibit the search funder from contacting employees, customers, and suppliers too early in the process, if at all. They want to ensure the deal is going to close before they are willing to announce a potential ownership change. This often stems from legitimate concerns that the news of a potential deal will create anxiety and gossip among these stakeholders and throughout the industry, potentially damaging the company's position and relationships and causing unnecessary turmoil if the deal does not close.

If the opportunity is actively for sale through an intermediary (e.g., business broker or investment bank), the process may be slightly different. The intermediary may assemble a "data room" (often online) with the information likely to be requested, set schedules for management meetings and submission of offers, and propose a compressed timeline to closing that the buyer is expected to meet. The quality of a brokered process will vary widely across intermediaries. A compressed timeline may make it difficult for a search funder to compete against established private equity firms with a team of professionals and an ability to hire additional outside resources.

INITIAL STAGE: THE "FIRST PASS"

When an acquisition opportunity is first uncovered, the searcher must make a quick evaluation of the business and industry. The initial stage of evaluation has many purposes:

- Determine whether or not to spend additional time and resources pursuing the transaction
- Identify the key issues to pursue in order to assess the merits and the risks of the company in order to make an investment decision
- Assess if the seller is genuine in wanting to sell the company
- Determine a rough range for the value of the company
- Understand the seller's expectations on the timing and next steps of the sale process
- Position the searcher as a credible buyer of the company

The commitments made by both the searcher and the seller are generally low at this stage. Even in an auction situation, the seller generally provides very limited information on the company. Much of the evaluation is done quickly by the searcher, who will modify this information based on other easily accessible sources of data and make simplifying assumptions based the searcher's personal knowledge of the industry. The searcher may refer to the industry and company criteria developed early in the search fund (addressed in the Setting Investment Criteria section of this *Primer*) and rank the company and

industry against these criteria. Searchers may also compare the company against other target acquisitions already evaluated across these dimensions. And searchers may run a simple financial analysis if sufficient information is provided. In this stage of evaluation, the searcher generally assumes the information provided by the seller, such as revenue and profitability, is accurate. The searcher may have the opportunity to meet the seller in person, but often will not visit the company. Note that the searcher often will be required to sign a confidentiality agreement (also called non-disclosure agreement) prior to the seller sharing any information; see **Exhibit 8** for a sample Confidentiality Agreement.

In some instances, especially auction situations, a positive result of this stage of evaluation will be an Indication of Interest (IOI) submitted on the company. The IOI is a non-binding document that includes a valuation range for the company and additional information requested by the searcher. Whether or not a formal IOI is submitted, it is of mutual benefit to the parties to ensure they are within the same valuation range for the business before deciding to invest additional time and money in the next stage of evaluation.

SECOND STAGE: VALUATION/LOI

In the second stage of evaluation, the searcher will perform additional analysis on the industry and company to be able to value the business more accurately, set out the major terms of an acquisition, and identify issues for further in-depth investigation. The goals of this stage are as follows:

- Qualify the owner as being ready to sell the company
- Value the business (or set the appropriate formula to value the business)
- Perform a more detailed analysis of the industry and the company's competitive position
- Delineate the major legal terms of a proposed acquisition
- Create a prioritized list of items to be explored in a comprehensive due diligence process
- Position the searcher as the buyer of choice
- Solicit feedback (potentially term sheets) from lending sources, if appropriate
- Notify the equity investors of escalating commitment and solicit any immediate feedback or guidance.

To complete this stage of evaluation, the searcher will request more complete financial information (e.g., historical and projected income statements, balance sheets, and cash flow statements). Searchers will also request more detailed information targeted to the key success factors of the business or its core risks. For example, if the company is a services business and has recurring revenue, the searcher would investigate the customer base: length and terms of contracts, how the customer base has changed over time, growth in new customers and growth with existing customers, why the company is gaining or losing customers, customer concentration in terms of revenues and profits, etc.

At this point, the searcher is still generally relying upon the information provided by the seller, without the opportunity to verify the information.

It is common in this stage for the searcher to have more interaction with the seller (or the intermediary, if any) and perhaps have the opportunity to visit the company and meet other members of the management team (although sometimes sellers will request that the visits occur in the understanding that the search fund principal is merely an “investor” or a “consultant”).

There are many ways to value a business, and detailed information on each approach can be found in finance textbooks and other notes. Searchers typically use more than one method to value a business, including, but not limited to, the following:

- “Buyout” model – A searcher will create a financial model that shows the potential returns (Internal Rate of Return and Return on Invested Capital in particular) based on the proposed purchase price and capital structure of the transaction and the company’s projected cash flows. **Exhibit 12** of this *Primer* shows a basic version of a buyout model. As the searcher obtains more information, the model becomes increasingly complex and dynamic. The searcher can run various operating scenarios, adjusting key expense line items, changing growth rates and margins and applying different purchase prices, capital structures, and exit multiples to scrutinize the company’s ability to service its proposed debt and the impact on returns to the investors and the searcher.
- Public comparables – Buyers can evaluate publicly traded companies that are analogous to the target (e.g., same industry, similar business model, shared customer base, etc.) to derive multiples which are then applied to the target company. Common multiples used by search funds are Total Enterprise Value/EBITDA, P/E, and Total Enterprise Value/Revenues. There is much subjectivity in the “comps” selected, as well as the appropriate discount to apply, given the likely difference in size between the public companies and the acquisition target.
- Precedent transactions (aka “deals done”) – A buyer can evaluate recent M&A transactions of analogous companies to derive multiples (commonly Total Enterprise Value/EBITDA and Total Enterprise Value/Revenues) to apply against the target company. Like public comparables, this analysis depends in large part on publicly available information. Likewise, a search fund may need to apply a discount to the multiples to adjust for size.
- Discounted cash flow model – The DCF derives as discount rate, based on the cost of capital of other companies in the industry and a hypothetical capital structure, to discount the target company’s projected future cash flows. As the DCF is more theoretical, it is typically used much less frequently than the valuation methods addressed above.
- Asset valuation – A company can also be valued based on its assets through measures such as the liquidation value or net book value. However, as most search funds target healthy companies with positive cash flow, this valuation method is not as relevant, and is even less relevant in services businesses, which do not have meaningful assets on the balance sheet.

If this stage of evaluation yields positive results, a common next step would be for the parties to sign a Letter of Intent (LOI). The LOI is a document that memorializes the principal terms of a proposed transaction, including the purchase price and certain other key economic and legal terms that form the basis for further negotiation. **Exhibits 9-11** of this *Primer* provide a detailed description of the purpose

and forms of a standard LOIs. LOIs serve a very useful role as a gating item in an acquisition process in several respects: (1) by signing the LOI, the seller is validating the intent to sell the business; (2) the buyer and seller agree upon a value for the business (or a basis upon which to value it) and major terms that otherwise could become deal-breakers; (3) it is a valid trigger for both the searcher and seller to commit to invest considerably more time and money in the third stage of evaluation; and (4) it usually contains a binding “no-shop” obligation on the seller to provide exclusivity in negotiating a transaction only with the searcher for a specified period of time.

Not all deals involve a LOI, and the buyer and seller may “go straight to contract” (i.e., negotiate the definitive purchase agreement). Searchers in this position are encouraged to be explicit in addressing the key aspects of a LOI early and often with the seller so as to minimize the risk of investing significant time and money in due diligence when there are meaningful gaps in expectations on price and terms between the parties. Other written forms of communicating expectations, such a non-binding term sheet, can be utilized effectively to force greater scrutiny by both parties.

THIRD STAGE: COMPREHENSIVE DUE DILIGENCE

In this third stage of evaluation, a search fund entrepreneur will go through a more thorough process of uncovering and analyzing specific information about the business and industry, a process termed *due diligence*. This process usually takes 30 to 120 days, depending on how much work was done in the prior two stages, and the seller’s ability and willingness to share information. The due diligence process itself is conducted in several stages, largely driven by the constraints of time and money and also the goals of the search fund entrepreneur, as discussed further.

There are many purposes to conducting a thorough due diligence process:

- Identify the key risks in closing the transaction and operating the business and determine how to mitigate the risks, including through terms in the purchase contract negotiations
- Test the assumptions that were the foundation of the offer
- Validate statements and data provided by the seller
- Further assess the industry and the competitive position of the company
- Reassess the desire to acquire the company based on discovered information
- Set the final price, structure, and terms for the acquisition
- Secure the necessary financing (debt and/or equity) to consummate the acquisition
- Guide the development of the post-closing strategy for the company
- Identify the necessary monitoring systems once the company is acquired
- Provide appropriate information about the business to the board of directors

DUE DILIGENCE PROCESS

Below is a chart showing the major areas of focus in the due diligence process, as well as potential resources that can be used. **Exhibit 15** and **Exhibit 26** contain a detailed example of a due diligence list. In the appendix is a more comprehensive list of issues that may be investigated in a comprehensive due diligence process.

Due Diligence Focus	Potential Outside Resources
Industry/Market	<ul style="list-style-type: none"> • General management consultants • Specialized industry consultants/professionals (incl. “River Guides”) • General or industry-focused research firms • Investment banking, consulting, or educational research reports • Industry targeted research reports, studies or publications
Company: Team, Profitability, Customers, and Customer Acquisition	<ul style="list-style-type: none"> • General management consultants • Specialized industry consultants/professionals
Management Team	<ul style="list-style-type: none"> • Public files • Firms that conduct thorough background checks • References, industry contacts • Psychological testing companies
Financial/Accounting/IT	<ul style="list-style-type: none"> • Accounting firms • IT consultants
Legal	<ul style="list-style-type: none"> • Law firms • Public documents
Insurance	<ul style="list-style-type: none"> • Insurance companies • Insurance brokers • Specialty insurance consultants
Human Resources	<ul style="list-style-type: none"> • HR consultants • HR service providers
Environmental	<ul style="list-style-type: none"> • Public documents • Environmental consultants • Law firms

While a corporate or private equity buyer may employ a team to perform due diligence and engage a battery of consultants and service providers, the bulk of the due diligence in a search fund acquisition is shouldered by the searcher. Accordingly, the due diligence must be prioritized and is typically staged, with the searcher doing diligence on financial/operating results, the industry, the management team, etc. before engaging outside resources to help. Third parties should be used effectively and strategically. Search funders almost always engage legal counsel and accountants to perform targeted due diligence, and may choose to use some of the specialists listed above as needed. For example, if the acquisition is a manufacturing company that owns its own facilities, engaging environmental consultants to perform Phase I audits may be necessary. In addition, the search funder may be able to get free due diligence work from resources such as insurance companies/brokers or HR consultants/providers under the assumption that these companies will gain the target company’s business post-closing.

Some portion of expenses incurred in a due diligence process can be deferred and paid upon closing the transaction, using funds raised to finance the deal, assuming the deal closes. Some expenses, such as fees

to accountants, are often paid at the time they are incurred for ethical and incentive reasons. If a deal does not close, certain service providers, especially lawyers, may be willing to “roll over” the bill into the next deal, although this requires more equity to be raised in the ultimate transaction and therefore more equity that has preference over the searcher’s earned equity interest. However, most service providers, such as consultants and customer or industry research firms, are unlikely to defer fees and must be paid regardless of whether a deal closes. Accordingly, search funders typically wait until later in the due diligence process to engage outside service providers.

Beyond budgetary reasons for limiting the amount of work delegated to third parties, it is in the best interest of the search fund entrepreneur to tackle core issues personally as this is the best way to learn the details of the specific business. However, search funders may need these core issues validated by experts (e.g., quality of earnings validated by an accounting firm). Also, there are some non-core issues that can be addressed in a much more cost-effective and time-effective way by third parties. Further, there are some issues likely to be outside the qualifications of the search funder (e.g., environmental or intellectual property review), and these must be outsourced to third parties if relevant to the business. One source for third-party experts is a marketplace such as zintro.com.

The highlights of a typical search fund due diligence process are as follows:

Days 0-45

- Searcher performs detailed business due diligence to answer key business questions
- Searcher may retain an industry consultant to assist with industry benchmarks and validate company performance
- Searcher drafts preliminary investment committee memo to distribute to equity investors; also checks in with investor base to indicate seriousness of pursuit, share basic financial information, ensure there is interest in the deal, and allow them to raise specific concerns
- Searcher and company prepare for accounting, legal, environmental (if applicable), and further industry due diligence

Days 46-90

- Use of third parties in due diligence commences: accounting, legal, environmental, industry, others as needed
- Searcher shows deal to potential lenders
- Searcher and seller begin legal documentation of purchase
- Searcher maintains information flow to equity investors

Days 91-120

- Searcher and seller negotiate purchase documents
- Searcher secures financing with equity and debt sources

- Searcher has increased exposure to management team
- Searcher (and potentially lenders/investors) talk to key customers and suppliers
- Searcher plans a highly detailed on-ramp process and “First 100 Days” (discussed in Part VII of this *Primer*)
- Sign, close and wire funds

Search fund entrepreneurs should also seek to leverage the experience of their investors and advisors during the due diligence process. Many investors and advisors have significant deal experience, and may help the entrepreneur put problems into perspective and offer solutions to mitigate the uncovered risks. Regularly communicating with the investor base and calling upon specific investors for assistance in due diligence will help the entrepreneur identify investors’ biggest concerns and include their “hot buttons” among the top priorities for action.

Also, just as the buyer will engage third parties and leverage the investor base, the seller will commonly have representatives, such as accountants and lawyers, and potentially brokers or bankers, involved as well. These representatives play an important role in the process. A searcher, along with the team of advisors, may be lured into thinking they can take advantage of and win negotiations if the seller’s advisors are inexperienced in M&A transactions. However, many past searchers have said having inexperienced advisors involved just drags out the process and may backfire, particularly if the advisor is unreasonable in negotiations, which may indicate a lack of experience with acceptable “market” terms. Encouraging the seller to engage legal counsel or other advisors experienced in M&A transactions, and even suggesting appropriate firms, can improve the likelihood of a more efficient process that results in a deal that closes.

The due diligence process is one of the most valuable ways in which a search funder on-ramps onto a business. This is a great opportunity for the search funder to work directly with employees, manage details, understand the inner workings of the company, develop relationships, and form early impressions of the team. It is also an opportunity for the search funder to make a first impression on the team regarding the incoming leadership and its management style.

EVALUATING THE DUE DILIGENCE FINDINGS

A thorough due diligence process yields four potential types of valuable information: (1) deal killers; (2) price issues; (3) terms issues; and (4) risks to be mitigated or opportunities to be explored when operating the company.

Deal killers

Some findings are so grave there is no choice but to stop the acquisition process. Some create too large a gap between the seller’s and searcher’s expectations on price and terms. Others present too much risk for an inexperienced searcher to assume. Some discoveries during due diligence could uncover fraud or illegal/unethical behavior. Specific examples of deal killers follow:

- Historical performance is vastly different than reported
- Company or industry prospects are significantly diminished

- Discovery of a major liability or potential liability
- A disagreement on earnings/add-backs leaves too big a gap in valuation (more on add-backs later in this chapter)
- Major concerns about the company's/management team's ethics and reputation, including criminal behavior
- Business is too reliant upon the seller and a suitable post-closing relationship cannot be agreed upon
- Significant unforeseen investments are required to achieve plans (e.g., working capital investment, capex, R&D)
- Systems and controls are deemed inadequate and cannot be upgraded or replaced in a reasonable amount of time or at a reasonable cost

Price Issues

In order to get to the stage of conducting due diligence, a search funder will likely have put a formal valuation on the company, perhaps through a letter of intent. However, once due diligence is underway, the search funder may discover facts that change the valuation. Many issues are similar to those listed above (e.g., historical and/or current earnings that differ from reported earnings, a change in the prospects for the company, or the discovery of unexpected investment requirements), but to a lesser magnitude where an appropriate reduction in price is a suitable remedy. Some price issues result in a dollar-for-dollar adjustment to price; for example, working capital is lower than expected/average, so the buyer lowers the price by the amount of the shortfall, reflecting the buyer's need to invest that amount to bring working capital to an appropriate level. Other issues affect the earnings of the business, and therefore the valuation of the company needs to be adjusted by the appropriate multiple of the earnings shortfall. Price issues may also increase the company's valuation, such as when the actual results exceed projections during the due diligence period.

There are various levers the searcher can use to change the price depending on the severity of the gap; beyond reducing or increasing the cash consideration, the search funder may convert some of the consideration into deferred or contingent forms of payments (e.g., earnout, seller debt, or seller equity).

Terms Issues

In the course of due diligence, the searcher will uncover information that will shape negotiations over the major terms in the purchase agreement. If negative aspects and specific risks come to light, the search funder may attempt to place the burden of the risk back on the seller through the terms. For example, it may be appropriate to ask for specific indemnification on a potential liability (e.g., lawsuit, tax issue, or environmental issue); a greater amount of indemnification in general with lower baskets, higher caps, and longer survival; additional reps and warranties about the condition of the company; or certain conditions that must be satisfied before closing the deal (see **Exhibit 16** for definitions of these key contract terms). The searcher may also require a greater portion of the purchase price to be placed in escrow, or allow for an offset against seller debt or rollover equity, to ensure payment of indemnification claims. If the transaction is structured as an asset purchase, the assets or liabilities in question can be specifically excluded. If it is a stock purchase, then all assets and liabilities of the business are acquired and the only

recourse post-closing will be through indemnification or contingent payments. In the case that due diligence findings show the company is fairly “clean,” the searcher may be willing to shoulder more of the risk and accept less indemnification.

Risks to be mitigated and opportunities to be pursued through operating the business

As the searcher learns more about the company’s operations, systems and controls, reporting, management, and employees, business risks that can be mitigated by a change in operations or procedures may become evident. One remedy might be to get insurance for a particular risk or increase the overall level of insurance either explicitly through a policy or implicitly by hiring an expert to help manage the risk. Another might be to institute new reporting, benchmarking, and compensation systems. It might be prudent to improve the controls in place or upgrade information systems. Otherwise, the searcher may undertake specific strategic initiatives to reduce the risk (e.g., expand distribution channels if there is too much customer concentration).

Likewise, during due diligence, opportunities may be discovered for the company that were not pursued by the current owner. The searcher should use these findings to help shape the agenda for the “First 100 Days” as well as the longer-term strategy. However, search funders should not assume that there are huge numbers of issues that represent low-hanging fruit. Often, improvements can be spotted by outsiders to the system; however, many business owners are very scrappy and savvy about how they run their businesses. Therefore, searchers should seek to balance opportunities for improvement with a true understanding for why things are done the way they are.

When evaluating due diligence findings, a searcher should think about the identified risks in the context of the overall opportunity and price. If a company is growing at 35 percent a year and is being purchased for a 4x EBITDA valuation multiple, there is more room to assume calculated risks. In addition, regardless of the nature of the due diligence findings, it is helpful for the buyer to establish “book-ends” around the issues, meaning the minimum and maximum potential impact to the business and price of the deal.

A NOTE ON “ADD-BACKS” AND “RUN-RATES”

“Add-backs” are adjustments made to the financial results of a company in an attempt to create “normalized” or “pro forma” results—specifically EBITDA—upon which the company should be evaluated and valued. There are various examples of add-backs: expenses that will go away post-acquisition (e.g., excessive compensation/personal expenses of the sellers or bonuses related to the sale of the company), income or loss from discontinued operations, and one-time “extraordinary” income or costs that are added back to “normalize” to a sustainable income level. The use of quotes here is to emphasize that the exercise of creating a “normalized” level of earnings does not adhere to specific GAAP rules of accounting, and therefore traditional accounting definitions—such as what qualifies as “extraordinary”—do not apply.

During due diligence, a searcher and the accountant team must carefully scrutinize and verify add-backs for several reasons:

- The buyer is being asked to pay a multiple on these “earnings”
- Banks will lend a multiple of the agreed-upon Adjusted EBITDA, but only adjusted for add-backs they agree are legitimate

- Covenants on debt will initially be set based on the Adjusted EBITDA
- The searcher needs to determine the appropriate historical earnings to use for benchmarking and budgeting purposes.

Some add-backs are relatively clear. For example, the seller may run personal expenses through the business; as the seller departs from the company, these expenses will not be incurred and can therefore be added into the normalized earnings of the company. In other instances, it may not be clear whether the expense truly is extraordinary or just the result of bad business decisions or wishful thinking. For example, should the expenses incurred by a seller to develop a product that was never launched be added back to calculate a “normalized” level of earnings? The answer depends on a number of factors. If it truly was a unique, one-time expense that will not be replicated in the future, perhaps credit would be given; however, if new product development is a part of the company’s strategy, adding back the expenses of a failed product launch rewards the seller for a bad business decision. Similarly, sellers may claim certain expense were “one-time,” but if they were necessary to achieve the growth of the business (such as a systems upgrade, or moving to a new facility), “adding back” the expense gives the seller the double benefit of capturing the growth without reflecting the true cost of that growth.

During due diligence, the searcher may also discover deductions to EBITDA or unrealized expenses that *reduce* the “normalized” level of earnings. Some examples include under-market rent or lease payments to related parties, inadequate insurance coverage, costs to upgrade or maintain existing systems, and unfunded liabilities for pensions or benefits.

In addition to add-backs, sellers often push to have the purchase price calculated off “run-rate” earnings rather than actual earnings, meaning the most recent monthly or quarterly results are annualized as a representation of the company’s earnings. Ultimately, the competitive situation of the sale process may dictate whether a searcher pays for those phantom earnings or not, but the searcher is cautioned against it. Searchers in this situation effectively will be paying for earnings that have not materialized, and therefore paying for the right to achieve those earnings through their ownership and management. Further, cash flow lenders often lend against trailing earnings, not based on the company’s run rate (although they may set future covenants off the run rate). This can be especially meaningful when the business has seasonal or cyclical sales.

If debt will be raised as part of the transaction, the searcher needs to ensure the add-backs the searcher agrees to with the buyer are also add-backs that meet the lender’s approval. Typical cash flow loans are based upon a multiple of normalized EBITDA; if lenders disallow an add-back to which the searcher and seller have agreed (and therefore the searcher is paying a higher multiple of EBITDA to the seller as the purchase price), the searcher will need to raise more equity to fill the gap.

The searcher can take measures to ensure the expenses added back do not continue post-closing, such as having contractual agreements with the sellers on what compensation and personal expenses will be allowed, if any.

As a last note on add-backs, if the searcher agrees to any of these adjustments, it is also important to ensure the adjustments are captured in the definition and measurement of EBITDA used in loan agreements (for purposes of covenants), earn-outs, and management performance measures going forward.

PART VII: TRANSITIONING OWNERSHIP AND MANAGEMENT

PLANNING FOR THE TRANSITION

HOW LONG, IF AT ALL, SHOULD THE SELLER STAY INVOLVED?

This is often a topic of debate in the search fund community. However, all parties should remember that the purpose of a search fund is not only for the search fund principal to acquire a company, but to run the business. In some instances, the search fund principal will take over as the CEO on the day the acquisition closes while the seller completely exits the business. In other cases, the search fund principal may arrange for the seller to remain in an active management position at the company, although not as CEO, for a transition period (e.g., 1 to 12 months). The role taken by the seller depends on the motivations and personality of the seller, the relationship established during the transaction period between the searcher and the seller, the perceived importance of the seller to the company's operations and customer relationships, and the continued economic stake, if any, taken by the seller (i.e., seller debt, rollover equity, or earn-out). However, searchers are advised to structure any ongoing relationship so that the searcher has full control and is able to terminate the relationship if it is not working out as intended.

Given the typical inexperience of search fund principals, some have found it useful to keep the seller involved for a transition period to help calm the anxiety of employees, customers, suppliers, and other relationships—as well as to allow the search fund principal to learn the business more thoroughly via an “apprenticeship” approach. However, many other searchers report that keeping the seller engaged in the company muted the effect of the transition and resulted in very negative ramifications including confusion around decision-making authority and leadership, a reluctance by the seller to turn over management, financial manipulation, and increased disagreements on the seller's economic stake (particularly earn-outs, which can be sources of conflict regardless of the seller's level of engagement). Other searchers experienced an inability to keep the seller motivated and engaged in a productive way. The searchers who had the best experiences suggest creating a detailed “Transition Services Agreement” with the seller, a legal contract spelling out specific roles and responsibilities, defined time commitments, and compensation, with these points agreed to by all parties prior to the transaction closing. Most searchers recommend this transition period be for a finite, and relatively short, period of time.

A common opinion is that a good relationship between the seller and the searcher is a key indicator of future success. A seller who appreciates the benefits of the search fund model and supports the searcher taking over as the role of CEO can smooth out and accelerate the leadership transition.

THE IMPORTANCE OF DUE DILIGENCE

The key to a successful transition period is a thorough due diligence process prior to closing the acquisition. **Exhibit 15** and **Exhibit 26** contain examples of detailed due diligence checklists, and the topic is thoroughly addressed in Part VI of this *Primer*. As discussed in that section, a thorough due diligence process yields four potential types of information: (1) deal killers; (2) price issues; (3) terms issues; and (4) issues to be mitigated or opportunities to be explored through operating the company. Presumably, issues in the first three categories are addressed in the negotiation of the deal. Issues in the last category serve as a good starting point for the entrepreneur to create a “First 100 Days” roadmap. It

is important to emphasize that the goal for the entrepreneur is often to structure the first 100 days to be spent learning more about the issues rather than trying to enforce immediate change to address the issues.

No due diligence process will uncover all the potential issues in a company. This is particularly true for search funds, where the due diligence process is constrained by the bandwidth of the search fund entrepreneur and limited dollars to engage consultants, accountants, and other advisors. Further, many sellers may limit the scope of the due diligence, particularly regarding access to employees and customers. However, conducting as thorough a process as possible should have a double benefit of preventing any major unforeseen issues post-closing and helping the entrepreneur set the priority list for the initial transition period and beyond.

SETTING PRIORITIES FOR THE FIRST 100 DAYS

Concurrent with conducting due diligence, negotiating the transaction, and arranging the acquisition financing, a searcher must develop a highly granular plan of attack for the first 100 days post-closing. To define “granular,” many searchers advocate developing a plan that is scheduled to the hour for the first week, daily for the next several weeks, and weekly thereafter. There is no one-size-fits-all guide for managing the transition. The details will vary based on the specific needs and complexity of the company, the quality of the management team, and the nature of the transition with the departing CEO/seller, as well as the background, strengths, and knowledge of the new principal(s). Regardless, there are four main areas of focus for the transition (each discussed in detail in the following sections):

- Communication – The entrepreneur must create a highly specific plan to communicate the transition to various key stakeholders: employees, customers, suppliers, the industry, and investors. Of utmost importance is creating a clear and consistent message, setting a specific timeline and sequence for the communication, and determining the best method of communicating to each group of stakeholders.
- Education – The first 100 days (and often first 6 to 12 months) should be focused on learning the business. The entrepreneur should meet and interview employees, customers, and important vendors/suppliers/partners. The entrepreneur should also work “in the trenches,” particularly in the areas that are core to the business (e.g., sales, customer service, manufacturing).
- Evaluation – The principal is thoroughly learning about the company’s operations, which means evaluating every aspect of the company, particularly the management team and employees, systems and controls, and the core competencies of the business. According to conventional wisdom, a search funder should make no substantive changes in the early days of running the company, but should focus on learning and evaluating the business.
- Governance – The new CEO should establish or enhance the governance mechanisms of the company. The new CEO will identify the initial board of directors before closing the deal and will hold a board meeting within a few weeks of closing, with one or two more during the first 100 days. Additional key governance tasks for the post-closing period include ensuring adequate checks and balances are in place (especially regarding cash management) and evaluating the systems and processes of the business.

COMMUNICATION

DAY ONE COMMUNICATION

The importance of thoughtful and consistent communication with key stakeholders cannot be emphasized enough. The company has undergone a major change in ownership and leadership, and effective communication is the critical first step for the CEO in the transition. Businesses consist of people, and people need communication; great leaders are always great communicators. In the absence of direct and specific communication, the rumor mill will run wild, especially with a young new CEO in place. Richard Brown, CEO of Electronic Data Systems, said, “After 32 years in business, I believe that people are not afraid of change; people fear the unknown. The most important thing that knocks at the heart of fear is communication.”¹⁵

The opportunity to make an impact with “Day One” communication is an opportunity that will not be repeated. Failing to effectively communicate creates unnecessary anxiety, allows for rumors and misinformation to spread, and precludes the entrepreneur from setting the desired tone and direction for the company. The message and means of communicating to each group may differ, but messages should be consistent and scripted in advance. The searcher must draft the communication well before the deal closes. Beyond crafting the outbound message, the entrepreneur must anticipate a wide range of questions and develop well-crafted, consistent answers.

When creating a script and answers to likely questions, the CEO should consider the viewpoint of each party and what matters to them. What are their concerns? What will they likely want? What will their expectations be? Targeting the message is for the benefit of the audience; however, the message must be consistent and the CEO should assume that anything said to one group will become known by the other groups. Accordingly, this means avoiding the sharing of information the CEO considers confidential, and thinking carefully about how the message delivered to any one group of constituents might be interpreted by the other groups. Speaking to other search funders about the questions they were asked, their answers, and the mistakes they made can help the new CEO prepare thoroughly. Rather than focusing on what message to convey, a focus on employee concerns and questions can be an effective way to establish credibility and trust early in a new leadership role.

As a general warning, the CEO should avoid making promises or commitments in this initial communication before fully learning about and evaluating the company. The tendency is to want to please everyone and provide comfort and inspiration. When a client, employee, or vendor asks for a promise, it is important to be careful with responses—and not make comments that can be construed as commitments, which cannot ultimately be fulfilled. For example, if an employee asks whether specific jobs are at risk, the CEO may find it difficult to calm the employee’s fears about job stability without becoming locked into a specific position before fully evaluating the company. Most search fund acquisitions are not turnarounds or situations where immediate employee cuts are critical; if so, the CEO can honestly answer, “No one will lose his or her job as a result of this change of control or me being here.” Depending on the existing company culture, the CEO may add, “However, accountability will be a key element I will encourage.” If layoffs are inevitable, it is important to give employees an honest answer with specific plans to back it up.

¹⁵ “My First 100 Days in Office,” *Chief Executive*, February 2002.

The entrepreneur should set a specific timeline for when the communication about the transaction will occur to each group and who will deliver the communication. The sequence of the communication is often as critical as the message, and may be influenced by the number and physical location of the key constituents. In general, most search funders communicate in the following order:

1. Employees
 - a. Executive team
 - b. Middle managers
 - c. Employees
2. Customers
 - a. Key customers based on size and/or influence
 - b. Remaining customers
3. Vendors/suppliers/partners
4. Industry/general marketplace

It is impractical for a solo searcher (and maybe for partners as well) to personally deliver all these communications, so the searcher must enlist the seller, key managers, and/or the sales force to participate. Depending on the trust built during the transaction, the entrepreneur can use the departing CEO/seller in many ways. The seller may announce the transition and introduce the new CEO to the various constituents; even so, the entrepreneur should control the message. Or, the new CEO may draw on the departing CEO's knowledge of potential hot buttons, and history of key relationships. While the advice of the departing CEO can be useful, the new CEO should realize this advice will be biased and based on the departing CEO's personal style. The new CEO should tailor the message so it can be delivered in a genuine way, and under the direct control of the incoming leadership team. Likewise, the entrepreneur can solicit input from senior managers prior to closing and use them to help deliver the message post-closing. This provides the entrepreneur an opportunity to jump in to lead the management team and also show respect for the opinions of the senior management staff.

COMMUNICATING TO EMPLOYEES

This essential task must be done the first day "on the job." There are two critical elements: how the communication will occur and the message to be delivered. Depending on the size of the organization, the new CEO may choose a different format for the first communication with employees. In smaller companies, addressing the entire company at once may be appropriate. In some instances, the news is first shared in person at the meeting; in other cases, written communication may be circulated in the morning (often by e-mail), with an invitation to attend an afternoon session to meet the new CEO and ask questions. In larger organizations or companies with multiple locations, the new CEO may meet with senior managers on the first morning and then use town hall meetings over the course of the first week to meet with the rest of the organization. Some CEOs brief the senior management, and then rely upon them to communicate the news to their teams; others use an e-mail or other mass communication to deliver the news in their own voices. Many suggest using multiple forms of communication with a consistent message, e.g., an e-mail/letter to all employees from the CEO, small group gatherings led by key members of the management team, and town hall meetings with Q&A and meet-and-greet sessions with the CEO.

As far as the message is concerned, unless the situation is a turn-around or other unique circumstance, most agree the purpose of the initial communication is to introduce the new CEO and the plan for taking over the company, as well as to ameliorate the natural concerns of the employees. Employees want to

know if they will keep their jobs and how their jobs may change. It is not necessary to share the background on the search fund or details of the transaction (and, in fact, disclosure of this information may be prohibited under confidentiality agreements with the seller). Likewise, the CEO does not need to share a grand long-term vision for the company or even specific tactics on short-term future plans. Rather, employees want to know if their jobs are secure and to begin to learn about the company culture under new leadership. Beyond this, a new CEO can emphasize how important the employees are to the business, emphasizing their importance in giving their input on a variety of topics to help the new leadership more effectively lead the business.

One example of the CEO’s talking points to employees is attached as **Exhibit 24**. The specifics to be addressed will vary in each situation, but the tone and message must be authentic in reflecting the true beliefs of the new CEO. The following table captures some of the overall topics as well as considerations when drafting the message.

Topic	Key Points	Considerations
Transition	<ul style="list-style-type: none"> • Clearly define the new position (e.g., CEO) and the ongoing role of seller, if any • Acknowledge the uncertainty that can come during a transition and the goal of providing as much transparency as possible 	<ul style="list-style-type: none"> • No need to discuss specifics about the transaction • The outgoing CEO may make a quick introduction, but the searcher should control the meeting
Job security	<ul style="list-style-type: none"> • Assure employees it will be business as usual, and that the employees are crucial to success of company • Acknowledge the importance of their assistance to CEO in learning the business • Let them know they will have ongoing opportunities to the extent the company continues to grow 	<ul style="list-style-type: none"> • Don’t make specific promises, especially if the plan is to replace people or reduce workforce

Topic	Key Points	Considerations
Professional background of searcher and investment group	<ul style="list-style-type: none"> • Been involved in many companies/leadership roles • Investment of experienced investor group reflects their confidence in me as a leader, the track record of success of this company, and our future prospects together • We'll all benefit from the experience of the investor group going forward 	<ul style="list-style-type: none"> • Depending on depth of experience, could fuel fears about inexperience • Could come across as elitist if emphasizing pedigree
Future prospects	<ul style="list-style-type: none"> • Express excitement about being part of the company and the desire to build and grow a successful company • Share the attributes of the company that are most compelling • Can make aspiring comments, keeping them general (e.g., "I hope we can build a leader in the industry") 	<ul style="list-style-type: none"> • Avoid making specific promises • Don't need to share a long-term vision • No need to address topics like growing shareholder value • Stay realistic
Value System	<ul style="list-style-type: none"> • Share core values (e.g., treating everyone fairly, honesty, hard work, commitment to having fun, dedication to providing unsurpassed services or products) • Set tone for ongoing communication (e.g., open door policy; commitment to honest answers or to say if information can't be shared; willingness to admit if there's no ready answer, but commit to get the answer as soon as possible) 	<ul style="list-style-type: none"> • Must be able to back these up and "walk the talk," or credibility as a leader is quickly destroyed • Consider how these values are congruent with or in conflict with current company culture

One entrepreneurial team used the introductory meeting as a way to boost employee morale. The main message was the company had been purchased as a result of the hard work and success of the employees. The new team told the group that their confidence in the business was reinforced through customer interviews. The team proceeded to read quotes from the company's customers, praising each employee until every employee in the room had been given a direct compliment, by name, from a customer. This team said that the "boost-up" session was a great way to break the ice, to show that they were going to learn and listen to what the employees had to say about the business, and to help quell fears that jobs might be in jeopardy as a result of the transition.

Past searchers warn that, despite their best efforts, rumors will persist and must be dealt with quickly; communication with employees is not just a Day One activity, but an ongoing process.

COMMUNICATING TO CUSTOMERS

Communicating with the company's customers is an important aspect of transitioning the business. Depending on the seller, the search funder may have had the opportunity to speak with key customers during the due diligence process, or such contact could have been forbidden. Regardless, during the pre-closing process, the searcher should endeavor to identify and prioritize the company's customers, as well as determine the appropriate contact person for each customer and the points of contact within the company. Prioritization should be based on size/profitability, strategic importance, and influence. Before engaging in direct communication with key customers, the new CEO will ideally research these customers by reviewing contracts (if any), order history, pricing, profitability (if possible to glean), order fulfillment history, payment history, customer service records, satisfaction surveys, and pertinent communication between the customer and company. As well, the CEO must spend time with the employees who have relationships with customers to ask if and how communication should happen, about the state of the relationship, what issues have surfaced with the customer and how they were resolved, and what they would expect the customer would want to discuss with the new CEO. It should be noted, however, that in some instances customers may not have engaged personally with the prior CEO and may not need to know there has been a change in ownership and management.

After gaining a sufficient understanding of the key customers and their points of contact, the new CEO should determine the best strategy for making the introduction. Examples include:

- The new CEO sends an introductory letter or e-mail that also provides a brief overview of the transition and goals for the company and its relationship with the customer (see **Exhibit 25**)
- The selling CEO or the sales or relationship manager sends a communication to introduce the new CEO
- Phone calls or face-to-face meetings are scheduled with the key customers, often also including the relevant employees within the company, to discuss the transition, any customer concerns, and opportunities to work together

There is a trade-off between speed of delivery versus efficient use of resources, specifically the CEO's time. The communication should focus on what the transition will mean for the customer and set the tone for the relationship going forward. Often, the transition does not mean much will be different from a customer's viewpoint (unless the former CEO was heavily involved in sales or customer service). However, the CEO must control the message to customers and ensure the communication happens quickly, before the key customers hear about the transition and begin to speculate on the ramifications. One pair of searchers took the approach of briefly introducing themselves to the most important customers immediately, while setting a time to meet with them a few weeks later. This alleviated the customers' fears about ownership, while giving the new co-CEOs time to understand more about the company and the industry from internal sources and from less important customers, with whom the risk of appearing inexperienced or ignorant is less critical.

Involving the employees who have the customer relationships is another way for the CEO to demonstrate a commitment to the value of employees and respect for their relationships with customers. However, the

CEO needs to control the message. Spending some time with the employee to prepare in advance of the customer meeting can help to ensure a positive and consistent message.

Communicating to suppliers

Similar considerations go into communicating with suppliers and partners as with customers. Depending on the nature of the relationship, and how crucial the supplier or partner is to the business, the forms of communication may vary. In general, new CEOs have placed a lower priority on communicating the transition with suppliers and have said that a simple letter introducing the change often was sufficient with most suppliers. However, many CEOs said conversations with suppliers were quite informative and presented good opportunities to ask basic questions about how the company is perceived, how it operates, and how it can be improved.

COMMUNICATING TO THE INDUSTRY

Depending on the industry, the transition of company ownership and leadership can be quite newsworthy. As such, the new CEO may wish to communicate proactively with relevant industry groups, trade publications, potential customers and suppliers, and the local business community. This can be done through basic PR techniques: press releases, advertisements, interviews, open houses, direct mail pieces, etc. While the CEO may not want to create a big stir, the transition could provide a stimulus for free press coverage that would promote the company and boost the new CEO's reputation within the industry.

COMMUNICATING TO INVESTORS

Well before the closing of the acquisition, the search funder will have sent an Equity Offering Memorandum to investors (see **Exhibit 19** for an example) along with the relevant legal documents to secure the funding for the deal (see **Exhibits 20-22** for examples). Through these documents, the investors learn many of the details about the company and the deal. However, circumstances may change in the business and/or in the transaction (the Purchase Agreement is not likely to be finalized at the time the Equity Offering Memorandum is circulated). Therefore, prior to closing, the searcher will send an update to the investors addressing:

- Debt – amount and general terms
- Equity – final amount needed
- Major due diligence findings
- Significant terms in the purchase agreement for the company

Within 30 days after closing, the searcher will begin regular reporting to investors. The first report will provide further updates on any last-minute changes to the transaction from the most recent pre-closing communication; highlights of accomplishments on the transition; personal impressions of the business; and a roadmap for the upcoming months.

EDUCATION AND EVALUATION

Successful search funders recommend the first 100 days be spent with the goal of learning the business intimately and evaluating all aspects of the business. Many view it as a second due diligence process, but this time the CEO has full access to employees, customers, suppliers, systems, and information. During the transition period, the search fund entrepreneur must shift from having the mentality of an investor to the mentality of an operator. The priority is to learn about and evaluate the people, processes, and products/services of the company. This period also provides a unique opportunity for CEOs to admit what they do not know, and to ask questions of every group of stakeholders.

During the due diligence process, the searcher should develop a strawman strategy and operating plan. This does not need to be, and probably should not be, communicated to anyone in the organization or on the board. However, having a set of hypotheses gives a basis for critical thinking about the copious amounts of information the new CEO will receive shortly after closing. This framework is used to evaluate new information in a systematic way. There is always the risk of confirmation bias, especially when the CEO has a strong opinion or idea about something, but having the framework to evaluate whether issues are as expected or different, and why or how that is the case, provides consistency in decision making and makes processing the information much faster.

Past searchers have followed various strategies for their “education,” all shaped by the specific situation, but the common theme is for the new CEO to be a good listener. Richard Brown, CEO of Electronic Data Systems, spoke about the transition to being a new CEO and said, “I will listen, listen, listen, acutely, and the priorities will form. And when we’re ready, we’ll announce what we intend to do, and by when...”¹⁶ There are various formats to listen to an organization: one-on-one interviews with employees and managers, off-site sessions with the management team, town hall meetings, small group sessions, broad or targeted surveys, open invitations for feedback, and even an anonymous “suggestion box.” Most searchers who bought companies with multiple locations felt it was very important to visit each location within the first two weeks, and again within the first 100 days. Regardless of the approach, the CEO should ask broad questions to allow employees, customers, and suppliers to talk about the business, and then narrow the questions to glean specific information. Following are some broad-based questions that can be used as a basis for a conversation:

- What do you like about the business and why?
- What are you concerned I might do and why?
- What would you change if you were me?
- What should not be changed?
- What can be done better?
- What is our business environment and how is it changing?
- What expectations do you have for me?

¹⁶ “My First 100 Days in Office,” *Chief Executive*, February 2002.

- What does your job entail? How did these processes come about?

By listening carefully to the answers, the CEO can also evaluate the team and determine the centers of power within the company and the flow of information.

Several common pieces of advice also emerged. First, as summarized by David Campbell, “Don’t listen to complaints about your predecessor. This can lead to a swamp, and you don’t want to be mired there.”¹⁷ Second, be clear that the goal is to learn, not to make immediate changes, and don’t make explicit or implicit promises in an effort to be liked. Third, outwork everyone. Be the first person in, and the last one to leave.

Beyond interviewing employees, customers, and suppliers, the new CEO should spend a substantial amount of time observing. The best way to do this is to become immersed in the daily operations of the company: joining salespeople on sales calls, answering the phone, acting as a customer service representative, spending time on the manufacturing floor or shipping facility, opening the (e)mail, posting orders into the system, etc. The new CEO should determine the functions most critical to the business, and dedicate substantial time “in the field” learning that function. To manage the business effectively, a CEO truly needs to understand the detailed work of running the company, and there is no substitute for direct learning.

Another explicit goal for most search funders is to gain a firm grasp on the cash flows of the company, learning the “who, what, when, where, and how” of the company’s cash flows and cash management. Very specific questions to ask include:

- How much cash do we have on hand? How is this verified?
- Who has control of the cash?
- How do we earn it?
- When and how do we bill for it and when and how do we collect it?
- Does our cash flow and cash position vary? Why?

This involves scrutinizing working capital accounts, particularly accounts receivable, inventory (if any), accounts payable, and accrued liabilities. Many search funders insert themselves directly into the cash management process during this transition period by reviewing daily sales, invoices, and receipts and signing every check/payment made by the company. This level of micro-management may not be practical for long, but it allows the CEO to evaluate the company’s systems and processes for managing cash flow to ensure sufficient checks and balances exist and to improve working capital management.

Many entrepreneurs use this period to create an operating “dashboard” (a report produced daily with the key metrics of the business). The metrics will vary by company, but could include:

- Measurement of cash flow (A/R collections, A/P, cash balance, float)

¹⁷ David Campbell, “Leadership in Action: Issues and Observations - Taking Charge: Your First 100 Days on the Job,” *Center for Creative Leadership*, February 1, 2003.

- Sales (often broken down by category or region)
- Sales pipeline
- Shipments, on-time delivery
- Key operating metrics
- Manufacturing statistics
- Customer service metrics

In many small companies, especially those that have been run by one individual for a long time, a dashboard approach may not have been used. Beyond determining the appropriate metrics, the CEO may have to work with the appropriate functions (accounting, sales, operations) to generate accurate information on a timely basis; if the IT systems are not suited for the task, a manual approach may be necessary for the initial transition with the goal of making it automated quickly.

Most search funders and search fund investors strongly advocate that no significant changes be made to the business in the first 100 days. However, there are exceptions to this rule. If the CEO sees individual behavior or business practices that are unethical, illegal, or fundamentally problematic (especially from a business risk or liability perspective), stepping in and mandating change is imperative. Acting quickly and firmly reinforces the values and acceptable behavior for which the CEO stands. Further, many CEOs lament that they waited too long to make personnel changes to remove people who were highly disruptive to the transition and the company. Not dealing with blatant performance issues or counterproductive team members damaged the credibility of the CEO, who spent too much time trying to coach the person and fix the issues rather than removing the person.

GOVERNANCE¹⁸

In the first 100 days, a new CEO should set the stage for how the company will be run. The first component is the day-to-day management of the company. This entails evaluating the company's systems, checks and balances, and availability and flow of information. In order to lead the company effectively, it will be important to determine what information the CEO and the management team need to receive, how often, and from whom.

The second key component is establishing a board of directors. Most likely, the new CEO will have given significant thought to the ideal board make-up, and will have recruited the directors, or at least key directors, prior to closing. The first board meeting will usually be held within weeks of closing, and there are likely to be two to three more board meetings within the first 100 days. Below are some considerations for the search funder in building an effective and helpful board. This *Primer* focuses specifically on boards for search fund-backed companies, and does not address commonly examined issues of boards of publicly listed companies or venture-backed enterprises.

ROLE AND RESPONSIBILITY OF THE BOARD

Before discussing how to recruit and use a board, this *Primer* will address the basic roles and responsibilities of a board:

- Overall legal responsibilities – Even with a private company, the board of directors has a fiduciary obligation to the company and its shareholders under state law. The two basic duties are a duty of care and a duty of loyalty, but there are other legal tenets relating to self-dealing, disclosure, conflicts of interest, business judgment, etc.
- Practical implications – From a practical standpoint, these legal duties boil down to the directors' responsibility to pay attention, make decisions that are not completely irrational, and to avoid conflicts of interest.
- Specific, defined duties – Directors may have specific duties defined in the company's incorporating documents or partnership agreements. Further, directors may be officially appointed or elected to serve on committees of the board, such as the Audit Committee or Compensation Committee.
- Common obligations – The board typically will formally evaluate the CEO on behalf of shareholders, discuss strategy, understand the company's operations and judge operating performance, approve budgets and compensation, and consent to major corporate events that affect shareholders (e.g., acquisitions, sales, investments, issuances of debt or equity, etc.).

¹⁸ Much of the information in this section was compiled by Rick Taketa in June 2008. Sources behind the work include: "Notes on Boards of Directors," Stanford GSB, Case E-175, September 22, 2004; "Building Better Boards," David A. Nadler, *Harvard Business Review*, May 2004; and "Some Thoughts on Board Governance," interview with A.J. Wasserstein, March 2008.

- Value-added activities – the board also acts as a sounding board to the CEO on tough managerial and tactical issues, provides encouragement and mentorship, and contributes business understanding and input and, potentially, industry-specific knowledge.
- Accountability – The board holds the CEO and the management team accountable for the company’s performance. One CEO expressed that the board creates a bond among the management team by “making it clear there is a ‘force greater than us’” accountability.

BOARD COMPOSITION

Ideally, as a searcher progresses through the initial fundraising, search, and second fundraising processes, the searcher will identify and recruit individuals who would be suitable to serve on the new board of directors. Most, if not all, of the board members will come from the investor base.

The first step is for the searcher to determine the size of the board. Common corporate governance suggests an odd number of board members; for search fund-acquired companies, a five- or seven-person board is most common.

The search funder will take one seat on the board, or two if a partnership. If the seller retains a meaningful equity position, perhaps there is a role for the seller’s continued involvement as a member of the board. Other members of the management team may join parts of board meetings, but do not sit on the board. The searcher will tap the investor base to fill additional seats, and may extend beyond this group to include at least one “independent” director. One difficulty in recruiting directors from outside the investor base is the limited compensation available for them. The searcher may have a former mentor who is willing to fill the role, or perhaps a former colleague or classmate. Customers or suppliers typically do not make good board members because they have specific objectives—and potential for conflicting loyalties.

The searcher should strive to build a balanced board, creating a mix of members with deep operational experience, specific industry or business model experience, and financial expertise. Smart entrepreneurs are not afraid of recruiting board members with specific expertise for fear of looking too inexperienced, but rather look for complementary skills to round out the areas in which they are weakest. For example, someone with a background in investment banking and finance may recruit board members with expertise in sales management and operations. Someone with a background in operations may recruit board members with stronger finance and accounting acumens. If the searcher does not have experience with hiring, a board member may prove helpful in recruiting and hiring key team members. For a relatively inexperienced searcher, having one or two board members who could act as mentors to be consulted outside regular board meetings can be extremely helpful. Regardless of the board member’s experience, the most important aspect is that the board comprises people the CEO trusts and respects. Board members are in a position of power and authority within the company, and new CEOs should ensure their values and belief systems are aligned with that of their boards.

The board often has set committees comprising a subset of board members who focus on specific topics with the goal of accomplishing more in less time. The most common committees for a search fund-backed company are an Audit Committee and Compensation Committee.

Each board seat should have a specific term. This structural mechanism allows the CEO to continually assess whether the board has the right skill set, and can be a good way to gracefully jettison semi-

productive directors. Bear in mind that it may make sense to start with a smaller board of people who are likely to be truly helpful, rather than trying to build a “full board” that may become a burden for reporting. The size of the board can subsequently be increased as appropriate.

Sometimes, lenders receive board observation rights and will join the board meetings. The CEO has the right to ask them to solely observe or may welcome their participation and question. Board observation rights do not convey a right to vote on any matters, and the CEO may hold an “executive committee” session as part of the board meeting in which no observers are included.

COMMITMENT OF THE BOARD

To create an effective board, the CEO needs to articulate expectations of board responsibilities, behavior, and level of engagement. Talented directors are often busy people. Before formalizing the board seat, the searcher and potential board member should have an explicit understanding of the expectations of the directors, as well as the CEO’s commitments to them. The following questions are a guideline:

- Is participation required in person, or can the members join via conference calls?
- How often will board meetings be held? (This answer may vary over time, with more frequent meetings in the first year and less frequent meetings thereafter.)
- How long will the board meetings last?
- When will information be sent to the board members in advance of the meetings?
- Will there be formal committees on which the member is expected to serve (e.g., Audit Committee, Compensation Committee)?
- How will board members be compensated—cash and/or equity—for service?
- Who pays the expenses of board members, such as travel to board meetings? Are there limitations on travel expenses (e.g., reimbursement only for a coach ticket, a limit on meals, etc.)?
- What directors and officers (D&O) insurance or other protection will be established to protect the board members?

The search fund entrepreneur’s legal counsel can provide information and guidance about good corporate governance for private companies as the searcher seeks to determine the appropriate structure for the board.

It is strongly suggested that board members are compensated, at a minimum by covering their expenses, even when the director is an investor. Some search funders also advocate that additional compensation is provided to all the directors, usually an annual fee and a fee for each meeting attended (the exception to this may be if the individual, such as a private equity investor, is being paid by the company/firm to sit on the board); the amount need not be large or place an undue burden on the business. The company will pay the expenses of the CEO, who should not need to be compensated for this service as that would be factored into the CEO’s overall compensation. Paying the directors can help demonstrate that the CEO values their time. It also can serve to professionalize the relationship and create an obligation for the director to perform, giving the CEO the moral high ground to insist on certain behaviors (e.g., to attend all

meetings, come on time and stay for the scheduled duration, prepare in advance, and refrain from cell phone use during meetings). Many searchers will emphasize that, even if a director is an investor, individuals agreeing to serve on the board are contributing above and beyond other investors to the benefit of all, so incremental compensation is justified. Having said this, some search fund entrepreneurs believe that search fund investors will already feel the obligation to perform, and their willingness to serve and reputation as a valuable board member should be part of the evaluation process before the board is selected. It is unlikely that the compensation a search fund-backed company could afford to pay would be a true motivator for this group.

BOARD MEETINGS

Most past searchers and search fund investors suggest approximately six board meetings during the first year, some in person and some via conference call. Too many meetings are a distraction to the new managers, who may spend too much time preparing for and responding to board meetings. After the first year, board meetings should typically happen quarterly, mostly in person; annual schedules should be established to avoid scheduling conflicts. To the extent there are major developments at the company, such as an add-on acquisition, refinancing, significant new product launch, or reorganization, more frequent board meetings may be necessary. Alternately, the CEO may call upon select board members for their involvement and guidance outside a formal board meeting.

When feasible, holding the board meetings at the company's headquarters or at field locations can be highly beneficial for educating the board.

The CEO needs to develop a formal agenda for each meeting, providing a judicious balance of information to maximize productivity. Most of the board meetings should be spent discussing "meaty" issues, not giving high-level reviews. Other members of the management team and, periodically, outside experts, may be brought in to address parts of the meeting and provide specific information or help deepen the conversation.

The CEO should set the tone of encouraging questions and debate of key issues. "Show-and-tell" presentations can serve specific purposes (e.g., initial education of directors), but are often of limited use.

To ensure the directors are prepared, a package of information should be distributed no fewer than three days, and ideally at least a week, in advance of the meeting. Useful ideas for the board package include highlights/lowlights, key takeaways, background for focused discussion with developed alternatives, transparent financial reports and key operational metrics, and procedural documents (e.g., minutes, resolutions). The operating and financial reports used to manage the business are often of limited use to the board.

Executive sessions, where the board meets without the CEO (or partners), serve to provide directors with a forum to see and discuss issues not through the eyes of the CEO. A best practice is to have at least one executive session (even if it is only ten minutes) in each board meeting. The executive session can also be used for formal discussions on the review of the CEO (or partners) and compensation.

THE FIRST BOARD MEETING

Once the transaction is closed, the first board meeting should occur within 2 to 4 weeks. The first board meeting is essential in setting the tone and structure for subsequent meetings, the relationship the CEO will have with the board members, and the relationship members will have with one another. In advance,

the CEO should send the board members a detailed package of information; some of the information may be duplicative for the directors who are also investors, but it is important to thoroughly educate the outside directors. The following list is not comprehensive, but offers a base guideline:

- Company overview – lines of business/products/service offerings, locations, key operating metrics, profit drivers, and historical financial information
- Overview of the transaction – major diligence findings, sources and uses of funds, key terms, post-closing considerations (e.g., earnouts, post-closing working capital adjustments), and breakdown of transaction costs
- Management – the seller’s ongoing involvement (if any), an organizational chart, and the initial management responsibilities being assumed by the new CEO (and the division of labor if a partnership)
- Post-closing activities to date – a recap of the communication with each stakeholder group, the CEO’s activities to learn and evaluate the company with any major findings, and major departures from expectations based on due diligence
- Preliminary concerns – an objective reporting of the issues and potential options to mitigate these concerns
- Financial results – recent financial results compared to historical results, compared to budget (which could be the company’s budget), and compared to projections (as formulated by the search fund during the transaction)
- Operating plan – focused on the next three months, with specific activities and benchmarks identified
- Opportunities – specific short-term and longer-term opportunities to improve or grow the business. Board members neither expect nor want the new CEO to present a full strategic plan at this stage.

BEHAVIORS AND PRACTICES OF EFFECTIVE BOARDS

As a searcher begins to develop and interact with the board, the following behaviors and best practices are useful to consider:

- Open communication – Effective boards interact openly and directly; they constructively debate key issues with candor and without overly formal rules of order or fear of offense or retaliation. No important information is ever hidden from the board, thus avoiding surprises. Bad news is communicated quickly and without sugar-coating. The CEO can admit to not having an answer. All this said, the CEO should also feel comfortable disagreeing with directors and disallowing directors from “hijacking” the agenda.
- Owning the company’s strategy – While strategy development is the responsibility of management, it is not enough for the board to “rubber stamp” management’s plans. Instead, the board should understand and insert itself at critical junctures in the continuing process of strategic

development. That said, it is the CEO's job to develop strategy and management's job to execute, and overly intrusive or tactical boards can become a hindrance to the company.

- Understanding the company's business model – A high-performing board understands how the company makes money, as well as the company's organization design and key processes. The board should encourage the development of a few key performance metrics.
- Aligning performance and compensation – A board must not only establish CEO compensation, but should match rewards to performance.
- Protect financial flexibility – A board should ensure that the company's capital structure and balance sheet are sufficient to execute strategy, and discourage the CEO and management team from taking unnecessary risks.
- Key risks – The board should identify and understand major risks and risk-mitigating factors, including commercial, operational, regulatory, financial, managerial, and legal risks.
- Power sharing – A CEO's open attitude towards sharing power (compensation, executive sessions, approving key decisions, etc.) is necessary to maximize board effectiveness. The CEO and the board should discuss the appropriateness of direct interaction between the directors and non-CEO management; this is typically encouraged, but there are situations where cons outweigh pros.
- Being incorruptible – An effective board remains an incorruptible advisor for the CEO, helping balance short-term and long-term performance. As one searcher put it, "The board is the only body in the corporate pyramid that can tell the emperor he has no clothes."

AVOID THE TOP 10 TRAPS FOR NEW CEOS¹⁹

This list was developed for CEOs taking over major corporations; however, the lessons apply to search funders transitioning into the CEO role at their acquired companies.

The seeds of destruction for new senior leaders are often sown in the first 100 days. Being aware of the main causes of failure and trying to avoid these traps will make your assimilation easier. Learn from CEOs who have identified 10 major traps to avoid for the first 100 days:

1. Setting unrealistic expectations – ‘The most universal trap for a new leader is wanting to do so much so fast that you over promise and over commit,’ says GlobalSpec CEO Jeff Killeen.
2. Rash decisions vs. analysis paralysis – In the first 100 days, new CEOs have more scope for taking action but it needs to be the right action. Sears CEO Alan Lacy says: ‘If you can get something resolved quickly that is appropriate, go along with it. However, if you just act to act or make premature pronouncements you can set yourself back.’
3. Being a know-it-all – The danger of know-it-alls is that they don’t know what they don’t know. Pat Russo knew Lucent Technologies well when she came back to the company as CEO but made a decision to assume she knew nothing. ‘I believed that before I made my own determination about what had changed the most and the least, the right thing to do was to be intentionally quiet.’
4. Living in the past – While your track record may have gotten you the CEO role, don’t assume that what worked for you before will work in the new organization. You need time to assess for yourself the talent and resources you need to execute your agenda. Likewise, don’t be trapped into adopting your predecessor’s budget.
5. Ivory towers – ‘Everything isolates you in this job. You’re surrounded by people who want to make you happy. And you don’t often get the nuance of what’s going on. If you don’t fight against isolation, you will be isolated,’ says Amgen CEO Kevin Sharer.
6. Stifling dissent – One of the traps of new CEOs is to smother discord and create an environment of fear. In such an environment only the mediocre survive as talented employees head for the door. Stifling dissent can cost you some of your most talented staff.
7. Savior syndrome – It’s a serious trap to try to—and believe you can—do it all alone. As Jim Kilts, CEO of Gillette, points out, ‘You can lead, but ultimately it is the people in the company who have to deliver.’
8. Misreading real power sources – Don’t ignore the unwritten rules about who really holds the reins. Sometimes a board can appear to give you a mandate, but if true power lies elsewhere, don’t try to do too much too soon. Gauging the true source of power is critical in the early days, but it’s also important to keep refreshing your assessments as you move forward.

¹⁹ This entire section taken from <http://8pointplan.spencerstuart.com/book/traps/>, based on Thomas J. Neff and James M. Citrin, *You’re in Charge. Now What? The 8-Point Plan*, (Crown Publishing, 2005).

9. Picking the wrong battles – Selecting the wrong priorities and concentrating on the big things at the expense of the little things is a common mistake, as Lawrence Summers, [former] president of Harvard University, explains: ‘There’s a tendency in the beginning to think that it’s more important to be visible and out at functions than taking care of business. Truth be told, if I’d been sitting at my desk answering my mail, I probably would have been more effective.’

10. Disrespecting your predecessor – ‘There are lots of dumb mistakes new CEOs can make, but one of the most common is to blame your predecessor for everything that’s wrong. People forget that just about everyone who was there when the new CEO arrives has worked for the old CEO and probably has some loyalty to him or her,’ warns Leo Platt, former CEO of Hewlett-Packard.”

EXHIBITS TO PRIMER

- Exhibit 1 – 2016 Search Fund Study: Selected Observations
- Exhibit 2 – Overview of Principal Search Fund Documents: Fund Formation and Search Phases
- Exhibit 3 – Private Placement Memorandum
- Exhibit 4 – Certificate of Formation of Limited Liability Company - Search Fund
- Exhibit 5 – Limited Liability Company Agreement - Search Fund
- Exhibit 6 – Investor Subscription Agreement
- Exhibit 7 – Accredited Investor Questionnaire
- Exhibit 8 – Confidentiality Agreement
- Exhibit 9 – Legal Memo on Letter of Intent for Corporate Acquisitions
- Exhibit 10 – Letter of Intent - Asset Purchase
- Exhibit 11 – Letter of Intent - Stock Purchase
- Exhibit 12 – Sample Search Fund Financial Models
- Exhibit 13 – Detailed Industry Evaluation Matrix
- Exhibit 14 – Advisory Agreement for River Guide
- Exhibit 15 – Sample Due Diligence Lists
- Exhibit 16 – Legal Memo on Mergers and Acquisition Documents
- Exhibit 17 – Asset Purchase Agreement – Acquisition
- Exhibit 18 – Securities Purchase Agreement – Acquisition
- Exhibit 19 – Sample Confidential Financing Memorandum and Update to Investors
- Exhibit 20 – Limited Liability Company Agreement - Sample 1
- Exhibit 21 – Limited Liability Company Agreement - Sample 2
- Exhibit 22 – Securities Purchase Agreement for Investment in Purchaser Entity
- Exhibit 23 – Letter to Employees
- Exhibit 24 – Letter to Clients
- Exhibit 25 – Sample Due Diligence Topics