Search Fund Study 2001

Selected Observations

Executive Summary

The Center for Entrepreneurial Studies (CES) at Stanford Graduate School of Business initiated this study to gather information about all search funds of which it was aware, make some general observations about selected "first-time" search funds and evaluate the investment returns generated by those first-time search funds to their original investors. At the time of this study, at least 32 first-time search funds resulted in either the purchase of a company or the closing down of the fund. With regard to the investment return analysis portion of this study, acquired companies were deemed to be relevant if they had been under search fund management for at least one year. Consequently, return results were obtained for 28 of the 32 first-time search funds. Using conservative assumptions, the blended pre-tax IRR for individuals investing an equal amount in each of those funds was found to be 35.9% or 36.8%, depending on the method used to calculate terminal value. See Table 1 for additional findings of interest related to the sample of first-time search funds evaluated in this study.

Search Fund Concept

The search fund concept has been in existence since 1984. A search fund is an investment vehicle in which investors financially support an entrepreneur's efforts to locate and acquire a privately held company. In the case of a first-time search fund, the entrepreneur is usually a recent graduate from business or law school and does not possess much, if any, general management or operating experience. In general, for their initial investment search fund investors receive both a carried interest in the acquired company, as well as pro-rata right of first refusal on the capital required to fund the subsequent acquisition.

In order to mitigate operating and investment risk, search fund entrepreneurs generally target industries that are not subject to rapid technology change, are fairly easy for them to understand, and are fragmented by geography or product line. Presumably, industries fragmented across one dimension or more offer enhanced opportunities for growth, either via acquisition or product extension. Within the "preferred" industries, companies are targeted based on their sustainable market position, their history of positive, stable cash flows, and opportunities for improvement and growth. Healthy, profitable companies with a proven second-tier management team are preferred over turn-around situations. By adhering to such a disciplined list of acquisition guidelines, search fund entrepreneurs have been able to greatly reduce the risks typically associated with investing in individuals possessing little-to-no operating experience.

If the target is a sustainable business with only modest growth, oftentimes it will sell for a multiple equivalent to 40% to 100% of revenues, with a portion of the purchase price financed with debt. Purchase prices generally range from $5 million to $25 million, with the equity portion of the completed transaction between $1 million and $7 million, or between 10 % and 75% of the total purchase price. The acquisition is expected to be at fair value. Ideally, the acquired company would provide generous cash flow and not possess significant debt service; thus, short-term superlative performance by the search entrepreneur would not be required.

The Process

The search entrepreneur begins by writing a business plan that describes what he or she hopes to buy in general terms, emphasizing the acquisition process and criteria. The document is used to amass a group of individuals who will provide advice and assistance, as well as contribute initial capital to pay the entrepreneur a salary and cover expenses during the search process. Typically, this group consists of 8 to 20 investors who invest $20,000 to $25,000 each. Search entrepreneurs raise these initial funds in about 3 to 4 months; two years or more are often required to identify an appropriate target and complete the acquisition.

When a target is located, each search fund investor decides whether to participate in the acquisition transaction. A capable board is recruited, often including investor representation. In the first 12 to 18 months after an acquisition is made, entrepreneurs typically make no radical changes to the business, opting instead to learn how the company has run successfully and keep it going. Once the entrepreneur gains familiarity with the chosen industry and is comfortable operating the business, then he or she usually begins to make changes, as necessary.

The Creation of Value

After a company is purchased, value can generally be created through one or more of the following ways: revenue growth, improvements in operating efficiency, appropriate use of leverage, or expansion of valuation multiples associated with the company's industry. Typically, those means of creating value are not mutually exclusive; ideally, more than one will apply to a search fund investment. Revenue growth may result from internal growth initiatives, pricing improvements or the acquisition of like businesses. After a growth plan has been executed, the resulting company can be expected to be much more valuable, even when sold at the same multiple for which it was purchased. Improvements in operating efficiency can make a business more profitable; thus, increasing its value. Purchasing a company with leverage can enable the equity in the business to grow as debt is paid off successfully. Through the use of leverage, economic value can be created for a company's investors, even if no other fundamental improvements are made to the business. Additionally, under search fund ownership, a company may possess increased cash flow available for reinvestment, as the search fund entrepreneur will typically receive much lower compensation than did the prior owner.

History and Selected Observations

According to research conducted by the CES, during the period from 1984 through 2000, at least 46 search funds were raised and at least 31 companies were acquired using the search fund model. The vast majority of these efforts were first-time search funds, but a few were second- or third-time search funds. Search funds have been raised by graduates of at least eight different graduate schools (six business and two law), and have been used to purchase companies in both the United States and the United Kingdom. Of the 46 known search funds raised, 67% were single person efforts and 33% involved two or more people working as partners. Two of the funds were raised by women.

Within the universe of search funds studied, search fund entrepreneurs came from many different professional backgrounds. Below is a rough breakdown of the backgrounds of search fund entrepreneurs to date:

Management Consulting	27%
Investment Banking	22%
Sales	12%
Venture Capital	8%
Line / General Management	6%
Marketing	6%
Law	4%
Operations	4%
Accounting, Engineering, Entrepreneur, Insurance, Military	2%

The businesses of a majority of search fund companies fall in the service or manufacturing sectors, with a few in retail and distribution. Below is a rough breakdown of the sectors represented by search fund companies, as well as a listing of selected industries in which search fund companies have operated:

Search Fund Industry Sectors:

Service	50%
Manufacturing	19%
Manufacturing/Service Combination	12%
Distribution	8%
Retail/Service Combination	8%
Retail	4%

Selected Search Fund Industries:

auto parts retail	lighting products manufacturing
background verification services	mail presort
beer distribution	marketing & organization systemsmedia distribution
cable television	medical products and services
circuit board manufacturing	natural food retailing
direct mail	non-hazardous liquid waste treatment
electronics manufacturing	packaging
emergency roadside assistance	plastics forming
fire sprinkler design, fabrication, installation & service	printer cartridge remanufacturing
forms printing	production waste extraction systems
genetics	security alarm installation and monitoring
hardware manufacturing	technical training
home building	telephone answering services

tool, equipment and special event rentals

Investor Return Analysis

Research Methodology

For the investor return analysis portion of this study, only first-time search funds were considered in order to understand the returns to investing with a new entrepreneur in an industry in which he or she had no prior experience. First-time search funds were defined as those started by individuals who had recently graduated from business or law school prior to beginning their search. In the past, several funds have been raised by individuals who came out of their respective industries and were funded to search in that particular industry. While these funds have also proven to be attractive investments, they fall outside the scope of this study.

After applying the stated definition of a first-time search fund to 62 potential search funds known by the CES, it was determined that 31 funds were appropriate for further evaluation. The chart below illustrates the screening process used to identify those first-time search funds deemed to be "qualified" for investor return analysis.

Click on the chart
to expand to full size.

Initially, 62 potential search funds involving 80 individuals were contacted to determine whether or not they qualified as first-time search funds. Sixteen of those funds either could not be reached or it was determined that they did not raise a search fund as previously defined in this study (although some of these did conduct self-funded searches, rather than investor-funded searches). One other group did raise a search fund, but the principals of that fund elected not to participate in the study. Four funds were raised following the conclusion of a previous search fund acquisition, but those funds were excluded from the study since they were not first-time funds and their principals were not considered "unproven" management. Two funds elected to pursue industry roll-ups via numerous small acquisitions in a fragmented industry. Given the financing structure and complexity of those funds, it was determined that they should be excluded from this study. Five other funds resulted in start-up companies and were excluded due to difficulty in objectively valuing their unsold businesses. Three funds were still in the process of searching for an acquisition at the time of this study.

Of the 31 qualified first-time search funds, one elected not to provide comprehensive valuation information, and two had acquired companies within the past year, which was considered too brief a period to provide meaningful return information.

Of the remaining 28 funds, four had already sold their companies and an additional four had closed their funds down without having purchased a company; thus, the returns on those funds were straightforward to calculate. In the cases of companies still under search fund management, several assumptions had to be made to determine investor returns. If a liquidity event had recently taken place at a company, it was used to determine a current valuation. Otherwise, to calculate a company's current value, two methodologies were used. The first assumed that companies were sold at the purchase multiple of EBITDA[1] paid at acquisition and the second assumed that companies were sold at a "current market multiple" of EBITDA for their industry, less a 30% private company / minority interest combined discount. The 30% discount was deemed to be conservatively realistic for the purposes of this study. While the first methodology might be considered the most conservative approach, the second takes into account the fact that a company's multiple can change with time and due to a shift in business mix. In all cases, the study assumed that all debt was repaid and that funds were disbursed to the original search fund investors in proportion to the equity and/or subordinated debt owned by them. All returns were calculated on a pre-tax basis to investors.

Finally, to eliminate a skew based on deal size, it was assumed that individuals invested equal amounts in each search fund and subsequent acquisition. In addition, all search funds were assumed to start on the same date. However, the actual search period was used for each fund. If one fund finalized its acquisition in 12 months and another in 24 months, those were the periods of time used. Utilizing the same investment size and the same start date had the effect of slightly lowering the blended IRR. Since the majority of the 28 search fund deals analyzed, including many of the larger deals, took place in the latter half of the period since 1984, these funds would have affected the aggregate return results. Thus, in order to be as conservative as possible, it was decided that the funds analyzed should be "normalized" in terms of both start date and investment size. Additionally, careful attention was given to whether search fund investors contributed equity, subordinated debt or both toward the acquisition.

Return results are based on projected annualized company performance as of June 2001.

Aggregate Search Fund and Search Fund Acquisition Information

To protect the confidentiality of the companies that participated in the study, no individual data on companies is provided in this report. However, summary data of interest for the group of first-time search funds analyzed can be found in the table below:

Metric	**Distribution of Findings**		
Statistics for First-Time Search Funds[2]	**Minimum**	**Median**	**Maximum**
Age of Search Funder(s)	26	30	35
# of Searchers	1	1	3

Amount of Search Funds Raised	$40,000	$290,00	$750,000
# of Search Fund Investors	2	12	25
Statistics for Search Fund Acquisitions[3]			
Length of Search Period	5 months	17 months	50 months
Purchase Price	$2.3M	$6.5M	$30.6M
Search Fund Investor Capital Raised for Company Purchase	$0.0M	$1.8M	$7.0M
Company Revenues at Purchase	$2.4M	$7.8M	$43.0M
Company EBITDA at Purchase	($1.6M)	$1.1M	$4.5M
Company EBITDA Margin at Purchase	(3.7%)	14.6%	42.1%
Purchase Price / Revenue Multiple	0.3x	0.9x	3.4x
Purchase Price / EBITDA Multiple[4]	2.3x	5.2x	11.4x
Company Employees at Purchase	19	78	740
Individual Company IRR to Investors[5]	(110%)	17.6%	98.3%

The blended IRR for a person investing an equal amount in each of the 28 "first-time" search funds at the same start date was found to be:

- 36.8% if the terminal value was based on the original purchase price multiple
- 35.9% if the terminal value was based on a 30% discount to the current industry multiple

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[1]EBITDA = Earnings Before Interest, Taxes, Depreciation and Amortization.

[2]Includes those search funds still searching for an acquisition at the time of this study, as well as those that became start-ups.

[3]Summary statistics and IRR calculations are based on financial information provided by the companies themselves. In many cases, this financial information has not been audited. Data on each metric in the table was not necessarily available for all search fund acquisitions analyzed. ãLength of Search Periodä and ãIRRä metrics include those search funds that closed without purchasing a company.

[4]In order to avoid ãN/Aä as a response, the Purchase Price/EBITDA Multiple metric does not take into account acquisitions of companies that possessed negative EBITDA.

[5]Based on 28 ãacquisitionsä, since IRR analysis only takes into account closed search funds and "acquisitions" under search fund management for at least one year. Negative 100% in the ãMinimumä column equates to a total loss of investor capital.

Printable version of the study [PDF 693KB]