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The Search Fund: An Investment Fund Model Finds the Spotlight

If there were a reality show for investment fund models, the search fund would be an obscure long-shot, overshadowed by competitors with far greater exposure, popularity and capital backing, like mutual, hedge and venture funds. Lacking even the appeal of novelty, this 25-year old model has managed to remain relatively unknown outside its home turf, the Stanford Graduate School of Business (GSB), and other business schools with active entrepreneurship programs. In fact, none of about a dozen very experienced corporate lawyers who were recently polled had even heard of the term.

Why then, should we be featuring the search fund? In a market short of capital, but long on underutilized talent, in which established industries have been hard hit and recovery appears to be a number of years distant, the search fund's low initial financing requirements, its focus on the utilization of entrepreneurial talent in the acquisition and operation of companies in established industries and even its protracted time frame to liquidity have contributed to the spotlighting of this sleeper.

What's a "Search Fund"?

A search fund is a capital pool raised by one or more founder-entrepreneurs, with the aim of financing their search for a private company acquisition target. Typically, the search fund is organized as a limited liability company (LLC) managed by the founders. Generally, the founders look to raise between $200,000-$500,000 from five to 25 investors in order to sustain search efforts for up to two years or even longer. The funds are used to pay organizational and due diligence expenses, as well as the generally modest salaries of the founders. Acquisition criteria may be sector, industry or geography-based; they may involve specified financial metrics or a combination of factors. Criteria may also be more or less "open-ended" to allow for the possibility of "opportunistic" acquisitions.

If a target deal develops, the founders will plan to raise additional funds from the original investors. Financing may also come from new equity investors, senior and mezzanine lenders, and sellers. The acquisition price will generally be in the $5-$15 million range, with a median of $9.4 million reported in a recent study. The founders will plan to operate the target until a sale, pubic offering or other "liquidity event" enables investors to cash out. Typically, the operational phase lasts from three to seven years.

What's in it for investors?

If the search is successful and an acquisition is made, an investment in the search fund will represent an investment in the target, on favorable terms. Investors also receive a right of first refusal to invest additional funds as part of the acquisition financing. In exchange for contributing "first money," the original investors typically receive a "step-up," often on the order of 50% (*i.e.*, each $1.00 initially invested in the search fund represents a $1.50 investment in the target). The form of the investment varies: investors may receive preferred stock, generally with a "coupon" (or accrual factor), or their investment may be split between equity and debt; other variations are also possible. The terms of these securities also vary considerably; however, debt held by search fund investors will, of course, be subordinate to any institutional debt. Regardless of the form and terms of their investment, the real pay-off for search fund investors (and founders) will occur upon a favorable liquidity event – if that outcome materializes.

What's in it for founders?

Founders are motivated by the prospect of fulfilling their entrepreneurial ambitions and managing a business, quite apart from the possibility of economic success. Founders' equity typically represents 20-35% of the target equity. The form and terms of the founders' equity vary widely, as do vesting provisions. Often, some founders' equity vests at the outset or upon the acquisition of the target, and some vests over time. Vesting may also be based upon performance, which typically means exceeding specified "hurdle" rates measured in terms of the internal rate of return (IRR) earned by investors.

How well do search funds perform?

The Stanford GSB has studied search fund performance for more than a decade. In their most recent study, conducted in 2007, the sample of 61 funds yielded a very impressive blended IRR of 52%. This level was achieved, in large measure, as a result of spectacular returns generated by a relatively small number of funds. Individual IRRs ranged from minus 100% (total loss of investment) to more than 100%; investors recouped their investment in 48% of the funds studied.

As these results demonstrate, search funds are a risky proposition. The founders may not find a suitable (and sufficiently cooperative) target or may be unable to obtain sufficient acquisition financing. (About a third of the sampled funds closed down without making a deal.) Even if an acquisition is completed, target performance may not live up to expectations. It should also be borne in mind that the 2007 results included IRR calculations for companies that had not yet been sold; obviously, the values of any companies that might have remained unsold a year or so after completion of the study are likely to have declined dramatically. Still, historic IRRs in other Stanford GSB studies have been in the 32-38% range.

How does the model work?

The search fund model was devised Stanford professor Irving Grousbeck. Professor Grousbeck sought to enable talented, young entrepreneurs (such as recent business school graduates) to own and manage a business, despite their relative inexperience and limited capital. The search fund (unlike the typical venture capital investment) is designed to target established industries and companies that have a positive cash flow. In these situations (unlike the inherently risky high-tech arena), hardworking and able management may increase target profitability by rationalizing the business and employing ambitious strategies that might not have been within the business armamentarium of the prior owners. Value may be enhanced through such methods as leveraging the business, growing revenue and improving or expanding operations. The risks posed by the entrepreneurs' inexperience may be partially mitigated during the extended and intense learning process imposed by the search and acquisition phases, and by the entrepreneurs' awareness that they need to actively seek the advice of more experienced parties, including investors, industry experts ("river guides"), board members and professional advisors.

Why now?

As we've indicated, search funds appear to be enjoying a modest vogue. In the current climate, many established businesses are obviously hurting, and some may be acquired upon favorable terms. Newly-minted MBAs are also facing a tighter job market, especially in the financial sector (which has traditionally attracted many of the most able graduates). Many observers have noted that more MBAs than usual are turning to entrepreneurship, despite the scarcity of start-up capital. The search fund provides a promising avenue for this pursuit, especially since the initial capital outlay is relatively modest. Moreover, the relatively lengthy time horizon to liquidity, coupled with the historically high rates of return, fuels the hope of a favorable, post-recovery exit. The recent proliferation of funds that invest in search funds (search fund "aggregators") also testifies to the current attractiveness of the model.

Of course, current economic and market conditions have generally made it more difficult to complete deals. Money is in short supply, even for smaller deals like the initial financing of a search fund. Owners of target companies may be reluctant to sell when prices are low, and they may feel unease at the prospect of investing acquisition proceeds in current markets. If target results have declined, search funds will need to determine whether the results signal company-spe-

cific or acute systemic or industry risks that militate against the acquisition or whether these are temporary "blips" that don't undermine the fundamental soundness of the target. Acquisition financing may also be harder to obtain. In recent months, senior lenders have often been unwilling to lend against cash flows, rather than assets, and mezzanine terms have often been draconian. Search funds have therefore been placing a greater emphasis on seller financing and earn-outs. Obviously, however, search funds that raise their initial capital in the coming months may well encounter different (and perhaps more favorable) market conditions if and when they're prepared to proceed with an acquisition.

What are the legal issues?

Like any private capital-raising enterprise, search funds must comply with federal and state securities laws applicable to private offerings. Search fund offerings should be designed to qualify for the "safe harbor" of Regulation D under the Securities Act of 1933. Because of the "blank check" aspect of the search fund and its high risk profile, founders must take great care to accurately disclose their acquisition criteria and spell out the risks of the investment, which has not always been the case. Deal terms vary considerably, and founders and counsel need to craft terms that will reflect market expectations and prove attractive to investors, while satisfying the founders' requirements. The fund's operating or LLC agreement will need to specify governance, distribution and allocation terms, among others. The model, by its nature, requires that the documents be crafted to maintain considerable flexibility, particularly at the acquisition and post-acquisition phases, since the contours of the acquisition transaction will obviously be unknown at the outset.

Search funds typically investigate a great many opportunities before concluding a deal with a target. At the appropriate stage, counsel may be consulted about acquisition terms, letters of intent and diligence concerns. The additional equity raise in connection with the acquisition of the target will require additional securities law compliance, including another round of disclosure and contractual arrangements with investors. These activities must be coordinated with any commercial loan arrangements, as well as the frequently detailed and protracted due diligence, tax planning, negotiation and drafting work imposed by the acquisition itself.

Where can I get more information?

The search fund page of the Stanford GSB website (http://www.gsb.stanford.edu/ces/resources/search_funds.html) is an excellent place to start. I am indebted to the Stanford GSB and, particularly, its study, *Search Funds – 2007: Selected Observations* (which may be downloaded from the search fund page), for much of the factual information, if not the opinions, presented in this advisory.

If you are considering forming or investing in a search fund (or require advice about an existing search fund situation), please feel free to consult with us about the model, deal terms and legal implications.

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