CO/INVESTOR CLUB

SEARCH FUNDS OVERVIEW

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Introduction

The search fund is an attractive private equity model built for those who understand the advantages of illiquidity and the value of acquiring maturing businesses. This process is determined by the existence of capable aspiring entrepreneurs who want to run a business but don't necessarily have the desire to start a new business. Therefore, they choose to do so through acquisition. Search funds have been around since the '80s, and have exploded in popularity in recent years due to the availability of capital looking for rewarding opportunities, the potential outsized-returns, personal structure, and the opportunities afforded to the searchers.

The Model

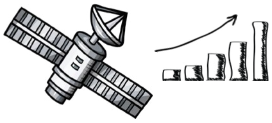
The search fund model is embedded in the more niche areas around private equity. These tend to be smaller funds or transactions averaging around $10-20 million, making them ideal for investors wanting exposure to private equity markets around specific transactions and leadership teams. The funding breakdown generally functions approximately as follows: A searcher approaches a fund, or several investors individually, and secures investment commitments for a future acquisition. Upon the ensuring of funds, the investors supply a limited amount of capital to fund the search (usually about $400,000 per searcher) and the searcher, or searchers, as they are often partnerships, put together a small team to begin canvassing the U.S. for buying opportunities among small businesses. This process usually has a time limit of 2 years. Once a desirable acquisition is found to meet preferable metrics, the investors then provide the capital for the acquisition, and equity is issued to investors through preferred stock. Searchers generally earn about 20% of the equity in the firm, with ROI hurdle rates, or other return-oriented metrics, provided to potentially deliver up to 30% of the equity for the searcher. This setup has historically proved over 30% year-over-year ROI for investors, according to the Stanford Search Fund Primer (which you can download here), and millions in wealth for the searcher upon exit.

The Searcher

Successful searchers come from various backgrounds, including traditional investment banking, private equity, military, and MBA programs. The successful searcher is characterized by intellectual humility and immense flexibility. Additionally, it is helpful for the searcher to have a background in a field related to the business they're acquiring. This does not need to be specific, but a successful searcher generally has some skills to run the operating business in some capacity before getting involved (e.g., A military background is useful for organizational and leadership skills). Finally, these searchers are hungry and informed. This is ideal as their success is tied to their performance. This is a group looking to realize dreams of being an independent entrepreneur, and this dream happens to align with the goals of investors looking for returns on capital. Check out this interview for more on the searchers perspective "A day in the life of a searcher."

The Investor

Many successful investors exist in the niche space of search funds, and most exhibit similar characteristics regarding their approach, although some variation does occur in essential areas. Some of the traits that can assist a successful search fund investor include patience, liquid capital, trust, and expertise. Patience is necessary as the returns from



search funds typically take years to manifest, sometimes decades, and sometimes (probably optimally) just become cash-producing mature businesses that pay out healthy dividends for the firm's lifetime, as well as the opportunity for firms to recapitalize their investment to expand equity and fund future growth or future acquisitions. Another valuable asset is liquid capital. The process of investing in these searchers requires a smaller initial investment to fund the search, and a second more significant investment—often upwards of several million dollars to support the equity purchase of the business. This necessitates access to liquid capital that provides a structural advantage to those who can provide it. Trust is another highly advantageous characteristic of a successful search fund. This is reminiscent of high-functioning decentralized models, where business leaders are intelligently and diligently selected, and then trusted to run their respective business to maximize long-term shareholder value. The critical part is selecting quality searchers. This is then compounded by the one aspect of investors which can vary the most: a willingness to help the searcher where needed. As is the case in many good businesses, a massive difference can be made by investors willing to provide their expertise and assistance to the executives and searchers who are shepherding their capital. This can provide tremendous value over time.

The Company

Target companies of searchers come from all industries and regions, but some trends exist based on the searcher. The acquired companies tend to be closer to the searcher, as this tends to be where searchers hold an advantage by building a relationship with management and where searchers have the most information. Further, successful businesses tend to be within the area of competence for the searcher (e.g., someone with a real estate background buy a property services business, or someone who worked in casinos as a teenager buys a small gaming chain). These trends are not at all rules or strict determinates of success, as many searchers have been tremendously successful by taking on challenges across the country and in unfamiliar areas. It's all about the quality of the manager.

The Exit

The culmination of any search fund is a successful exit. This can take many forms, but the most common is a sale to a large private equity firm or acquisition by an industry competitor once the searcher has managed the firm to growth and profitability. This sale has several structural tailwinds that can accelerate returns, including natural business growth, multiple expansion, and the premium placed on quality management. Several other potential exits can be highly beneficial for investors and searchers, such as the continuous growth and maturity of the firm into a mature, free cash flow producing business that naturally becomes a wealth-generating asset for the investors. There are many more alternatives for a successful investment, including an IPO, further fundraising rounds, and mergers—providing plenty of opportunities to realize returns. Make no mistake, search funds are not riskless assets. They require tremendous diligence and effort placed towards selecting searchers who are determined, intellectually flexible, and trustworthy with your capital. Therefore, search funds are much like any other asset class or financial tool. It is the investors who work the hardest to understand the risks and general landscape who will achieve the most desirable returns. Search funds may be a viable and attractive asset class for family offices, high net worth individuals, private equity funds, and Co/Investor Club members looking for an alternative and creative way to maximize potential returns while fostering the entrepreneurial dream.

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