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A Note to Investors Who Are New to Search Funds

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Abstract

Search funds have become increasingly popular among both entrepreneurs and investors, and more new investors are now trying to get into search fund deals. This paper highlights certain characteristics that are unique to search fund investing with the objective of sustaining key factors that have led to past successes in this ecosystem.

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Introduction

At the time of writing this note, search funds have recently become widely recognized as highly attractive investments, yielding consistently high returns for investors. As a result, a rapidly increasing number of new investors are being attracted to the asset class. This note is intended to help these new investors understand certain key factors behind the enduring success of search funds.

This note presupposes a knowledge of search funds on the part of the reader, though a new investor would also benefit from reading the note *Search Funds – What has made them work?*[1] There are references in this note to the biennial studies (the "Studies") published by the Stanford Graduate School of Business (reporting on search funds in the United States and Canada)[2] and by IESE Business School (reporting on international search funds outside those two countries).[3] In this note, the term "company" means a company acquired by a searcher and their investors.

This note is based entirely on interviews with 11 serial search fund investors (the "Serial Investors") conducted in the spring of 2023. The contributors include US individuals who have been investing in search funds and their acquired companies since the first search fund was raised in 1984, as well as early investors in international search funds outside the United States. They also include several former successful searchers who are now investing. A number of these people have invested in hundreds of search funds around the world. Some began investing personally in search funds and are now managing institutional funds that invest solely in search funds and search-acquired companies.

Like its sister note referenced above, the text of this note includes the words of the Serial Investors with minor additions by the author. The author would like to thank these investors for their insights. Their names are listed at the end of the note.

Investment Framework

As the Studies make clear, investing in search funds is a portfolio play, not a single shot investment. The minimum portfolio size to ensure a reasonable chance of achieving average returns is 10–15 companies (some even say 20). Assuming a target portfolio of 12 companies, given that nearly one third of searchers finish their search without acquiring a company, one would have to invest in 18 search funds in order to see 12 acquisition opportunities. Since few (if any) investors will choose to invest in every company presented, the number of search funds one needs to invest in will be significantly higher. If, for example, one anticipates investing in half the companies presented (a percentage mentioned by a few of the Serial Investors), then the number of search funds required jumps to 36. Building such a portfolio requires a lot of work.

It is important to recognize that this investment model involves a slow-developing investment outcome. One must expect that in the first year following completion of an acquisition, the focus of the entrepreneur will be on simply learning the business and settling into the new role as CEO.

[1] Rob Johnson, "Search Funds – What has made them work?" IESE Business School, ST-0357-E, 2014.

[2] Peter Kelly and Sara Heston, *2022 Search Fund Study: Selected Observations*, E-807 (Stanford Graduate School of Business, July 15, 2022).

[3] Lenka Kolarova, Peter Kelly, Jan Simon and Rob Johnson, "*International Search Funds - 2022: Selected Observations"* (IESE Business School, ST-629-E, October 2022).

Real value creation often occurs after years two or three, when the entrepreneur begins to hit their stride as a CEO.

An investor will invest a fair amount before taking money out, as confirmed by the Studies. The average time from acquisition to exit is six years. Given that the average search time for a completed acquisition is nearly two years, an investor just beginning to invest in search funds should not expect to see meaningful returns for at least eight years and probably longer. This also means that the investor has to invest consistently over time if they expect the investment strategy eventually to become self-funding.

For some investors there is the obvious challenge of staying the course. The deep-pocket investor faces a different challenge—putting enough capital to work. The average search fund has 14 investors, so no single investor can write a big check, as their pro rata share of the equity being raised is usually well below $1 million. Also, building such a portfolio is not something one can do in one's spare time—it is a full-time job (more on this point below). For these reasons, some investors choose to invest via one or more of the specialty funds that invest solely in search funds.

It is not Venture Capital or Private Equity

Investing in search funds is not the same as investing in venture capital or private equity deals. There is a big difference between doing a deal and buying a good company for a newly minted CEO to run. There is also a big difference between directing a venture capital or private equity-backed management team and mentoring a young person stepping into an existing company as a first-time CEO.

The key is to provide support for the new CEO following the acquisition, recognizing that this is the first time the entrepreneur will have been in this position. The primary role of the investor group is to help a new, inexperienced CEO become a successful CEO. That, above all else, is what distinguishes this asset class and has underpinned its successes to date.

Search funds are more entrepreneur-friendly than venture capital or private equity. The legal structure for search fund acquisitions, with the earned equity component for the searcher, provides better alignment between the entrepreneur and investors; and while a good board will not avoid taking a tough decision when necessary, the benefit of the doubt resides with the CEO. A search fund investment is more than a financial transaction, and the result is a true partnership. It can also be the start of a lifelong relationship beyond the CEO role.

Unlike venture capital or private equity deals, exit timing cannot be dictated by a single investor. Indeed, it is the entrepreneur who will determine when an exit will occur, and some entrepreneurs may want to continue running and building their business for the long term. Many experienced search fund investors are not constrained by arbitrary exit deadlines and will support a long-term hold as long as the company is continuing to grow.

The Search Fund Model

There are two key components of the search fund model that new investors should understand. The first is the importance of the alignment of interests between the entrepreneur and the investors. One of the biggest temptations of both new searchers and new investors is to “improve” the search fund model by modifying some of the investment terms. It is important to remember that the search fund model has been working consistently well for both entrepreneurs and investors for nearly 40 years. One of the biggest risks to search funds is tinkering with the model: the more you tinker with something, the more likely you are to break it.

The second key element centers on identifying the right kind of company to acquire. This model is not simply about buying a small company and then professionalizing it. It begins with matching a good business with a first-time CEO. Over the years, experienced search fund investors have refined their criteria for identifying companies that are well suited for a new CEO. While it is not the objective of this note to examine company criteria, they include a profitable company in a growing industry with substantial recurring/repeat revenue, low capex, and high cash conversion. Few companies will check every box, but it is important to understand that these criteria are there for a reason, and experienced search fund investors pay close attention to them.

Engagement

Investing in search funds is not simply about providing money—the ecosystem already has plenty of money. There is a significant participation component for investors that involves engaging early, staying close to the action, and being ready to help, while not micromanaging.

Participation can start during the search when the searcher needs both guidance and feedback on the search process, help in assessing acquisition opportunities, and guidance during negotiations and due diligence. Once an acquisition has been made, participation means supporting the CEO—understanding that this new CEO may never have hired a vice president of sales, never fired an employee, never had to manage under the shadow of bank loan covenants, and more. There is a steep learning curve and a need for coaching and mentoring—not for telling and directing.

This participation also goes beyond any single investment and involves contributing to the whole ecosystem in a collegial manner. That includes working in collaboration with other investors, serving on boards, supporting a board’s decisions when not on that board, and more. All this involves a certain level of trust, which can only come from working closely with other investors over time.

The constraining factor in the system is the bandwidth of support from investors who have a deep understanding of the search fund model. Underscoring the importance of this point is the fact that increasingly experienced investors are now carefully scrutinizing the cap table before making a commitment to invest in new search funds or companies to ensure that the investor group includes people whom they trust and who have demonstrated that they will do their share of the work.

It is a lot of work for the investor, but many experienced search fund investors will tell you that they are investing in search funds not solely for the returns but also for the fun and personal satisfaction of working with and mentoring a new CEO.

Access to New Search Funds

For the investor who decides to invest directly in search funds, the challenge is how to get into the game—how to become known and, especially, how to become sought out by new searchers. The best new searchers will have their choice from a growing pool of investors, so a new investor needs a sound plan for how to access good searchers.

Rather than focusing simply on providing money, a new investor needs to address how they can add value, because in the search fund ecosystem, the investor's reputation will be a function of how engaged and supportive they are. The best searchers ask two questions:

1. Will this investor increase my chances of finding and acquiring a good company?
2. Can this investor help me become a successful CEO?

Elaborating further, will the investor be available to be a close advisor to the searcher during the search? Can the investor offer experience and/or provide introductions that may be helpful to the searcher? Will the investor be compatible with other investors and add real value to the search or the acquired company? One of the most critical ingredients of a successful search fund investment is a good board, yet one of the biggest constraints in the search fund ecosystem is the availability of good directors who understand the search fund model and can commit the time to serve on company boards. This is an area where a new investor with the right experience and the right "search fund mentality" can burnish their reputation in the search fund community.

Deep-pocket investors may find it difficult to justify the amount of effort required in a single deal in which they are investing such a relatively small amount. Yet it is important to recognize that search funds are collegial investments shared among investors, not competitive investments; and the investors work collaboratively with other search fund investors. There is a sense among Serial Investors of "you do your part, and I'll do mine." In other words, investors work for the good of the wider search fund community.

Concluding Observations

The term "search fund community" is often used to refer to this asset class. The choice of the word "community" is not accidental. A community implies common interests and values among a group of people, and the search fund ecosystem is driven by values that are reflected in this note. Indeed, the Serial Investors listed below exemplify those values that have characterized search fund investing from the start.

The best entrepreneurs realize that it matters who is in their cap table. As this note emphasizes, those investors who commit the time and make the effort to support and mentor a new CEO and who are seen to work collaboratively with other investors are the people most likely to be on the best new searchers' target lists.

Contributors

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In keeping with the collaborative nature of the search fund community, they all know one another.