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INTERNATIONAL SEARCH FUNDS – 2011
Selected observations

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Abstract

This note is a biannual study completed by IESE Business School on search funds that were formed outside the United States and Canada. It was undertaken in partnership with Stanford Graduate School of Business.

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Introduction

In 2011, IESE Business School (IESE) agreed with the Stanford Graduate School of Business (GSB) to identify and track international search funds.[1] This note is the first to be published by IESE, which plans to update it biannually in concert with Stanford's note on search funds and with recent data from international search funds.

By using a quantitative survey-based research methodology, this note aims to shed light on the distinctive characteristics of international search funds. Furthermore, as the number of search funds outside of North America increases, this report will also include performance results on the asset class.

Additionally, since the principals tracked in this study are from diverse locations, qualitative observations based on a series of interviews are presented in the Appendix. As the search fund investment model originated in the United States, the Appendix is meant to provide a rendering of the different experiences and obstacles faced by international searchers.

As a summary introduction to the asset class, search funds offer prospective entrepreneurs the possibility of becoming equity-owning business operators. For investors, the asset class is a stage-based investment in an entrepreneur and an existing business venture. The life cycle of a search fund can be reduced to four stages: (1) raising a search fund, i.e., a pool of capital by which the searcher(s) find a company to acquire; (2) search and acquisition, during which time the searcher(s) locate and acquire an operating business; (3) operation, the longest stage, during which the searcher(s) operate and grow the business; and (4) exit, at which point the searcher(s) and investors achieve a liquidity event by a number of means. For additional background information on the search fund asset class, see the Stanford GSB Center for Entrepreneurial Studies (CES) Search Fund Primer.

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[1] For more information on Stanford's research efforts in the United States, which have tracked more than 150 search funds since 1996, see http://www.gsb.stanford.edu/ces/resources/search_funds.html.

International Search Fund Asset Class

This study is drawn from a pool of 21 first-time search funds, the earliest of which was formed in 1992. This study only considers first-time search funds and excludes search vehicles that are self-funded, since self-funded searches are not subject to external pressures such as defined search periods or third-party investor demands.

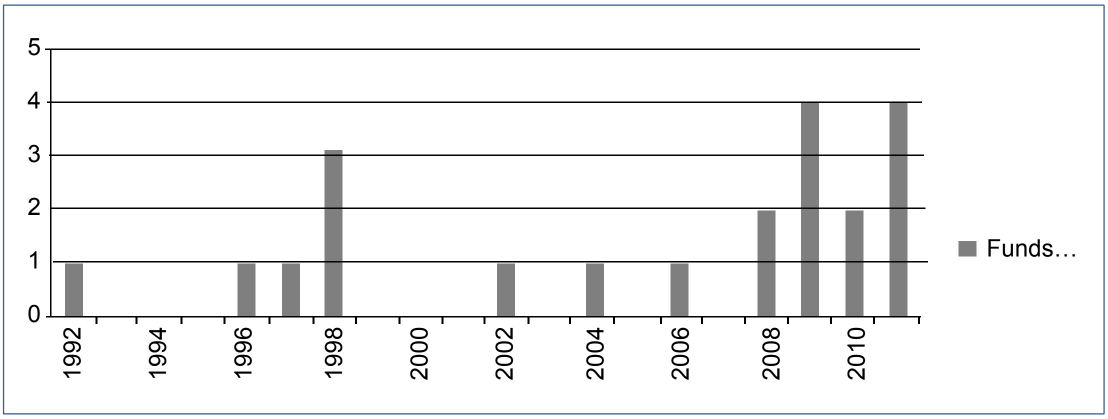
Each principal, or pair of principals, was asked to complete a standardized, electronically distributed survey that included questions about their personal background, professional profile and motivations for starting a search fund. They were also asked about the fundraising process and the focus of their search fund in terms of geography and potential acquisition characteristics. Searchers that had completed an acquisition were asked about operational metrics and those that had completed a liquidity event were asked a series of questions about the achieved return.

Given that the pool of international searchers in this study formed their search funds in more than 10 countries across four continents, the sample set is diverse. Although every effort was made to contact and collect information from every known search fund outside of the United State and Canada, readers are cautioned that as this study is repeated, additional searchers may be retroactively added to the sample set as they become known, thus possibly affecting the information presented in this report.[2]

As Figure 1 demonstrates, search fund activity outside of the United States and Canada has increased steadily. Additionally, while the early international search funds were formed in the United Kingdom, beginning in 2003 search funds were formed in Latin America, Continental Europe, the Middle East, Africa and Asia.

Figure 1

International Search Fund Activity by Year



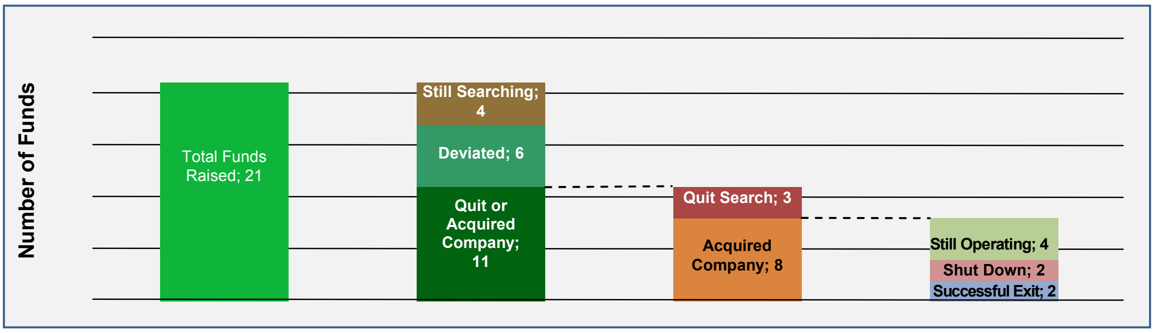
Of the 21 funds raised since 1992, as of year-end 2011 four search funds were either searching for an acquisition or were fundraising for a planned acquisition, four had acquired and were

[2] Two search funds in Brazil refused to participate in the study and three search funds in the United Kingdom were unresponsive. This study includes information for these funds when it was possible to collect information from their investors.

operating a company, six had deviated from the search fund model and seven were classified as "terminal."[3] Of those seven terminal funds, two had acquired and exited a business for a positive return to investors, two had acquired and then shut down a company at a loss to investors and three had ended their search without making an acquisition, resulting in the investors' loss of search capital. These findings are summarized in Figure 2.

Figure 2

International Search Fund Activity by Stage



Principal Background

The profile of international search fund principals is quite diverse, with the youngest age at the beginning of the search being 26 and the oldest being 49. As is consistent with the original search fund model, the majority of principals (90%) graduated from an MBA program, with 81% closing their search fund within two years of graduation. Not surprisingly, given that the model originated in the United States, 73% of those who completed an MBA graduated from a U.S. business school. (See **Exhibit 1** for additional reporting on principals' background.)

Part of the appeal of the search fund model is that searchers come from an array of pre-professional backgrounds and, as summarized in the Appendix, many of the investors interviewed did not have a preference for any particular professional background, stating that search funds are an effective way for young people with a variety of backgrounds to run a company. (See **Exhibit 2** for additional reporting on principals' professional background.)

Additionally, 38% of search funds were formed by two or more principal partners. Most of the searchers interviewed stated they had decided to search with a partner for a variety of reasons – e.g., wanting someone with a complementary professional background, being able to more efficiently search with two principals instead of one or simply having someone else to accompany him on what is often described as a "lonely" journey.

[3] Of the six funds that deviated from the search fund model, principals most commonly reported pursuing a startup after closing the fund, either by utilizing the remaining search capital for startup costs or by raising startup capital from a fresh set of investors.

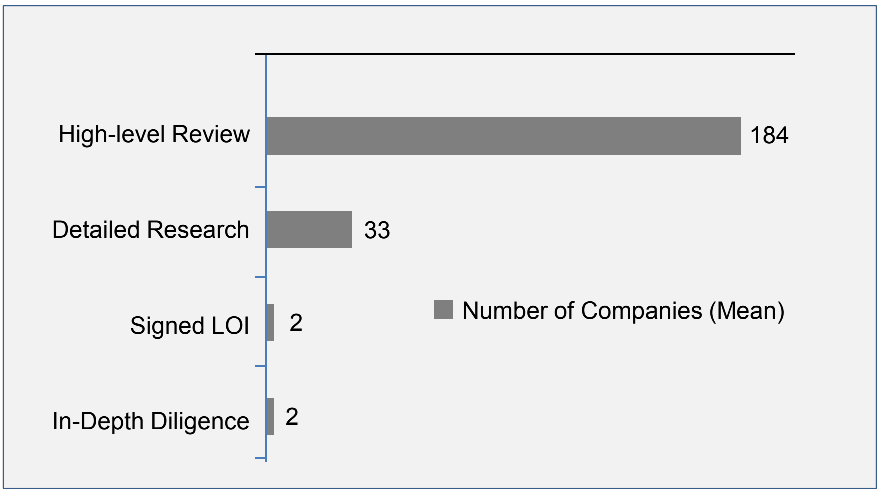
Fundraising and Search

Fundraising metrics varied widely; the median amount raised equaled $283,000 but the minimum amount was $15,000 and the maximum was $640,000.[4] This divergence in search capital needs can be explained in part by the practice of dual-searcher funds to raise more search capital to cover dual salaries and can be further explained by differences in local searching costs.

The international searchers generally described themselves as "opportunistic" in their search process but did exhibit some industry preferences. Service businesses were generally a popular industry theme, with 52% of searchers stating that business services were a priority industry. As shown in Figure 3 (below), the path to acquisition is a long one, with the mean number of companies reviewed before acquisition totaling more than 184. In general, this is lower than the number of companies considered on average by North American funds, perhaps since international funds are often constrained by smaller economies. (See **Exhibit 3** for additional reporting on additional metrics, including the search stage.)

Figure 3

International Search Fund Aggregate Pipeline



Acquiring a Company

The search fund model often relies on a common investment criteria trifecta of recurring revenue, high EBITDA margins and stable cash flows. In a sample of offering memoranda reviewed by the research team nearly all mentioned these acquisition characteristics. Given that the search fund model is relatively young outside North America (21 tracked by IESE versus 150 known U.S. and Canadian search funds tracked by Stanford GSB), there have only been eight acquisitions made outside the United States through the search fund model to date. Of these eight acquisitions, two were successfully sold, four are currently operating and two were shut down. The median search fund acquisition has the following characteristics: $5.5 million

[4] All financial information presented in this study has been converted to U.S. dollars using the historic conversion rate as quoted by XE. USD was chosen for two reasons: (1) the Euro was not in circulation for search funds raised prior to 2002 and (2) many search funds, although located outside the United States, are denominated in USD since many of their investors are in the United States.

in revenues, EBITDA margin of 20% and a purchase price to EBITDA multiple of 4.3x. Additionally, perhaps due to the nascent stage of some industries outside the United States and Canada, searchers in some geographic regions have failed to find suitable acquisitions in targeted industries and instead, with investor support, considered a startup. Even though most search investors discourage search entrepreneurs from planning a startup at the beginning, and indeed the search fund path is seen as less risky than a startup, investors' participation in these deals has followed the typical search fund economics model. Indeed, of the six searchers that deviated from the search fund model, three founded startups with the backing of their search investors. Again, because of the limited sample set, readers are cautioned against making conclusions concerning a typical international search fund acquisition.

Financial Performance

Given that there have only been two exits made by search fund entrepreneurs as of December 2011 and two cases of companies failing, it is too early to publish meaningful performance data. However, directionally speaking the performance seems to mirror the search fund performance data published in the 2011 Stanford GSB note on U.S. and Canadian search funds; of the 40 search funds that made acquisitions, 23 (58%) resulted in a successful exit and 17 (42%) resulted in the company being shut down. As a means of reference, the same study reported an aggregate internal rate of return of 34.4% and 11.1x return on investment.

Outlook

Given the low number of "terminal" international search funds, it is too early to judge the performance of the search fund model outside the United States and Canada. As the number of acquisitions made through the model increases, IESE plans to publish performance information for the international search fund asset class. Since December 2011, seemingly promising search acquisitions have been made in Germany, the United Kingdom, Mexico and other countries. Searches have begun in even more countries, including some in Africa. Still, readers are cautioned against making firm conclusions about the model's viability in the international arena for this note alone. As detailed in the Appendix, many searchers were able to successfully export the model internationally, whereas others faced significant difficulty for a variety of reasons. Thus, rather than using this note as a basis of judging the performance of international search funds as an asset class, this note should be interpreted as a means of understanding common search fund characteristics outside North America.

Exhibit 1

International Principals' Background

	Pre-2002	2002-2006	2007-2011
Age at Start of Search			
Minimum	29	29	26
Median	31	31	30
Maximum	35	34	49
Under-30	17%	33%	50%
30-35	83%	67%	28%
Over 35	0%	0%	22%
Number of Post-MBA Years Before Search Fund			
Minimum	0	1	0
Median	0	4	1
Maximum	1	6	6
0-2 Years	100%	50%	77%
3-6 Years	0%	0%	8%
>6 Years	0%	50%	15%
Gender			
Male	83%	100%	100%
Female	17%	0%	0%

Exhibit 2

International Principals' Professional Background

	Pre-2002	2002-2006	2007-2011
Professional Background			
Management Consulting	17%	0%	23%
Investment Banking/Finance	0%	50%	46%
Sales	33%	0%	15%
Line/General Management	33%	0%	8%
Marketing	0%	50%	0%
Accounting	17%	0%	0%
Private Equity	0%	0%	8%

Note. As a means of comparison, the IESE student profile is comprised of the following professional backgrounds: 21% general management, 18% marketing and sales, 17% consulting, 14% finance, and 30% other.

Exhibit 3

International Search Fund Metrics

	Pre-2002	2002-2006	2007-2011
Number of Principals			
Single	83%	50%	54%
Partners	17%	50%	46%
Amount of Search Capital Raised			
Minimum	$145,899	$170,000	$15,000
Median	$234,447	$180,000	$440,000
Maximum	$283,000	$190,000	$640,000
Number of Search Fund Investors			
Minimum	8	7	2
Median	10	8	14
Maximum	11	9	24
Number of Months Fundraising			
Minimum	2	6	1
Median	6	6	6
Maximum	7	6	12
Targeted Industries (Frequency)			
Distribution	0%	0%	31%
Education	0%	0%	54%
Healthcare	17%	0%	54%
Internet or IT	17%	0%	46%
Manufacturing	33%	0%	15%
Manufacturing/Service	33%	0%	15%
Media	0%	0%	23%
Service (incl. Retail and B2B)	33%	50%	62%
Utilities	0%	0%	8%
No Preference	0%	0%	15%
Other	17%	50%	15%

Appendix

Qualitative Observations

This appendix is meant to provide a deeper perspective on the experiences and obstacles faced by international searchers. It is organized into four stages and attempts to focus on instances in which international searchers' experiences departed from those in North America.

The qualitative observations presented are based on interviews with more than 40 current and past international search fund entrepreneurs and investors based in Europe, North America, Latin America, Africa and Asia. Because the experiences presented were those faced by individual search funds, readers are cautioned against drawing definitive conclusions from them.

Stage 1: Raising a Search Fund

Many international searchers found the initial fundraising process to be the most challenging stage. As noted earlier, the median time given to raise funds was six months, versus less than four months as noted in the Stanford GSB study. With more than 25 years of search fund activity in the United States, hopeful searchers in North America have access to serial search fund investors, including small search-focused funds as well as a roster of successful search fund entrepreneurs currently investing in the model. With only a handful of acquisitions completed internationally so far, a prospective international searcher does not have this resource from which to raise a fund.

In most instances, the prospective international searcher faces the task of educating many potential investors about search funds – how they work and why they can be attractive. One such searcher raising the first search fund in Spain described taking more than 11 months to raise the capital even though he had a top-tier U.S. MBA and had interned at a search fund in the United States. U.S. investors were not familiar with investing in his country of origin and in total the searcher reported having to hold more than 100 meetings with local and international investors. In many cases, prospective investors wanted to know why search capital was needed (e.g., "come back to me when you have a deal") or how the search model differed from traditional private equity. This scenario was common among international searchers, who described having to spend much more time "selling the model" than "selling themselves." Having committed investors familiar with both U.S. and target-country searchers seemed to help the process significantly.

Additionally, a handful of searchers reported that it became apparent that their local investors did not fully understand the search concept. In India, one searcher decided to shut down his fund in part due to his realization that his local investors were only seeking venture-capital type growth and returns, which differ significantly from those of typical search funds, and were unlikely to provide the necessary acquisition capital. This highlights the importance of ensuring that investors who are unfamiliar with the model clearly understand the likely risks, returns, opportunities and functioning of prior search funds.

Appendix (Continued)

There were exceptions and a few international searchers reported that raising the search fund was relatively easy. The majority of searchers in Latin America reported a quick fundraising process, perhaps due either to strong family connections or to the fact that serial U.S. search fund investors were more comfortable investing in a closer geography. In Israel, one searcher realized that it would be incredibly difficult to find investors from his home country and as a result purposefully raised a relatively modest amount of search capital, soliciting units from a handful of investors; the same happened in Brazil. A Kenyan searcher reported that she had learned about the search fund model more than three years before beginning business school and as a result had been pitching the concept to local investors well before beginning to fundraise. Another searcher in India said that because his country had become a hotspot of private equity activity, he was able to secure more than half of his commitments from U.S. investors (most of whom had previous experience investing in the asset class).

From the investors' perspective, many U.S.-based serial search fund investors said that they relied on the knowledge of local investors before making a commitment, since it was likely to be their first investment in that country (or region). Interestingly, this has also been the case among local investors. One European investor who committed to a domestic search fund reported that he made the investment primarily because of the quality of serial search fund investors that invested – the search fund model and the entrepreneur were secondary considerations.

After raising the search fund, many searchers expressed frustration at the lack of an appropriate legal entity. U.S. searchers most commonly form a limited liability corporation (LLC) since its flexibility allows for various outcomes, including the conversion of search into different kinds of equity. However, the LLC vehicle does not typically exist outside North America. Many searchers reported forming an LLC in the United States in order to attract U.S. investors and Latin American searchers did the same since many of their local investors were already familiar with the LLC structure. However, European searchers have had to be very creative, with one fund reported having to sell their units as pieces of debt. One Spanish searcher set up a U.K. company for the search fund because (a) the structure had already been created in the United Kingdom for prior search funds and (b) the searcher had commitments from several U.K. investors as well as U.S. investors who had invested in those prior U.K. search funds. The associated costs have also been significantly higher, with many funds reporting initial legal costs above €20,000. Many North American lawyers will delay payment of structuring costs, whereas most European lawyers require upfront payment.

As these anecdotes demonstrate, the initial hurdles of raising search capital and forming the search entity are surmountable, but international searchers face unique challenges that may contribute to the formation of fewer international search funds, even with a 20-year history outside North America.

Appendix (Continued)

Stage 2: Search and Acquisition

During the search phase, the most limiting factor that international searchers face is the size of their local economy. In Germany, one searcher mentioned that even though his country is home to Europe's largest economy, there are less than one-third the number of small and medium-sized businesses as in the United States. This is a common complaint of European searchers and many have resorted to regional and even pan-European searches (citizenship in an EU state provides residency). This is done especially when a searcher can speak multiple European languages (one U.K. searcher has looked for companies in Spain, Italy, Austria and Germany) and even more common among countries that share a mother tongue (a failed Austrian search also covered Belgium, Germany and Switzerland). In Africa, one searcher reported that she is based in Uganda and is searching across East Africa (primarily Kenya) to increase the chances of buying a high-quality company.

Searchers reported a common, initial approach to searching for acquisition targets: mass emailing, cold calling and letter writing, as is done in the United States. However, many international searchers learned that sometimes these methods did not work in the local context. In Spain, a searcher stated that owners' email addresses are not normally public and mass emailing was therefore not viable. In Germany, cold calling was seen as being too direct, while letter writing was seen as the most appropriate form of communication. In Brazil, where personal ties are paramount, cold calling and letter writing simply did not work; using his personal and professional network generated most of a searcher's successful leads.

In addition, the same education about search funds required of investors was also needed for owners. One searcher in Asia reported that he was unable to convince sellers that his search investors would also provide sufficient acquisition capital, so he decided to market himself as a "private equity fund," while German searchers avoided that term and its pejorative connotations in Germany.[5] Indeed, there is often no translation for "search fund" in the local language and entrepreneurs can find themselves inventing descriptions – "business partnership" (unternehmer-partnerschaft) in Germany, "investment society" (sociedad de inversión) in Spain, "succession entrepreneur" (nachfolge-unternehmers) in Switzerland.

One of the attractive features of the search fund model is a roster of accomplished investors and entrepreneurs that add credibility to a searcher's efforts. Many international searchers said that although they received capital from some of the most respected serial investors in the United States, the local connections mattered more. One searcher in India reported that he relied almost exclusively on the strength of the reputations of his local investors to find deals and one search team in Mexico stated that they did not accept U.S. investors because they believed that only local names would help the search process.

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[5] The search fund entrepreneurs asked specifically to have their countries of origin remain anonymous.

Appendix (Continued)

Furthermore, unlike their U.S. counterparts many international searchers reported that they used publicly-available business registries to screen potential acquisition targets, particularly for companies registered in Belgium, Austria, Germany, Italy, Spain and the United Kingdom. This made the screening process much more efficient since searchers could quickly find attractive companies in industries of interest rather than having to invest time "pre-screening" businesses before contacting them. U.K. searchers could also see the names and ages of all directors, which revealed any issues with succession. However, it is generally understood that companies often do not report full revenues and profits, which clouds the accuracy of public records.

Many international searchers found cultural sensitivities particular to their country of origin. In the United Kingdom, business owners wanted to know how a searcher would create value. In Germany, Spain, and Austria, where most businesses are family owned, the prospect of ending a family's control over a multi-generational company was quite sensitive; thus, in many cases final negotiations centered on both price and on whether a searcher was the right "fit" for a company. In India, it was almost shameful for a family to sell their multigenerational enterprise. Generally speaking, in the few cases that families did decide to sell their company, it is still hard to replace not only the owner but also other family members that have key roles.

U.S. search funds have traditionally relied on bank debt to finance an acquisition, at times around 50%. However, this has sometimes been impossible in other countries. In India, where banks are not allowed to lend for acquiring company shares, searchers report that the only available options are non-traditional financing, such as asset-backed or working capital loans, that carry high interest rates and short payback periods. In the United Kingdom, because of local market conditions and the quality of the deal, one search fund entrepreneur was able to convince his investors to invest in both debt and equity to finance the deal. In Mexico and Brazil, because the leveraged buyout model is not as established, searchers reported using a relatively modest amount of debt (e.g., 20% of enterprise value). Another common form of search fund acquisition capital in North America is seller financing. While searchers have been able to negotiate seller financing in the United Kingdom and Germany, searchers in India, Spain, Mexico and Kenya have reported that seller financing is not traditionally used.

Unlike U.S. search funds, European search funds are often formed as corporate entities that, by regulation, have a Board of Directors. As a result, European searchers often meet regularly with their Board members (typically three or more investors), which strengthens the relationship between a searcher and those investors and provides a model for post-acquisition mentorship. Additionally, this gives the searcher frequent feedback on deals but may lead the entrepreneur to under-rely on input from the other investors.

Appendix (Continued)

Finally, because international search funds often have investors in far-off countries, entrepreneurs have had to be especially cognizant of investor reporting. In India, a searcher closed his fund early without an acquisition after concluding that it was too difficult to get enough attention from both U.S. and Indian investors. Using modern technology, some searchers have creatively kept foreign investors involved. In Germany, two searchers reported regular videoconferences with their backers and in Spain a searcher dialed-in foreign investors during meetings with potential sellers.

Stage 3: Operation

Search fund entrepreneurs have bought companies in Mexico, Brazil, Chile, the United Kingdom and Germany and have experienced operating conditions similar to those of North America search funds. Many past and current search fund operators described the role as a juxtaposition between a salaried CEO and a significant equity owner. Similar to a salaried CEO, search fund operators have to receive approval from a Board of Directors to make major financial or strategic decisions (including that of executive compensation). However, unlike a purely salaried CEO, search fund owner-operators are more highly motivated to make the business succeed. In Chile, a current CEO said fatigue is common, given the lengthy time of the project (fundraise, search, and then operate); his business partner decided that the eventual payoff was too uncertain and left the company in pursuit of investment banking.

Searchers also reported that the search fund model allows operators to benefit from the experience of their investors. In Mexico, a current CEO stated that having external investors forces him to be more disciplined and also gives him the freedom to make more rational decisions. In the United Kingdom, a former CEO said that having the backing of very experienced entrepreneurs helped him successfully manage his company through multiple recessions, eventually leading to the successful sale of the company. In Germany, a current CEO realized that he did not have direct industry experience and the company's founder agreed to stay on as a minority shareholder and a member of the executive team in order to ensure a smooth transition.

Lack of operating and management experience is common among search fund entrepreneurs of all continents and their investors report that there is no ideal preparation for the CEO's chair. This lack of experience is a risk and while it has contributed to failures it has not prevented significant successes.

Stage 4: Exit

With only two known exits by international search fund entrepreneurs, one in the United Kingdom and one in Brazil, comparisons about this stage are particularly hard to make. Two investments, both in Europe, resulted in the company entering receivership.

Appendix (Continued)

For the exit in the United Kingdom, the searcher reported that one contributing factor to his success was that two of his investors sat on the Board of his search fund as well as the Board of the company that he eventually acquired. From a mentoring and advice perspective, this was very helpful, especially while managing the company through difficult periods. As mentioned, this is a departure from the U.S. model, since search funds there are often structured without a formal Board and mentorship is less formal. Regardless of how it is achieved, meaningful mentorship from investors who are wise and experienced businesspeople appears to be central to a search fund's operating success.

For the exit in Brazil, two unusual qualities stand out. The holding period was brief (less than one year) as the entrepreneur repositioned the company to take advantage of fast industry growth and a booming equity market. Furthermore, two of his investors with a combined 50 years' experience in executive positions at multinational consumer goods companies in turn joined the acquired company's management team. The searcher in this case reports that the successful exit would not have been possible without the active operating role of his investors and Brazil's rapidly growing economy. It has been rare for search funds to use public markets to achieve liquidity, although several in the United States have had the scale to do so and one has actually done this (ServiceSource; NASDAQ: SREV).

Some of the significant successes in U.S. search funds have had long holding periods, over 10 years at times (for instance: Asurion, ServiceSource, Alta Colleges, MedMart). Some international searchers report pressure for short holding periods from their domestic investors who prefer "flipping" companies and redeploying the returns in new high-return opportunities. This and other possible differences with U.S. search investor practices will affect each stage of international search funds and further data will shed light on the impact of these trends on the next generation of international search entrepreneurs.