Search Funds: Death and the Afterlife

2012 Academic Study

Benjamin Kessler, Author
Professor Jim Ellis, Advisor

STANFORD
GRADUATE SCHOOL OF BUSINESS

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Executive Summary

The Search Fund concept was first conceived in 1984 when Professor Irving Grousbeck and searcher Jim Southern formed the first Search Fund. This model, in which an entrepreneur raises capital from a group of investors to cover expenses related to searching for a business, has gained popularity at many top MBA programs since its inception. This study, *Search Funds: Death and the Afterlife*, is an effort to understand and evaluate common themes present in unsuccessful Search Fund acquisitions.

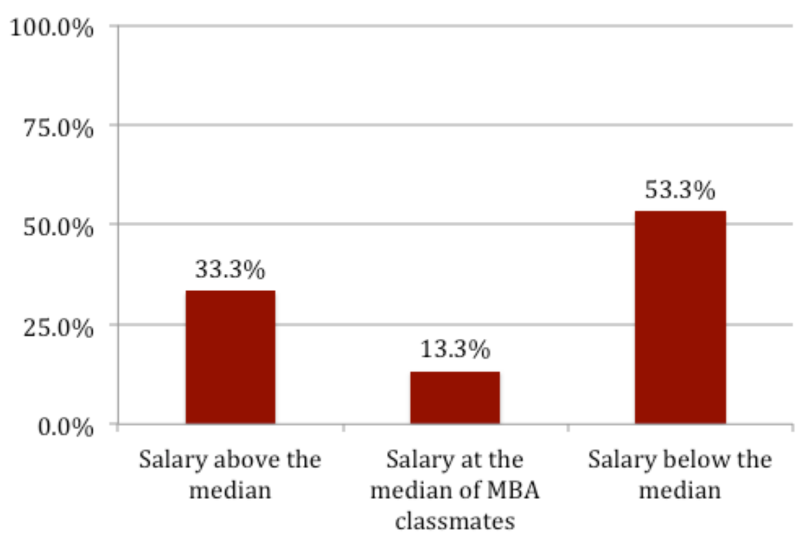
In preparing this paper, 29 interviews were conducted and 22 unique unsuccessful Search Fund acquisitions were studied. The 22 acquisitions studied account for nearly three-quarters of the 30 unsuccessful Search Fund acquisitions known to this study's author.

Search Funds: Death and the Afterlife contains three sections.

Section I, "Death: Nine Themes Across Unsuccessful Acquisitions," presents nine common themes, or causes of failure, that were found within the 22 studied acquisitions. The nine themes presented in Section I are found in the table below.

Nine Most Common Themes	
• Low or negative industry growth	• Customer concentration
• Complex operations	• Restrictive capital structure
• Troubled dynamics between searcher and board of directors	• Conflict with previous owner
• Low gross margin	• Inability to retain or hire adequate talent
• Execution failure	

Section II, "The Afterlife: Life After an Unsuccessful Acquisition," presents income and position data, as well as intangible information, on searchers following an unsuccessful acquisition. A summary of the income of the 15 searchers studied, in relation to the median income of his or her MBA graduating class, is provided in the chart below.



Section III, "The Beatific Vision: Components of a Hypothetical Model Search Fund Acquisition," uses the lessons learned from the 22 studied acquisitions and presents attributes of a hypothetical model, or ideal, Search Fund acquisition.

To conclude the Executive Summary and present this study's findings in a modified way, the table below has been prepared. In the table, the likelihood of each common theme is predicted for a business in each of the following three industries: Business Services, Manufacturing, and Retail.

As can be seen, Manufacturing businesses have all nine themes present, Retail businesses have eight of the nine themes present, and Business Services businesses have only five of the nine themes present.

Rank	Theme	Bus. Services	Manuf.	Retail
1	Low or negative industry growth		X	X
2	Complex operations		X	X
3	Troubled dynamics between searcher and board of directors	X	X	X
4	Low gross margin		X	X
5	Execution failure	X	X	X
6	Customer concentration	X	X	X
7	Restrictive capital structure	X	X	X
8	Conflict with previous owner	X	X	X
9	Inability to retain or hire adequate talent		X	

Context of Academic Study

Since the Search Fund concept was first conceived in 1984, only minimal research has been compiled on unsuccessful Search Fund acquisitions. In an effort to expand the amount of research on and share the lessons from unsuccessful Search Fund acquisitions, this project, *Search Funds: Death and the Afterlife*, was undertaken.

In order to expand research and share lessons, this study has the following three objectives:

- Identify common themes present in unsuccessful Search Fund acquisitions and share common themes with the Search Fund community, including investors, searchers (former, current, and future), and future business school courses
- Understand the life of searchers following an unsuccessful acquisition
- Identify, from the common themes, components of a hypothetical model Search Fund acquisition

Prior to presenting and analyzing the data collected, a few terms must be defined. The Center for Entrepreneurial Studies at Stanford Graduate School of Business defines a Search Fund with the following definition:

> Conceived in 1984, the Search Fund is an investment vehicle in which investors financially support an entrepreneur's efforts to locate, acquire, manage, and grow a privately held company. The model offers relatively inexperienced professionals with limited capital resources a quick path to managing a company in which they have a meaningful ownership position[1].

All 22 acquisitions studied in this paper were acquired by a Search Fund, as defined by the Center for Entrepreneurial Studies at Stanford Graduate School of Business, or a similar financial vehicle created by an entrepreneur for acquisitions.

To date, the primary hub of research on Search Funds has been Stanford's Center for Entrepreneurial Studies. Most notably, the Center for Entrepreneurial Studies has conducted a series of studies on Search Funds since 1996. The most recent study, covering Search Fund data through 2011, was released in summer 2012. It is important to note that second and third Search Funds raised by Search Fund entrepreneurs have been excluded from the Stanford Center for Entrepreneurial Studies' reports. However, all acquisitions made by follow-on Search Funds have been considered for the current study.

For the purposes of this study, a Search Fund acquisition is defined as unsuccessful if one or more of the following four circumstances occurred:

- Business acquired by Search Fund declares bankruptcy
- Business acquired by Search Fund, upon exit, to investors, returns no capital or returns an amount below the original amount invested
- Searcher who raised Search Fund and acquired business is released from leading the business

[1] "Search Fund Resources" on Stanford Graduate School of Business Center for Entrepreneurial Studies website: www.gsb.stanford.edu/ces

- Searcher who raised Search Fund and acquired business resigns from leading the business

The author of this study knows of 30 acquisitions that fit the definition of unsuccessful Search Fund acquisition. Of the 30, 22 acquisitions were analyzed for this academic study.

Information on the 22 studied acquisitions came through 15 interviews with Search Fund operators who held leadership positions at one or more of the unsuccessful acquisitions and 14 interviews with Search Fund investors who invested in one or more of the unsuccessful acquisitions.

In order to protect the searchers and investors involved with each of the 22 acquisitions, company, individual, and, at times, industry, identities have been masked in this study. In addition, during each of the 29 interviews held when collecting data, information and identities from previous and subsequent interviews were not shared.

The study's commitment to confidentiality protects the searchers and investors involved with the studied acquisitions. In addition, confidentiality allowed each interviewed party to speak openly and honestly about his or her experience.

Section I: Death: Nine Themes Across Unsuccessful Acquisitions

The first objective of the study, *Search Funds: Death and the Afterlife*, is to identify common themes present in unsuccessful Search Fund acquisitions and share these themes with investors, searchers, and business school courses. To achieve these objectives, in each interview conducted, the author asked each interviewee to identify the causes of failure for the acquisition being discussed.

Of the 22 acquisitions studied, a range of two to eleven causes of failure was provided for each studied acquisition. A single cause, or theme, was never cited as leading to failure, and, in one case, eleven causes were used to explain the unsuccessful acquisition.

The most common nine causes of failure, or themes, will be discussed in this section. Each of these nine themes was considered to have caused, in part, seven or more unsuccessful Search Fund acquisitions. Exhibit I provides a graphical overview of the nine most common themes.

In the following pages, each of the nine common themes is discussed. In addition, where possible, the detail of one or two masked acquisitions is provided.

Theme one: Low or negative industry growth

Low or negative industry growth is defined as industry growth of 5% or less at the time of acquisition or shortly into the Search Fund's ownership of the acquisition. Industry is defined as the primary industry within which an acquisition operates.

16 of 22, or 72.7%, of the studied unsuccessful Search Fund acquisitions were in industries with low or negative growth.

Common drivers of the low or negative growth were outside shock and the obsolescence of a key product or service. In five of the studied acquisitions, an outside shock caused low or negative industry growth. External shock is defined as a natural disaster near a production facility or within a key end market, a national tragedy, such as 9/11, or an economic recession. External shock can slow or eliminate growth for an entire industry. When this occurs, the Search Fund acquisition has only limited opportunity to avoid the downward trend.

In three of the unsuccessful Search Fund acquisitions, a key product or service became obsolete. Obsolescence can occur when a competitor or substitute introduces a new product or service, or when the buying habits of a target market change.

Beyond the eight acquisitions discussed immediately above, eight acquisitions were in industries that had low or negative growth without an external shock or the problem of product/service obsolescence. In some instances, the pressure to achieve growth in a business despite slow industry growth causes Search Funds to attempt to grow through acquisition. In at least four of the studied acquisitions, the strategy of growth through acquisition was adopted. In each of these examples, the individual companies were not able to overcome slow or negative industry growth through a roll-up strategy.

Provided below are two examples of unsuccessful Search Fund acquisitions in industries with low or negative industry growth:

- Company A, a business services provider, experienced negative industry growth due to the external shock of an economic recession. The economic recession caused a significant decrease in demand for Company A's services. Prior to the recession, Company A's industry experienced strong positive growth.

- Company B, an OEM, experienced negative industry growth due to a change within a primary end market, the hospital industry. Hospital industry participants experienced decreased profitability and decided to limit capital expenditures. This end market's decision to limit capital expenditures spurred a decline in industry growth and, on a micro level, a decreased appetite for Company B's products.

<u>Theme two</u>: Complex operations

Complex operations are defined as business operations that are more complex than the searcher, the management team, and/or the board of directors are able to manage. Failing to successfully execute the complex operations of an acquisition often led to the loss of the company's competitive advantage. In the acquisitions that share this common theme, one or both of the following variables led to the acquisition's loss of its competitive advantage and eventual failure:

- Complex business operations
- The inadequate capabilities of the searcher, management team, and/or board of directors

14 of 22, or 63.6%, of the studied unsuccessful Search Fund acquisitions were businesses with complex operations that led to failure.

Beyond the capabilities of a Search Fund's team and complex business operations, more granular drivers were identified. Within the 14 studied unsuccessful acquisitions, five common drivers were found in one or more acquisitions. These common drivers include:

- <u>Retail space</u>: Acquisition is in retail space, and business has high fixed costs and unpredictable revenue
- <u>Roll-up strategy</u>: Strategy of Search Fund is to purchase more than one business and consolidate operations
- <u>Manufacturing</u>: Acquisition is in manufacturing industry, and business requires some technical expertise
- <u>Highly skilled service</u>: Acquisition is provider of highly skilled business or consumer service, and business requires some technical expertise
- <u>Geographic distance between sites</u>: Acquisition has facilities or worksites with enough geographic distance to increase complexity and/or require additional management

This second common theme is closely associated with common theme five, which is execution failure. Theme two points to the gap between a Search Fund's capabilities and the acquisition's complexity, while theme five points to the gap between what was accomplished and what could have been accomplished.

Provided below are two examples of unsuccessful Search Fund acquisitions that were businesses with complex operations that led to failure:

- Company C, a retail provider of consumer services, had complex operations due to being in the retail space. Complexity in Company C was seen through shrinking operating margins due to a shift in technology, a significant number of competitors that competed on price and undifferentiated products, a high level of fixed costs tied to large, high profile locations, and a lack of repeat business.

- Company D, a provider of outsourced business services, had complex operations due to the Search Fund's plan to grow through acquisition. Complexity in Company D was seen through the strategy of growth through acquisition, the challenge of financing such growth, the geographic distance between acquisitions, and the managerial complexity of consolidating separate businesses.

Theme three: Troubled dynamics between searcher and board of directors

Troubled dynamics between a searcher and the acquisition's board of directors is defined as an issue with the searcher, an issue with the board of directors, and/or an issue with communication between the two parties that prevents the two parties from dedicating their undivided attention on operating the business.

13 of 22, or 59.1%, of the studied unsuccessful Search Fund acquisitions had poor dynamics between the searcher and board of directors.

Poor relational dynamics were presented as a cause of failure by both searchers and directors. In seven of the acquisitions, over half of the 13 reporting this common theme, concerns arose from both searcher and director about the relational dynamics.

Over the course of the interviews, the searcher issues and board of director issues provided below were offered as preventing an undivided focus on the business. The "Searcher Issues" are taken from the perspective of directors and investors. The "Board Issues" are taken from the perspective of searchers.

Searcher Issues	Board Issues
• Failure to be fully transparent about current operations and/or future strategy	• Inadequate operating experience to make helpful recommendations
• Failure to deliver board materials and/or financials in a timely manner	• Inadequate time allocated to searcher and/or acquisition
• Request for non-market salary and/or equity ownership	• Collusion with other board members that prevent independent advice
• Inability or lack of interest in learning operations and/or managing people	• Unmentioned relationships with lenders chosen for acquisition
• Inability to request, listen to, and/or implement suggestions from board	• Lack of confidence in searcher because of previous interactions and/or decisions

Theme four: Low gross margin

Low gross margin is defined as an acquisition's gross margin being below the industry median or an acquisition's gross margin, if at or above the industry median, resging below 20%. Company gross margin that is below the industry median was seen to signify products or services that could not be differentiated from the products/services of competitors. Industry gross margin below 20% was seen to signify a near-commoditized product or service with only minimal value added by industry participants.

10 of 22, or 45.5%, of the studied unsuccessful Search Fund acquisitions had gross margins below the industry median and/or below 20%.

Two common drivers were seen among many of the ten acquisitions that had low gross margins. Five of the unsuccessful Search Fund acquisitions in this dataset had one or more competitors providing undifferentiated products and winning on price. Failing to offer a differentiated product or service and competing on price forced the acquisitions to experience margin erosion.

A different three unsuccessful Search Fund acquisitions in this dataset experienced an increase in the cost of inputs that could not be effectively passed through to customers. In these examples, the price of inputs increased because of the dependence on a commodity or a limited number of suppliers.

Theme five: Execution failure

Execution failure occurs when a searcher experiences challenges learning and executing the detailed operations of the acquired business. In each of the acquisitions that share this failure, a better understanding of the acquisition's operations could have been gained but was not gained by the searcher. Most often, a lack of time, prioritization, or a lack of experience led to the gap between what could have been and what was completed.

10 of 22, or 45.5%, of the studied unsuccessful Search Fund acquisitions had execution failure.

In 6, or 27.3%, of the 22 cases, as pointed out by searchers and investors, searchers experienced challenges learning to operate as effectively as the previous owner. In most of these cases, market conditions stayed the same, and the searcher could not master the operations in a reasonable amount of time.

As mentioned earlier in this study, theme five is closely associated with theme two, complex operations. The primary difference between the themes is theme two points to the gap between a business' operations and the skillset of the Search Fund team, including the searcher, management team, and board of directors. Theme five focuses less on the gap between business complexity and team skill and more on the gap between what could have been accomplished and what actually was accomplished. The diagram below shows the two gaps, each side of the two gaps, and the primary causes of each gap.

Theme Two: Failure caused by complexity of business

Search Fund's Capabilities	• Complexity of business • Skillset of searcher, team, and board	Acquisition's Competitive Advantage
Location reached	Cause of Gap	Goal

Theme Five: Failure caused by searcher's execution failure

Actions Taken by Search Fund	• Time • Prioritization • Experience/ skillset of searcher, team, and board	Actions Needed for Successful Operations
Location reached	Cause of Gap	Goal

While complexity of operations can be found in both theme two and theme five, complexity of operations is the primary focus of theme two, and searcher execution failure is the primary focus of theme five.

Provided below are types of searcher execution failure that occurred once or more in the 10 studied transactions:

Searcher was unable to . . .
• Manage multiple project or facility locations
• Execute a strategy of growth by acquisition
• Manage people within business, including employees and/or board of directors
• Maintain a satisfied customer base and minimize customer attrition
• Manage supplier relationships that outnumber the relationships of a typical Search Fund acquisition
• Learn and execute the day-to-day operations of the business in a reasonable amount of time

Theme six: Customer concentration

Customer concentration is defined in this study as one customer representing greater than or equal to 25% of revenue. Customer concentration at this level has led to problems in unsuccessful Search Fund acquisitions due to a customer's departure, a customer's financial trouble, or a customer's request for price decreases.

9 of 22, or 40.9%, of the studied unsuccessful Search Fund acquisitions experienced customer concentration at or above 25%.

High customer concentration is problematic because the business is at the will of one or a few customers. While the concern over customer concentration is less threatening at customer concentration of 25%, the threat increases as the percentage of revenue from a top customer increases. Some acquisitions within this study's dataset had customer concentration at or above 50%.

Related to high customer concentration is high industry concentration. Industry concentration is found when a business is selling into one or only a couple end markets. Being dependent upon one end market was found in 7 of 22, or 31.8%, of the unsuccessful acquisitions.

Please note that the seven acquisitions demonstrating industry concentration do not overlap perfectly with the nine acquisitions demonstrating customer concentration. Within the studied companies, acquisitions with customer concentration both had and did not have industry concentration. Similarly, acquisitions with industry concentration both had and did not have customer concentration.

Provided below are one example of an unsuccessful Search Fund acquisition that experienced customer concentration and one example of an unsuccessful Search Fund acquisition that experienced industry concentration.

- Company E, a provider of industrial services, had customer concentration from its top customer of approximately 50%. Following the acquisition, after a conflict with this key customer, Company E lost the customer's business and, instantly, 50% of its revenue.

- Company F, a provider of products and services for the building and construction industry, generated nearly 100% of its revenue from sales into two segments of the construction industry. After a national tragedy, nearly all construction in the two segments stopped. This caused a significant portion of Company F's revenue to immediately evaporate.

<u>Theme seven</u>: Restrictive capital structure

A restrictive capital structure, typically created by an excessive amount of seller or institutional debt, is defined as one that forces the acquisition to use a substantial portion of free cash flow to service interest and principal. The company's free cash flow is used to service debt in lieu of financing working capital, capital expenditures, and other expenses needed to grow a business.

9 of 22, or 40.9%, of the studied unsuccessful Search Fund acquisitions were reported, by a searcher and/or investor, to have a restrictive capital structure.

Of the nine acquisitions that were reported to have a restrictive capital structure, the precise capital structure is known for eight. These eight acquisitions had a median debt to capitalization of 63% at the time of the acquisition.

In the nine acquisitions with reported restrictive capital structures, excessive leverage caused problems both with and without an expected level of cash flow. With an expected level of cash flow, excessive leverage can require a substantial portion of free cash flow to go to supporting interest and principal payments. When an expected level of cash flow is not present in the business, excessive leverage can cause the business to go into forbearance, undersupply operations with cash, and even file for bankruptcy.

Provided below are two examples of unsuccessful Search Fund acquisitions that were considered to have restrictive capital structures.

- Company G, a manufacturer, had had over 81% debt to total capitalization at the time of purchase. Upon losing a key customer that accounted for approximately 50% of revenue, Company G was unable to make interest and principal payments. Despite this, upon recovery, a significant portion of excess cash flow went to repaying lenders instead of being used to stabilize the business.

- Company H, also a manufacturer, had over 72% debt to total capitalization at the time of purchase. A slow-down in demand realized in Company H's end markets caused all customers to decrease purchases. Despite Company H's request for a forbearance agreement and an extension on the maturity of its loan, Company H's lender granted neither request.

Theme eight: Conflict with previous owner

Conflict with a previous owner is defined as conflict caused by one or more of the acquisition's previous owners following his or her sale of the majority share of the business. In the instances studied, the pervious owner was found to negatively influence operations, board meetings, employees, and/or the searcher following a sale.

8 of 22, or 36.4%, of the studied unsuccessful Search Fund acquisitions experienced conflict with the previous owner.

The table below provides three ways in which conflict with previous owners has occurred. The table also provides consequences that occurred when an owner creates such conflict.

Conflict with the previous owner appeared in the following ways	Consequences of such conflict
• Pressure from previous owner: In four acquisitions, when holding a seller note, retaining equity, or expecting an earn-out, the previous owner put pressure on the searcher and board of directors to repay the amount owed. Pressure is most frequently applied by the previous owner's unwanted presence at company headquarters.	• Clear leadership transition does not occur and business has two leaders • If owner is part of board, alignment of clear strategic vision is impossible • Owner, as a note holder, disagrees to provide period of forbearance and pushes business into default • Owner reclaims business because of default
• Fraudulent presentation: In three acquisitions, the previous owner presented fraudulent information to the Search Fund in due diligence that was only discovered later	• Margin generated by one or more customers is lower that presented and, thus, earnings are lower • Revenue generated by one or more customer is fraudulent and, thus, revenue and earnings are lower
• Stealing business: In two acquisitions, the previous owner stole customers from the business he sold when operating a separate entity after the sale	• Stolen customers honor relationship with previous seller over relationship with legacy business • Revenue and earnings decrease because of customer attrition

Theme nine: Inability to retain or hire adequate talent

The inability to retain or hire adequate talent is defined by the searcher's inability to retain middle management after the acquisition or his or her inability to hire middle management talent needed to replace departed employees or grow the business.

7 of 22, or 31.8%, of the studied unsuccessful Search Fund acquisitions had searchers that encountered the problem of not being able to retain or hire adequate talent.

Searchers and investors provided three primary drivers that led to the studied acquisitions' inability to retain and hire talented employees.

- Geographic location: Unappealing geographic location of business makes living viably close to business undesirable
- Negative to low industry growth: Negative to low growth of business and/or industry makes providing attractive financial incentives difficult
- Leadership ability: Lack of searcher's leadership ability to hire, retain key management and employees, and fire underperformers creates challenges independent of industry and geographic location

A strong middle management team allows a searcher to focus on other, higher-level parts of the business, including strategy and business development. Some searchers could not effectively retain or hire a strong middle management team. These searchers were often forced to focus on lower-level parts on the business such as day-to-day operations and management of frontline employees.

Provided below are two examples of unsuccessful Search Fund acquisitions that demonstrated a searcher's inability to retain or hire adequate talent.

- Company I, a manufacturer, demonstrated a Search Fund's inability to retain and hire top talent due to the remote location of the business. Company I was located in a very small town with few other enterprises. Because of these circumstances, the searcher had a difficult time hiring middle management. Everyone the searcher attracted to the town eventually left.

- Company J, a provider of business services, demonstrated a Search Fund's inability to retain and hire top talent. Immediately after the acquisition, the searcher left one of Company J's locations under the supervision of former management. After this management departed, a lower level manager was promoted but proved incapable of leading the auxiliary location.

Section II: The Afterlife: Life After an Unsuccessful Acquisition

The second objective of this study, *Search Funds: Death and the Afterlife*, is to understand the professional life of a searcher after an unsuccessful Search Fund acquisition. Each searcher interviewed was asked to explain his or her career path after exiting the unsuccessful Search Fund acquisition. Additionally, each searcher was asked to compare his or her income upon regaining work to the median income of his or her MBA graduating class. It is important to note that all of the searchers reporting their position and income for this study hold an MBA from one of the following three business schools: Harvard Business School, Stanford Graduate School of Business, and The Wharton School of the University of Pennsylvania. Data on 15 different individuals was gathered through the interview process.

5 of the 15 searchers, or 33.3%, reported having incomes above the median of their MBA graduating classes upon regaining work. Career tracks, after exiting an unsuccessful Search Fund acquisition, of these five individuals include Search Fund entrepreneurship, more traditional entrepreneurship, and Search Fund investing.

It is important to note that one driver of the incomes that are above the median is capital gains from equity positions the searchers held in the company or companies they started, purchased, worked for, or invested in following their experience with an unsuccessful Search Fund acquisition. This study did not analyze the income of these individuals exclusive of capital gains.

2 of the 15 searchers, or 13.3%, reported having incomes at the median of their MBA graduating classes upon regaining work. Career tracks for these two individuals were a more traditional post-MBA track, such as consulting or investment banking, for one and Search Fund entrepreneurship for the other.

8 of the 15 searchers, or 53.3%, reported having incomes below the median of their MBA graduating classes upon regaining work. Career tracks of these eight included Search Fund entrepreneurship, more traditional operating roles at large- to mid-size corporations, wealth management, and Search Fund investing.

In addition to data showing the relative incomes and career tracks of searchers who have exited unsuccessful Search Fund acquisitions, it can be helpful for future searchers and investors to learn about the intangible consequences of an unsuccessful Search Fund acquisition. Searchers and investors interviewed shared both negative and positive intangible consequences.

Negative intangible consequences include emotional and physical stress, relational break-ups and divorce, the need to change industries, and the need to cultivate a new professional network. Emotional and physical stress often results from the pressure of failure. Adding to the searcher's stress is the fact that the unsuccessful Search Fund acquisition is often the first true failure of the searcher's life. The stress can be seen through the fact that most searchers take several months off after exiting the unsuccessful Search Fund acquisition.

A relational break-up or divorce has happened in at least two of the unsuccessful Search Fund acquisitions studied. In certain situations, unsuccessful searchers must change industries and develop a new professional network. This happens most frequently when a conflict arises between the searcher and board of directors.

Positive intangible consequences include a long-lasting relationship with Search Fund investors and advisors, the ability to raise a follow-on Search Fund, and lessons that impact areas outside of the searcher's professional life. Many searchers who have maintained an open relationship with their boards during the difficult periods of the unsuccessful acquisition have been able to maintain long-lasting relationships with their boards and investors. These long-lasting relationships have allowed many searchers to raise a follow-on Search Fund, find work from another Search Fund operator or investor, receive positive referrals from the Search Fund community, and, eventually, become Search Fund investors.

Beyond the positive professional implications, many searchers associated with the 22 unsuccessful Search Fund acquisitions say that the experience has had a long-term positive impact on their personal lives. Despite the fact that the failure provided one of the worst short-term experiences of the searcher's life, a searcher's long-term values and priorities are often changed in the years following an unsuccessful acquisition.

Section III: The Beatific Vision: Components of a Hypothetical Model Search Fund Acquisition

The third objective of this study, *Search Funds: Death and the Afterlife*, is to identify, from the common themes seen in the unsuccessful Search Fund acquisitions, components of a hypothetical model Search Fund acquisition. Using the common themes identified from the 22 unsuccessful Search Fund acquisitions, a hypothetical model, or ideal, Search Fund acquisition can be laid out. Based on the results of this study, an ideal Search Fund acquisition would have the components outlined herein.

Prior to discussing the detail, it must be remembered that no Search Fund acquisition, even the most successful acquisitions, has ever had all the components of a perfect hypothetical model. A critical part of operating and investing in Search Fund acquisitions is developing an understanding of which business components are necessary for success and which business components are not necessary for success. Search Funds typically acquire small- to mid-size businesses, and most acquisitions of this size are imperfect.

A hypothetical model Search Fund acquisition, based on the results of this study, has components that fall into six categories: Industry, Business, Searcher or Operator, Board of Directors, Former Owner, and Capital Structure. Each of these categories, as well as the components within each category, is outlined below.

<u>Category one</u>: Industry

- Future growth at or above 5% per annum
    - Strong preference for industry growth above 10% per annum
- Gross margins at or above 20%
    - Strong preference for gross margins above 25%
    - Strong preference for EBITDA margins at or above 10-15%

<u>Category two</u>: Business

- Relatively simple operations that can be learned and executed by a recent MBA graduate, the typical Search Fund entrepreneur
- Growing at or above industry growth rate
- Has differentiated product or service that will remain differentiated over long-term
    - Strong gross and EBITDA margins provide a clear indication of a differentiated product or service
    - Differentiated product or service protects margins when competitor or substitute enters market
- Each customer accounts for less than 25% of revenue
- Differentiated end markets, with no one end market accounting for 100% of revenue
- Located moderately close to attractive geographic area
    - Attractive geographic area ensures that valuable human resources can be retained and increased when needed

<u>Category three</u>: Searcher or Operator

- Willing to work with, and be transparent with, board of directors
- Has following attributes when working with board:
    - Listening ability
    - Willingness to learn from board of directors
    - Humility to recognize and admit mistakes when made

- Able to learn a new industry and leadership position
- Willing to spend time and effort learning detailed operations of acquired business
- Leadership ability to retain key employees, make appropriate hires, and motivate team to accomplish company objectives

Category four: Board of Directors

- Willing to trust, work with, and be transparent with searcher
- Has following attributes across members of board:
    - Operating experience
    - Time to frequently speak with searcher on phone or in-person
    - Experience working with young entrepreneurs in a levered, growing business

Category five: Former Owner of Business

- Does not present fraudulent information to searcher at time of acquisition
    - Held accountable with a seller note, earn-out, or minority equity
- Remains as employee or outside consultant to business for one year or less
    - Does not hold board position
    - Does not hold equity or, if necessary, holds only minimal equity stake
- Does not start competitive business in same geographic footprint after exit from business
    - Held accountable with non-compete agreement, seller note, an earn-out, and/or minority equity
- Has reasonable expectations regarding repayment of seller note or earn-out and understands that temporary stoppages may occur during cash flow shortfalls

Category six: Capital Structure

- Acquisition is purchased and maintains capital structure with less than 60% debt, including both seller and third-party debt
- Previous owner can hold seller note, and, holds, if any, only small equity position
    - Earn-out can be used as a financial instrument but should be used with caution

Conclusion

This academic study, *Search Funds: Death and the Afterlife*, began with the intent of covering the following three objectives:

- Identify common themes present in unsuccessful Search Fund acquisitions and share common themes with the Search Fund community, including investors, searchers (former, current, and future), and future business school courses
- Understand life of searchers following an unsuccessful acquisition
- Identify, from the common themes, components of a hypothetical model Search Fund acquisition

Over the course of the study's three sections, each of the three objectives is covered. Section I identifies nine common themes present in unsuccessful Search Fund acquisitions and begins the process of sharing the themes with the Search Fund community. Next, Section II provides data about the career and income of 15 searchers following their departure from unsuccessful Search Fund acquisitions. Lastly, Section III, from the nine common themes, lays out a hypothetical model Search Fund acquisition.

To conclude, additional research can and should be done on the 30 unsuccessful Search Fund acquisitions uncovered by the author, as well as other unsuccessful Search Fund acquisitions that have occurred but were not uncovered by the author. While the themes presented in this study are valuable for the current and future Search Fund community, these themes are only initial and merely hypotheses at this time. The topic of unsuccessful Search Fund acquisitions has a scope beyond a two-credit MBA academic study and could potentially be used as a topic of Master's or Doctoral research. The author of this study applauds all further research on the topic, including business school case preparation and academic study.

Exhibit I: Top Nine, or Most Common, Themes in Unsuccessful Search Fund Acquisitions

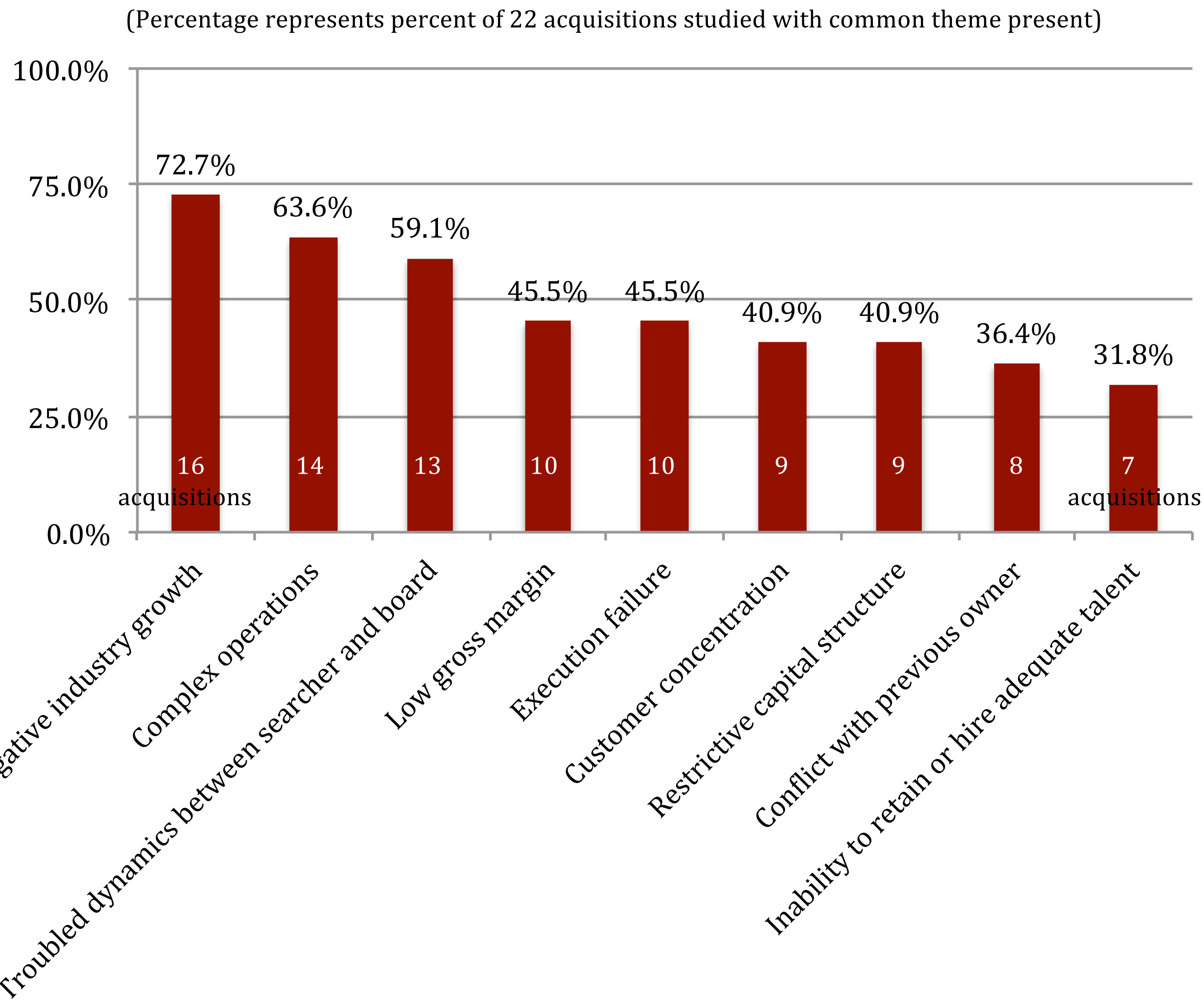


Exhibit II: Distribution of Incomes for Searchers Following Unsuccessful Acquisitions