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Field Study

Feasibility of the Search Fund Model in Spain

Key Takeaways

Carlos Julia
Borja Lomba
Jesús Moreno Sosa
José Ojeda

Faculty Supervisor: Paul Marshall

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Special thanks to Jim Sharpe

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Introduction

After the research conducted during this Field study we have gained deeper insight into the feasibility of the Search Fund model in Spain. We believe that the model can be applied in the Spanish market, but with some differences with to the U.S. Model.

The main take-aways, which are explained in further detail below, can be summarized as follows:

- There appears to be a market for medium-sized companies of typical size for search funds, although this market is less liquid that in the US
- Investors in Spain don't feel comfortable investing their money in someone without operational experience. This contrasts with the mindset of investors in the US. Starting a Search Fund in Spain will be much easier after having had some years of operating experience. Another possible mitigating factor is to target a company with very straightforward company.
- A possible way to overcome that barrier is to find and investor through personal acquaintances
- The Search process will most likely have to be self-funded by the Search Funder, since investors are reticent to fund the search
- A difficulty in the economics for the Spanish Search Funder is receiving equity up-front (unless he/she co-invests). It will be easier to negotiate the vesting of equity over time and the vesting of equity based on performance
- The investment case will more likely have to be based on operational improvement, as leverage cannot be used as a driver given the low access to debt Small and Medium Enterprises face in Spain
- Revenue growth in the domestic market seems to be the most appropriate lever of value creation, expanding a “regional champion” to a national level.

Comments on each stage of the Search Fund

Raising the funds for the search

- A key to raise funds is the personal trust/relation with the investor. Bringing acquaintances on board gives unknown investors more confidence in the Search Funder
- It appears to be important to be backed by investors during the search process because it adds credibility to the searchers in the eyes of the business owners. On the other hand, Spanish investors are not very keen on investing in the search stage, which

translates into a vicious cycle. A way to overcome this would be educating the investors and get letter of commitment for the funds.

- Specific about US investors.
  - They are willing to invest internationally to diversify their portfolios and get greater returns. Examples of Search Funds have been found in India, Austria, Germany and Mexico, as well as a frustrated attempt in Spain.
  - They expect to pay lower EBITDA multiples than in the US to take advantage of the less liquid market and the shorter amount of capital to invest in SMEs
  - They want local investors co-investing in all the stages if possible We found mixed opinions about the possibility to invest in the search period without the presence of local investors. Local investors would be completely necessary for the acquisition round.
  - US investors are becoming more sophisticated when investing in Search Funds. The mentoring and coaching element of investing in a young entrepreneur is becoming less important. The main motivations for investing in search funds (which may be good selling points for investors in Spain) are:
    - The investor gets to decide on the actual investment, as opposed to a PE fund
    - The small business asset class is very attractive due to lower competition for the deals
    - Superior cost structure of the SF versus PE
    - No definite time horizon, which is an issue in PE investments
    - Lower minimum investment to enter in the asset class vs. PE

- Specifics about Spanish investors
  - The Spanish investor is more conservative that the US investor, with big business acumen but not financially savvy. This conservatism is reinforced by the lack of knowledge about the Search Fund as an investment vehicle.
  - Some investors do not to understand the funding of the search period, i.e. “paying the searcher to search”. They think “find me a deal and we’ll talk”. However, they are willing to co-invest in good deals and get a "hands-on" board role. "if you find a good deal you will find investors"
  - Previous experience in the sector of the target industries seems to be an important factor. Investors want a CEO with operating experience. However,

this can be overcome if there is a personal/trust relation, if an attractive deal is found and in deals with very simple operating models. This reinforces the thesis of the difficulties in funding the search stage, before a deal is presented to investors.

- Giving equity to the search-funder up-front without putting money in seems also challenging, although there were different opinions among the investors interviewed. However, a scheme of vesting equity over time and over success may work.
- In Spain, there is a sizable segment of investors with Net Worth between 20 and 100M (business owners): owners with a full or partial exit, senior partners of professional services firms, etc. Availability of capital should then not be a primary concern.
- Bigger institutional investors (such as private equity firms or big family office) looking for diversification and high returns are also an alternative.

Searching target candidates:

- Most active source of deals are brokers (e.g. VR business brokers, OneToOne and GDA) and advisors (ie: 360 Corporate Finance, GBS, Lincon International), however the best deals are generally not "in the market". Although there is a significant amount of middle-market private equity shops, they do not usually operate in the market for businesses with enterprise values below 20M€, which is therefore quite illiquid
- Thus, the target business segment of up to 20M€ it does not overlap with the PE market: The PE market plays over the 10-20+ market, being most of the competition in the +50M€ segment. This also suggest an interesting opportunity: paying low multiples the illiquid <20M market, and exiting at higher multiples in a sweeter spot for PE funds
- The best deals seem to be opportunistic, so being close to the market is important. There seem to be opportunities in owners with difficulties finding successors . Spain is a relatively small country and market, so the structured search approach may not yield many companies to fill the pipeline, so this approach must be combined with the opportunistic one
- It is important to test the real willingness to sell, some sellers will just want to receive a free valuation of their business. Those interested are many times willing to sign letters of intent with break-up clauses

Closing the deal

- Traditionally there has been reluctance by owners to sell the family businesses because of a social perception of failure or bankruptcy. This tendency is disappearing (in some regions faster than in others), partly because of the activity of PE, so that it is now well seen to sell the business to make money. This is so in spite of the strong incentives for family business to stay within the family (e.g.: tax exemptions to inheritance and no capital gains tax on the "sale"), and there are business owners in specific situations willing to sell.

- It seems that what makes the market illiquid is the lack of buyers for this segment rather than lack of owners willing to sell.
- Financing (debt) is not currently available for deals of this size. It was available during the economic peak, but there are different opinions whether it will come back or not and when. Anyway, starting at ~60M€ deals are considered corporate lending and it is possible to obtain leverage against EBITDA. Debt characteristics in the medium term in this segment are expected to be:
    - Up again to 3xEBITDA in the medium term (up-to 50%EV)
    - 5-6 years with principal amortization
    - Not any kind of subordinated debt
- Smaller deals go though the commercial banking division. Here the long-term financing is based on guaranties (eg: personal warranties, asset backed, …)

- Small businesses in Spain tend to make extensive use of short term financing by banks and suppliers on their day-to-day operations. This can add up to a substantial amount of leverage. The challenge is to refinance this with the banks
- The alternative sources of debt are:
    - Seller notes, which play a really important part. The existence of this kind of debt is related to the specific situation of the seller, and has a higher probability in urgent sales.
    - Restructuring of current debt with new equity infusion, lowering the cost of capital and increasing the maturity of the loans. The likelihood of finding investors willing to buy companies to restructure the debt is medium/low.
    - Mezzanine debt. It's becoming a more important source of capital for Search Funds in the US. The interest rates paid on this debt are very high (above 20%), but some financial institutions are willing to lend to small businesses. The probability of getting this kind of financing in our segment is low.
    - Investor debt. In addition to equity, investors sometimes provide debt financing for the acquisition. Only few investors are willing to provide this kind of lending

Managing acquired firm:

- It is much easier to create value for the shareholder through revenue increase than by leveraging the firms like in traditional LBOs. Growing a “regional champion” to a national level seems the fastest and more reasonable way to do it. Trying to tap new markets (specially international markets) is difficult because it requires more resources and may also take a significant amount of time, which might not match the investment horizon, capital availability and risk profile of investors.

- Reducing labor costs as investment strategy seems more difficult since it requires more management experience and has considerable legal costs.An "ERE" (Spanish process for collective dismissal of workers) which can require a payment of 45 days of work per year of seniority, and up to two years of full salary would be necessary. However, the agreed payments are normally bellow this level (6 months to 2 year range).

- Income taxes for a business this size in Spain will be 25-30%, and goodwill can be depreciated for tax purposes.

- There appears to be a lack of managerial skills in small and medium enterprises, which leads to significant potential for improvement

Exiting the investment

- There are alternatives in both financial and strategic investors
  - Financial investors: the target company has to be attractive for these investors (leverage, future projections, ...)
  - Strategic investors: there are sectors in which there has been more M&A activity than in others
- Exit alternatives increase with the size of the business at the time of exit:
  - If the business is grown to 40M€, it will be in the sweet spot for PEs, but some PEs may also be willing to buy in the 20-40M€ range
  - If growth above 100M€ IPO in the MAB (MercadoAlternativo Bursatil), which is an alternative stock exchange. This alternative is very unlikely in the case of a search Fund

Legal aspects of investing in Spain

- There are no significant legal hurdles that would undermine the attractiveness of the search fund model

- Regulations on business transfers and the legal burdens of the due diligence process are in line with the US

- A remarkable factor is the tax exemptions of business transfers to as part of the estate in an inheritance

- Tax carryforwards from past losses can still be used after the acquisition, but the new owner is liable for any past tax obligations and fraud derived from them. Contigent contracts with seller notes are used to mitigate this risk.

- Labor regulations are quite rigid. A legal process exists when more than 20% of the workforce must be laid off. The average severance payment is between 25 and 45 days of pay per year worked. This process takes between 3 and 6 months.

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Investment Thesis

Carlos Julia
Borja Lomba
Jesús Moreno Sosa
José Ojeda

Faculty Supervisor: Paul Marshall

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Investment Thesis

General Investment Philosophy

The Search Fund model in Spain should be focused on creating value primarily through growing an asset light firm at a domestic level in a "healthy" industry in Spain. That investment thesis is based on the findings from our research on investor preferences, debt markets and industry dynamics in Spain. The table below shows our main findings and how they compare to our initial hypothesis about the investment thesis in Spain:

Aspect of the model	Initial Hypothesis	Change in hypothesis from research
Leverage	An LBO, though unlikely to happen in the current context, should be applicable in the Spanish market in normal circumstances • Financial leverage will be a significant driver of value creation for a Search Fund in Spain and will come from banks	An LBO is not as likely to occur in Spain as it is in the US, even in an ordinary economic environment: • Spanish debt markets are much less liquid for SMEs than what they are in the US. Banks are not willing to provide a significant amount (i.e. more than 30-40%) to lever up acquisitions with an EV lower than EUR40MM • Given the search funder profile (MBAs with limited experience in a particular industry) it seems much easier to pitch an investment that limits the risk on the financial side, as investors would feel more comfortable with the abilities of the funder to manage a not highly levered company Rather, value creation for this type of investment should be driven by growth in the Asset value (i.e. growth in the value of business of the acquired firm) The limited debt used for the acquisition will be a mix of seller's notes, bank debt and rarely investor's debt

Driver of growth	International growth should be a strong driver for growth and the main pitch for individuals with our background for a Search Fund investment thesis • Firms operating within strong Spanish clusters would be good candidates for this strategy	International growth does not seem to be a suitable scenario for this type of investment • The LT horizon of international growth poses a problem of timing mismatch between the growth plans and the investor´s investment horizon (which is likely shorter) • Internationalization introduces additional risks to the investment, which investors do not seem to value Rather, growth should rather come from expanding a firm within the national market • A good strategy lies on acquiring a firm with a regional focus (“regional champion”) and expanding it to a national level

Type of industry	Manufacturing and product oriented industries would be suitable candidates for this type of investment • Due to its more stable cash flows • Due to a higher ability to raise asset-backed debt	Firms requiring heavy financing for step-type of growth are not suitable candidates for this type of investment • There is a limited amount of capital (both equity and debt) that can be used to finance this type of growth • Significant amounts of capital expenditures introduce additional risks to the investment that are not valued by investors Rather, asset-light service oriented industries seem to be a much more attractive option • Growth does not require a significant amount of capital expenditures • Working capital increases will be financed with the operating cash flows (target is very profitable company) and some bank debt associated to the working capital
	Unprofitable or declining industries do not seem to be suitable for this type of investment	This hypothesis has been confirmed through our research • Investors seem to value limiting the risks associated to the investment as much as possible • Does not seem aligned with the kind of skills that as recent MBA graduates we can bring to the table

These guiding principles have helped us define some criteria that should be used to filter industries and specific companies in the structured search.

Industry criteria

We have defined the following criteria to choose industries in which we would invest. They will help us narrow the search down to the 10-15 industries that are most attractive to us:

- Asset light industries, primarily service oriented that do not require heavy capital expenditures to grow
  - [Quantitative measure, e.g. CAPEX/Growth]
- Reasonably growing industries, as a measure of growth potential
  - [Quantitative measure, e.g. Revenue CAGR last 5yrs o Expected CAGR in next 5yrs]
- Profitable industries, to mitigate the risk of entering industries that might pose potential problem down the line
  - [Quantitative measure, e.g. Average EBIT Margin last 5yrs]
- Reasonably fragmented industries, with no clear leader
  - [Quantitative measure, e.g. Number of firms making up the 30% of the total sales in the indsutry]
- Industries with simple and understandable operations, where we can add value as recent MBA graduates

We acknowledge that the selected industries might not meet ALL of the criteria.

Company criteria

We have defined the following criteria to choose companies in which we would invest. They will help us narrow the pool of companies to target in the selected industries:

- Regional firms lacking (and suitable for) expansion at a national level, that allow us to use regional expansion as a driver for growth
  - [Quantitative measure, e.g. % Concentration of sales in home region vs other regions in Spain]
- Reasonably growing firms
  - [Quantitative measure, e.g. Revenue CAGR last 5yrs o Expected CAGR in next 5yrs]
- Profitable firms, with lower risk of distress and easier managerial issues
  - [Quantitative measure, e.g. Average EBIT Margin last 5yrs]

- Firms with strong middle management, which enables the firm to successfully face the growth phase
- Recurring revenue model if possible

We acknowledge that the selected companies might not meet ALL of the criteria.

Opportunistic approach to complement structured search

With the goal to increase the probability of success in finding a company, the Search Fund should follow an opportunistic approach to complement the structured search

- The Search Funders should be focused on building strong relationships with brokers and other sources of deal flow
- The Search Funders should be actively open to new opportunities that might present from these and other sources
- However, the opportunities coming from this approach should still be evaluated using the criteria above to test the attractiveness of the investment