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FIRST 100 DAYS:
A SEARCH FUND LAUNCHES

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Abstract

This note describes a searcher's experience fundraising and preparing for a search for a company to acquire. The decisions of the searcher were based on "best practices" shared by both peer searchers and the investor community. The note includes four sections: pre-launch, fundraising, forming the fund and searching.

Keywords: Search funds; Entrepreneurial acquisition; Launch; Fundraising

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FIRST 100 DAYS:
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I am an IESE MBA '14 graduate and I started a search fund backed by U.S. and European investors. The IESE Search Fund Center asked me to write this note on my experience fundraising and preparing for my search. The decisions that I made were based on "best practices" shared by both peer searchers and the investor community. However, I defer to the Stanford Search Fund Primer, which has been recently updated to reflect current trends in the asset class.

This note is made up of four sections: pre-launch, fundraising, forming the fund and searching. I also included some materials in the Exhibit section which reflect, in part, the work that I completed to these ends.

Pre-Launch

The number one question that investors will have is why you are raising a search fund. This should be the number one question that you have for yourself. Unfortunately, many would-be searchers think of a search fund as a "mini private equity fund" or a relatively easy way to obtain wealth and an executive title. Both of these assumptions are wrong.

A popular metaphor is Blackstone/KKR/Apollo (etc.) as a barge, the searcher as a life raft. Private equity funds, in a broad sense, are highly structured and the experience of a post-MBA private equity career looks very different (although superficially similar) to that of a searcher. Private equity firms tend to have full-time business development (i.e., deal-sourcing) professionals, legal staff, HR support and general administrative resources. As a quick example, searchers are left to decide how they will structure their fund, what type of health insurance to buy, where they will work. A young private equity professional would never spend time on these matters.

Most importantly, a private equity fund is a closed vehicle. A fund's investors have committed a certain amount to fund future transactions. This is not the case with a search fund, a fact that many prospective searchers overlook. Committing the first-round ("search") capital is not a commitment to fund the deal. The search period is really another interview process: the searcher learns about his investors; the investors learn about the searcher.

That said, for me the search fund was the most attractive opportunity I could think of pursuing post-MBA. In fact, the "search fund bug" bit me four years before I even applied to IESE. (I was working in private equity, and we invested in a fund that made tandem investments in search deals.) I enjoyed private equity, but I wanted to be with one company for the long term. Since I had done a start-up in college, I knew what it felt like to be in charge and to have ownership in something. Although there were many ways that I could have achieved this (more on that later), the search fund made sense for me.

After I first learned about the search fund model, I tried to contact as many people as possible: investors, searchers who had made an acquisition, searchers who had failed. One of the mentors that I met during this process was a professor at a leading U.S. business school. He believed that I had what it took to do a search fund, but he asked me a question that stumped me: Why now? That's the second part of the question that you need to answer.

Again, to reflect on my personal experience, I had just gotten married and my wife and I knew that a family would be coming soon. The professor's question was one that made sense. When I first learned about search funds, I was an unmarried young professional in finance. By the time I had entered business school, it really was time to "make the jump." My wife and I decided that this would be the best time to try something risky; if I failed, I would still be relatively young in my career.

Fundraising

Pre-Raise

Prospective investors always asked me why I was doing the search fund. This was the most prevalent issue on their minds. If you can answer this question honestly, and the answer makes sense for both you and the investor, then the rest of the conversation should go quite well. In order to do this honestly, I spoke with more than 100 searchers based in the United States. I also spoke with international searchers, since I thought it would be helpful to learn about the international investor community as well. This should be a familiar theme for international MBA students.

Before calling searchers, I made sure that I was already up-to-date on the publicly available information on search funds. After more than 25 years of history as an asset class, search funds have been the subject of research published by Stanford, Harvard, Dartmouth, IESE, LBS, etc., in addition to the attention received from the press, including the *New York Times*, the *Financial Times* and *Forbes*. Since there is so much research available, I decided to list the themes I read about for each stage in the process (search, acquire, manage, exit). For example, what are the best practices for the search stage and why? What is the difference between an opportunistic and a proprietary sourcing strategy? Do geographically limited searches work – why or why not? In other words, before I even began speaking with members of the community, I tried to construct a vision of what my search fund strategy and journey should look like, based solely on third-party information.

Doing this allowed me to really focus the conversations that I had. For searchers, I tried to ask for a list of their investors (normally this is advertised on their websites, but names are often removed if an acquisition has already been made or if the search was unsuccessful). I asked about the search strategy they used and tried to figure out why it was successful for them or why not. Beyond just the idea of "proprietary vs. opportunistic" (as an example), I asked how they were able to get owners to speak with them, how they handled difficult negotiations (especially concerning valuation) or even how they got people to take them seriously (in my case, I am Asian and look particularly young in the general U.S. context).

If they had already made an acquisition, I tried to collect as much information as possible. Beyond valuation, I was much more interested in learning what they thought about the trajectory of the company they were buying before the acquisition had closed. For example, one searcher told me that he knew that the company was solid and that, even with a full valuation and constant growth rates, he could improve profitability significantly simply by putting in more professional back-end systems. Another searcher told me that the business model was a perfect candidate for SaaS adoption, and the company was intended as a growth investment rather than a traditional LBO.

A key area that I focused on was the searcher's relationship with investors. Many prospective searchers do not realize this but the search fund journey can easily last up to a decade (or more) and understanding your investors can be one of the most important tasks when it comes to raising funds. I wanted to be able to trust my investors and think of them as partners, instead of just as sources of capital. I wanted them to understand me as well – my background, what I value, what motivates me, my understanding of business and society. Obviously, having just met me over the phone, searchers weren't ready to be completely open with their opinions (and one opinion among many, at that), but you should be able to get a sense of who might be a good fit.

In addition to searchers, I also made sure to involve my business school professors. In particular, I constantly spoke with a professor at IESE (since he was on campus and knew me on a professional and a personal level) and a professor at HBS (since he also knew me personally and could provide information that was more pertinent to a U.S.-focused fund). I did this for a few reasons. First, as a partner-less searcher, I needed a sparring partner who would question me but in a safe and open environment. Second, the knowledge that these professors brought about search funds, coupled with their knowledge of me as a person, was very powerful in keeping me honest, both to my family and to myself. Third, having "someone to talk to" was also a good tool to keep me on task.

After completing the reference calls with searchers, I made a summary document of learning points so that I would be able to have intelligent conversations with investors (and to help me structure my own search). The next step in the process was to speak with former employers and people within my professional network who would be interested in investing in the search fund. One of the most prolific search fund investors told me in a private conversation that one of the best ways to jumpstart a fundraising process is to already have a few investors who do not know about the search fund model but who do know you, either professionally or personally (or both).

Before leaving my previous employer for IESE, I had already started having conversations with my colleagues about the search fund model. When it came time to ask for an investment, they were not surprised to hear about my plans and I did not have to educate them about the search fund model. Most people who have investors from their personal networks say that the hardest part is convincing them that the search fund model works, which is why I decided to start courting my personal network relatively early on.

My final "pre-raise" conversations were with professional search fund investors, mainly fund-of-search funds, although I did speak to some private equity funds that have search fund allocations. I always asked a current or former searcher to make an introduction for me, since many of these investors are inundated with requests for conversations. I spoke to these investors before formally launching my search for two reasons.

First, I wanted to know if I would make an attractive candidate. Based on my own personal reflections, conversations with other searchers and my mentors, and after speaking with my wife *ad nauseam* on the subject, I thought that the search fund route was the road for me. But I wanted to make sure that my hypothesis was correct, and an investor who has participated in 100+ searches giving me informal, personalized feedback would make for a powerful data point.

Second, I wanted to introduce myself to the investor community, but I wanted to keep my conversations informal. Once you have begun fundraising, conversations turn more towards the process (who else you are speaking with, the number of units, etc.). I wanted these conversations to help me set the tone for that very process.

PPM

Although many varieties of the funded search exist, I knew that mine would be pretty standard. I would seek standard terms, and many of my investors would come from the search fund investor community. As a result, when writing my PPM, I did not focus on how the fund would be structured or what my terms would look like. My fundraising document uses "market" language and I knew that if I did a good job fundraising, then the investors that I would be surrounded by would be as interested in our success as in the terms governing our deal.

I took about one month to write my PPM. The document contains these main sections:

1. Summary
2. Investment thesis
3. Principal background
4. Investment opportunity
5. Appendices: résumé, industry deep dive and illustrative economics (see **Exhibit 1**)

Items 1, 2 and 4 are relatively standard, and I used the template provided by Stanford GSB. Many searchers told me to focus solely on the industry section, since you cannot change your résumé and the illustrative economics section is an LBO printout.

For the industry section, I did a deep-dive analysis of three industries. The objective of the exercise is to generate ideas for your search and to demonstrate to your investors that you have the ability to understand what a good search fund industry candidate looks like and to find and analyze these industries. To guide me, I spoke to private equity investors and current and past searchers. I also concentrated on taking the Stanford Search Fund Primer material to heart. The Primer is very explicit in detailing the characteristics that make for a promising industry (e.g., low capex intensity, high recurring revenues, high industry niche growth, etc.). I used Stanford's industry rating metrics, also included in the Primer, and for approximately one month I tried to find at least three ideas that could be high-potential industries. For each industry that I qualified, I spoke to the trade group president, to at least one head of business development at a publicly traded firm in that industry and to a small business owner in that industry. By doing this, I was able to give my prospective investors a view into my thought process that went beyond just public numbers that anyone can easily find online. An example from my industry section is in **Exhibit 1**.

Road Trip

Since I was coming from Spain, I set up around 30 meetings that took place in New York (tri-state), Boston, San Francisco and Los Angeles in a time span of two weeks. The majority of search fund investors are located near these hubs. I completed the informal conversations with investors in May and June of my first year at IESE, and I scheduled follow-up meetings for the following August to have formal conversations. These investors also introduced me to other investing members of the community, which was very helpful since the asset class is still growing and it is hard to keep a current view of the people who are currently active. Specifically, this was very helpful in reaching former searchers who had exited their investments and were now investing in search funds. I had not considered this group of potential investors, since I had somewhat underestimated their size.

The average investor meeting was no longer than two hours. One investor invited me to dinner with him after our conversation, and another investor only had time to meet with me at an airport Starbucks; we coincidentally had a layover at the same airport at the same time and on the same day. Some investors had me meet them at their offices, some at their homes. But, because I refused to take an investment from any investor whom I had not met in person, I did have to be very flexible in my scheduling. (In another example, I had a meeting with a potential investor in Sacramento, but because the traffic was so heavy from SFO I ended up being invited to eat dinner with his family instead.)

As stated previously, nearly every investor wanted to know about my background, why I was doing the search fund and what industry ideas I had come up with. The interview is not “hard”; the hardest part is getting the investor to say yes. One investor told me that our interview really wasn’t about listening to my pitch (since you can get that from reading the PPM); rather, it was about seeing how I was able to turn a one-hour meeting into a firm commitment to invest. Because I already had two commitments from my personal network, investors seemed more comfortable giving me the green light.

Structuring the Fund

In the United States, since the search fund model is already well established, a few law firms have gained significant experience dealing with the structuring of these funds. Although the search fund is not theoretically complex, there are some issues that make the fund unique from a structuring perspective (e.g., transferring units, allocation rights during the step-up, catch-up provisions, carry calculation, etc.). Many searchers do not choose their attorney based on who is best to set up the fund. In many circumstances, the lawyer who sets up the fund also completes the diligence work during the acquisition phase and also acts as in-house legal counsel post-close. However, some searchers prefer to have a separate lawyer for each stage in the process. I chose my lawyer based on who I thought I would have the best long-term relationship with, and as a result our understanding is that he will also complete the acquisition work and post-close representation.

Typically, the fund is set up two to three months before the fund is closed and money is called from investors. In my case, because I had a relatively early raise, the fund had a “dry close,” although the vehicle itself was not funded for another six months (i.e., until after my graduation date).

Most search funds in the United States do not have Advisory Boards. However, when I was in Europe I interned for a search fund that did have one, and the searcher found the structure to be very useful. My Advisory Board is not compensated, but a portion of my carry will go to a charity of our mutually agreed-upon choice. Because of my personality type, I need to have structure, and I knew that regular meetings with my Board would keep me on track and give me a sense of pressure.

Searching

At the time of writing this note, my search fund hasn't been funded yet. However, there are many activities that I was able to complete before the search capital was dispersed (see **Exhibit 2** for the full list).

I believe in the industry-based approach, since it's easier to be more disciplined when you have set guidelines to work with. Based on conversations that I had with searchers, investors and my Advisory Board, I came up with the following metrics (these are just my own and by no means the "perfect" solution) to "quick kill" an industry:

- Industry revenue above $1 billion
- Annual growth of 3% or greater
- Gross margin higher than 20%
- ROA greater than 5%
- Return on tangible capital between 0% and 10%

It's easy to waste time on opportunities, and the metrics above helped me keep disciplined while researching. To further qualify opportunities, I used a weighted scoring system (see **Exhibits 3** and **4**).

Exhibit 1

Sample Industry Analysis From PPM

<table>
<tr><th colspan="2">Category</th></tr>
<tr><td>Industry Primer</td><td>
Parent Industry: Laboratory Testing Services
NAIS Code: 54138
Parent Industry Size[1]: $16.8 B, >9,000 Firms
Profit Before Taxes[2]: 9.2%
Profit Before Taxes/Total Assets[3]:
<table>
<tr><td>High</td><td>26.6%</td></tr>
<tr><td>Median</td><td>12.4%</td></tr>
<tr><td>Low</td><td>3.4%</td></tr>
</table>
The calibration and validations services industry covers companies that calibrate, repair and maintain test and measurement devices across a wide variety of industries, including biotechnology and medical device manufacturing, industrial manufacturing companies, the energy industry and power, natural gas and water utility companies, and the chemical process industry. Within this category, the company will focus on niche calibration and validation services, examples of which are:

Radiation dosimetry services
Ultrasonic flow meter calibration
Home health medical device inspection and calibration

</td></tr>
<tr><td>Industry Size and Growth</td><td>The total calibration and validation market has a total revenue size of more than $1 billion, with overall growth from 2011-2018 modeled at a 5.4% CAGR. Growth is expected to come from industry trends towards outsourcing calibration and validation services away from original equipment manufacturers (OEM's). Furthermore, within the past two years the highest growth has been seen in aerospace, defense, and medical device testing.</td></tr>
<tr><td>Business Model and
Strategic Analysis</td><td>Given the highly sensitive nature of end-user activities, many companies utilizing high-end measurement and testing devices are required to undergo regularly scheduled calibration examinations regardless of economic conditions. Such activities can be relatively simple, such as verifying weight scales in hospitals, and incredibly complex, such as validating flow level monitoring devices used by natural gas production companies. Often, government regulation requires regular testing, however, niche non-mandatory activities (such as specialized food production certification and environmental inspections) are often high-margin and recurring. The sector is also expected to grow due to the increasingly varied type of equipment that end-users are required to purchase and maintain. Given that key economic drivers include total health expenditures and R&D spend, strong growth is expected from underlying demand industries. Additionally, growth for calibration and validation services will increase as companies opt to extend the usable life of existing assets rather than purchasing new ones.</td></tr>
</table>

[1] US Economic Census
[2] RMA eStatement Studies
[3] *Ibid.*

Exhibit 1 (Continued)

Value Drivers	Added value will come from expansion to other customer locations and segments (e.g., in the case of radiation dosimetry, selling monitoring contracts to non-traditional users such as dental offices, research laboratories and medical device manufacturers). Value creation will also come from targeting new construction locations as well as becoming a single-source provider of industry-wide calibration services (i.e., being able to utilize existing assets to service a wider range of sectors is generally more profitable). Since smaller firms are generally limited to specific geographic areas or instrument sectors, additional value may be realized from add-on acquisitions. Furthermore, firms are generally able to increase prices as new industry standards are implemented that require new methods, equipment and training for tests.
Key Resources	Industry Groups NCSL International Tradeshows NSCLI Workshop & Symposium Measurement Science Conference

Source: Own elaboration.

Exhibit 2

Pre-Fund Timeline ("T-100")

General/Administrative Activities

- Search fund registered as a Delaware entity
- Payroll and corporate account application sent to bank
- Office space secured
- CPA selected for K-1 filings and accounting system purchased for ledger management
- Marketing material produced by segment (CEOs, intermediaries and non-financial audiences)
- Other searchers' quarterly reports reviewed
- E-mail marketing provider selected
- Website agreement finalized
- Online file management system created (Google Drive for Business). This system is used to track industry and deal data, as well as to share project files with interns and investors
- Investment fund documented and closed. Funds to be held in escrow until post-graduation
- Company underwriting and screening model created

Industry-Based Sourcing

- Researched more than 500 industries (classified by NAICS industry code) alongside interns
- Initial search resulted in 25 "high-potential" industries
    - For each "high-potential" industry, I conducted phone interviews with trade group associations, business owners and specialized intermediaries to qualify the industry as a potential area of interest
- Identified industry experts and riverguides. Completed riverguide agreement via lawyer
- Since business registries do not exist in the United States, I formalized a company database creation process (Data.com, ReferenceUSA, Hoovers, Capital IQ) based on interviews with past searchers and current investors

Source: Own elaboration.

Exhibit 3

Sample Industry Screening Template

INDUSTRY QUICK REVIEW	
Name:	**For-profit Education**
NAICS code:	61131b
Score:	8.6

Notes: Focus on niche offerings for areas that are projected to have job shortfalls

Next steps: Connect with APSCU CEOs; speak with searchers who have bought for-profit companies; intern to create industry map

		Input	Notes/Instructions	Where to Locate Number
Financial Characteristics	Annual Revenue ($B)	27.2	*Should be above $1b*	IBIS
	Annual Growth (%)	8%	*Kill industry if <2%*	IBIS
	Gross Margin (%)	57%	*Kill industry if <20%*	IBIS/Leading public company
	Return on Assets [1]	13%	*Kill industry if <5%*	eStatement Studies/Leading public company
	Recurring Revenue	60%	*Estimate potential % of revenue*	
Barriers to Entry	Supply-side economies of scale	High	*Firms that produce larger volumes enjoy lower costs/unit because they can spread out fixed costs*	IBIS
	Demand-side benefits of scale	Medium	*"Network effect": customers are discouraged from buying from newcomers*	IBIS
	Customer switching costs	High	*Switching costs are the fixed costs customers pay when switching providers*	IBIS
	ROTC [2]	18%	*Capital requirements, related to scalability. Kill industry if 0%<>10%*	See footnote
	Restrictive government policies	Medium	*In favor of business*	IBIS
	Fragmented Industry:	2	*Fragmented Industry, rate:* 0 The industry is dominated by a few key players 1 A few players control 40% of the market 2 A few players control 20% of the market 3 No player controls more than 5% of the market	IBIS

NOTES

(1) Using eStatement Studies: PBT/Total Assets

(2) To calculate ROTC, operating income from continuing operations is adjusted for restructuring charges and amortization of intangible assets, and this adjusted operating income is applied to average tangible capital. Average tangible capital is calculated as total assets less cash, investments, goodwill, and intangible assets, net of current liabilities excluding short term borrowings. Can be estimated by using % Profit before Taxes / Tangible Net Worth.

Source: Own elaboration.

Exhibit 4

Sample Industry Screening Score Loadings

Total Weighted Score: 8.55

		Input	Score	Weight	Adjusted Score	
Annual Revenue		27.2	3	10%	0.3	
>$1.5B	3					
$1B <> $1.5B	2					
$.5B<>$1.B	1					
<$.5B	0					
Recurring Revenue		0.6	3	20%	0.6	
No recurring	0					
>20%	1					
>40%	2					
>60%	3					
Gross Margin						
<20%	0	57%	2.5	20%	0.5	
20%<>30%	1					
30%<>40%	1.5					
40%<>50%	2					
50%<>60%	2.5					
>60%	3					
Annual Growth		0.077	3	20%	0.6	
7%	3					
5% <> 7%	2					
2% <> 5%	1					
<2%	0					
ROA		0.133	1	8%	0.075	
20%	3					
15%	2					
5%	1					
<5%	0					
Supply-side economies of scale		High	3	2%	0.06	*Firms that produce larger volumes enjoy lo*
Demand-side benefits of scale		Medium	2	1%	0.02	*"Network effect": customers are discourag*
Customer switching costs		High	3	2%	0.06	*Switching costs are the fixed costs custom*
ROTC		0.18	2	10%	0.2	*Negative ROTC can be good*
20%						
15%						
10%						
Restrictive government policies		Medium	2	3%	0.05	
Fragmented Industry:		2	2	5%	0.1	

Source: Own elaboration.