Strelia M&A Series

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Search Funds: A Once-Obscure Asset Class Now Worth Getting Excited About

Pioneered by the Stanford Graduate School of Business, search funds enable aspiring entrepreneurs to find, acquire, and grow existing companies into high-performing businesses. Search funds have been rather popular in the US for many years and were relatively unheard of in Europe until recently. They are now indeed reaching new heights in terms of the number of funds raised, acquisitions made, amounts of searcher equity earned. Several private equity firms have also begun investing in search funds. In this Series, we take a closer look at the concept of search funds, how they work, their success factors, as well as their risks.

What?

A search fund is an investment vehicle led by one or two individuals, the searchers, together with a group of investors to search for, acquire, and lead a privately held company for the medium to long term. Search funds are technically a form of private equity, as they exist to acquire and operate private companies. But, unlike conventional private equity, search funds look for companies in which the searcher will also take an active role in operating the business post-acquisition. Search funds do not have a portfolio objective, and they have an involved investor base. Unlike venture capital, search funds traditionally target established companies with a proven track record and high-profit margins. Search funds are also different from SPACs in that search funds' capital comes from private investors.

How Do They Work?

Search funds typically go through four stages: fundraising, search and acquisition, operation and value creation, and exit. Raising sufficient capital for search fund investors can take several months and is done in two phases: the search phase and the acquisition phase. Searching for a target can take up to two years and comes to an end with a due diligence of the potential target. Usually, targets must meet the following criteria: be within a growing market, have been profitable for the last five years before the acquisition, for sales to be recurrent with a diversified base, preferably have a low CAPEX and OPEX investment to support sales growth and have leverage capacity to boost returns. Each investor has a *pro rata* follow-on right, allowing it to invest its *pro rata* share of the equity tranche required to close the transaction. As compensation for this risk, the investor's initial equity is usually stepped up by 50%. As for the searcher, he or she takes over the management of the company usually up to 5 or 7 years until an exit opportunity arises. The exit could involve a direct sale of the company, a public offering, or an alternative liquidity event. A search fund's structure involves a share subscription and shareholder agreement outlining governance, earnings distribution, and financing terms. Structuring can become somewhat complex, however, given the investors and searchers' jurisdictions and any regulatory and tax planning considerations. In addition, the pending Belgian tax reform is expected to impact carried interest structures significantly, so this deserves close attention.

Why Are They Becoming So Popular?

Search funds offer numerous benefits to both investors and searchers. Investor returns have indeed been in excess of 30%. Compared with other similar asset classes in private equity, such as venture capital and buyout funds, search fund returns are often superior by 10-15%. The sector has been growing considerably in activity, allowing potential investors to pursue a diversified portfolio allocation and putting non-negligible sums of investor capital at work. They also permit individual investors to be far more active in the companies they invest in, leveraging decades of experience and know-how. Finally, they require a limited initial investment, and they offer downside risk protection because investment failures are usually identified during the due diligence stage.

The most obvious benefit to searchers is that the model allows them to own, manage, and scale an existing company. In addition, searchers can call on experienced investors. And last but not least, searchers can also earn a sizable share of the total equity through equity grant upon acquisition, cliff vesting, time vesting, performance-based, or a combination of some of these options.

What Are the Risks?

We should bear in mind certain aspects of search fund investing, however. Many searchers have little or no experience in acquiring companies; some of them might have less experience in dealing with company operations. This could be more problematic for some sectors, such as technology, as tech companies are rather complex. Also, search funds remain illiquid investments, so investors should firmly allocate them in their alternative asset portfolio allocations. Given that the number of search funds in Europe are still limited, creating a diversified portfolio of search funds can be challenging. As most search funds are backed up by investors, a seller may end up selling the company twice, first to the searcher and then to the investors. Finally, capital is not the only thing that enables the target to succeed; searchers need feedback and guidance from investors to help them run the target company properly. Experience tells us that, given the various legal issues associated with raising capital, obtaining sound advice on financial restructuring, acquisitions, and tax at the beginning stages of a search fund helps ensure adequate solutions.

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