PART III: SEARCH FUND ECONOMICS

OVERVIEW

The basic economics for entrepreneurs and investors in search funds are determined primarily by two major factors: the structure of the investor capital and the amount of the entrepreneur's earned equity (referred to as "Manager Equity" in this Primer; also often called "Carried Interest").

The search fund acquisition is often structured as a participating preferred equity investment. This means that the investors receive a return of their initial capital, often with a modest preferred return, before the searcher begins to participate in equity appreciation. As a result of this structure, investors receive protection in downside scenarios. Manager equity is usually issued as common equity; as such, the search fund entrepreneur begins to realize equity value in the company once some or all of the investor capital has been returned.

This section on economics is intended to emphasize that the primary drivers of economic return are the performance of the company and the absolute dollar gain on the investment. However, it also illustrates how the form and structure of the investors' capital can affect the split of proceeds between investors and search fund entrepreneurs.

INVESTOR CAPITAL

Search fund investor capital is provided in two stages: (1) a smaller amount to fund the search (the "search capital," perhaps $400,000 per one or two search entrepreneurs) and (2) a much larger amount to fund the company acquisition (the "acquisition capital," perhaps $5,000,000 but varying greatly). Upon an acquisition, the search capital converts into the same securities issued for the acquisition capital investment; typically, this conversion is done at a stepped-up value, often 150 percent of the original investment, to compensate investors for running the risk on the search.

Once an acquisition is completed, the post-closing capital structure will include some or all of the following:

- Traditional debt (e.g., revolving line of credit, senior term debt, and, potentially, mezzanine debt)
- Seller financing (e.g., seller notes or earn-out)
- Preferred equity (e.g., one or more senior instruments)
- Common equity

Investor capital can come in various forms, including, but not limited to, those addressed here:

Preferred equity – There are many variations, and therefore there is room for creativity, in structuring preferred equity. Preferred equity is junior to all debt securities but senior to common equity. In search funds, preferred equity is often issued as participating preferred stock, although in Europe and some other countries, "participating" securities work quite differently than in the United States.

- *Preferred stock* offers the holder the right to **both** (1) the initial value plus accumulated and unpaid preferred dividends (if any); **and** (2) 100 percent of the common equity, less vested Manager Equity (described below) upon sale or liquidation. Preferred stock can be issued as redeemable preferred stock or nonredeemable participating preferred stock:

- *Redeemable preferred stock* can be redeemed in whole or in part prior to a sale, recapitalization, or liquidation. Once redeemed, the redeemable preferred stock has no further participation.

- *Nonredeemable participating preferred stock* cannot be redeemed prior to a sale, recapitalization, or other liquidity event as defined by the terms of the agreement.

For the sake of simplicity, the following analysis focuses on two potential structures of investor capital:

- Structure 1: For every $1 of investor capital, $1 buys nonredeemable participating preferred stock with preferred return (often ~5-8 percent).
- Structure 2: For every $1 of investor capital, $0.50 buys redeemable preferred stock and $0.50 buys nonredeemable participating preferred stock.
    - Series A - Redeemable Preferred Stock (~10-17 percent coupon)
    - Series B - Nonredeemable Participating Preferred Stock with No Coupon (~0 percent).
        i. Manager Equity comes in the form of common shares that participate with the Series B Nonredeemable Participating Preferred Stock

Structure 1 and Structure 2 can be substantially equivalent at certain interest rates and preferred returns.

It should be noted that the two structures described in this section, "Preferred Equity" and "Split of Redeemable Preferred Equity and Nonredeemable Participating Preferred Stock," apply primarily to U.S. investments. In the United Kingdom, for example, the bulk of investor capital goes into a redeemable preferred share, not participating preferred stock. In these U.K. instances, a very small amount of capital (sometimes only 1-2 percent) goes toward purchasing ordinary shares. As a result, there is no need for a participating feature within this structure since there is no conversion. The two key advantages of this structure are that most of the capital can be repaid out of retained earnings, and option awards can be made to key employees at quite low exercise prices. An alternative is to use debt instead of preferred shares for the large amount, which can be repaid at any time. Searchers in foreign countries should consult with their local investors and advisors on the appropriate structures for their search and acquisition.

So, why choose one structure or the other? Historically, as investors familiar with traditional private equity buyouts engaged in search fund transactions, they preferred Structure 1. However, many high net worth individuals or professional search fund investment firms with extensive search fund investment or operating experience preferred Structure 2. Recently, approximately 75 percent of deals have been executed with Structure 2, at the election of the search fund entrepreneur.

The advantages/disadvantages of each structure for the investor and the entrepreneur are depicted in the following chart:

	Structure 1 Preferred Equity	Structure 2

	Usually 6-8% coupon	Split of Redeemable Preferred Equity and Nonredeemable Participating Preferred Stock 15-17% Series A, 0% Series B
Investor	Pros • Maintains uncapped returns on entire investment Cons • In a middling outcome, the preferred return can become onerous and lead to misalignment of incentives between the entrepreneur and investors • May promote excessive risk-taking by searcher to create outsized growth in equity	Pros • Focuses managers on cash flow generation and early return of capital • Early return of capital allows for reinvestment in other opportunities • Investor still maintains 100% of the upside • Provides opportunity to take "chips off the table," and therefore opportunity to reinvest redeemed capital in other growth investments while still preserving upside potential Cons • Searcher has a better chance of redeeming the high coupon debt quickly, thereby driving down returns
Searcher	Pros • More commonly known structure outside the search fund community Cons • 100% of the investor equity investment has a coupon attached, so significantly more cash generation and return to investors is required in initial years to stop coupon accretion • In mid-growth scenarios, significant accretion of the preferred equity can lead to misalignment of incentives and be demotivating to entrepreneur	Pros • Allows paydown of expensive component of capital structure more quickly because only half of the total investor equity investment is accreting • Early redemption of Series A Preferred creates economic value to entrepreneur, similar to paying down third-party leverage • Early return of capital can boost IRR and allow for early vesting of performance-based carry Cons • In middling outcome of greater than 5 years, significant accretion of Series A can become onerous

Some investors warned that Structure 1 could be "massively demotivating to managers" and, if growth lags plans, could have "a devastating effect on the entrepreneur." These negative consequences are more acute

in low-growth outcomes without significant free cash flow generation. In these cases, the original investor capital plus the preferred coupon may prohibit the entrepreneur from participating in any meaningful equity gain. Ultimately, investors all noted that the equity capital should be structured to align the interests of investors and entrepreneurs.

MANAGER EQUITY

The typical search fund entrepreneur(s) will vest into 20 to 30 percent of the common equity ("Manager Equity") of the acquired company in three equal tranches:

- Tranche 1: Upon acquisition of a company.
- Tranche 2: Over time, as long as the searcher remains an employee of the acquired company (commonly, a four- to five-year vesting schedule).
- Tranche 3: By achieving performance benchmarks (e.g., IRR hurdles).

Partnerships typically earn 30 percent of the common equity, while solo searchers earn up to 25 percent.

Performance benchmarks most commonly start at 20 percent IRR net to investors and max out at 30 to 40 percent IRR, net of Manager Equity (but may occasionally be based on ROI. Performance vesting can be on a sliding scale or in increments upon achieving minimum thresholds (e.g., 20 percent, 25 percent, and 30 percent IRR hurdles). Neither IRR nor ROI is a flawless measure of performance; very generally, IRRs have been preferred for holding periods under five years and ROIs have been preferred over five years. Some search funds have been structured with either declining IRR ladders over time periods greater than five years or a switch to an ROI table after five to seven years in order to align investor and entrepreneur interests over long periods (i.e., an investor might prefer a 20 percent IRR on a 10-year investment over a 35 percent IRR on a two-year investment).

In some instances, the entrepreneur can request a third-party valuation of the company if a liquidity event has not occurred after five years. The IRR calculated at that point can be used for purposes of vesting the performance equity. In many instances, investor agreements allow the board of directors to decide how to best handle these and other issues. This is another reason to have an engaged and experienced board.

The question of currency denomination for entrepreneurs' performance vesting calculations is a routine problem in structuring international search funds. Choosing between local or another benchmark currency (typically US dollars) has notable advantages and drawbacks. One common solution has been to use local currency and to adjust for inflation differences between the local country and the currency of a major group of investors (often from the United States). For example, if a company was acquired in Mexico, and projected inflation in Mexico was 5 percent compared with 1 percent in the United States over the earned equity vesting period, then the effective ladder would be 4 percent higher (say 20 percent to 35 percent would turn into 24 percent to 39 percent). This specifically adjusts for what some call the "free" return* created by inflation, its associated price increases, and the mathematical devaluation foreign investors will experience as a result of this inflation difference. (However, "free" return is at best a term of art, as returns generated by differing inflationary forces are complex.)

VALUE CREATION

There are three primary levers used to create equity value in any company:

Operations

- Revenue growth through sales and marketing efforts or strategic initiatives (e.g., sales improvements, new products/services, geographic expansion, pricing)
- Margin expansion through cost reduction or operating leverage
- Add-on acquisitions to enhance scale, product/service offerings, or capabilities

Finance

- Capital structure decisions
- Cost of capital
- Capital intensity reduction – fixed assets, working capital, and/or capital expenditures

Valuation multiple

- Buy at lower multiples, sell at higher multiples (due to professionalization of management, improvements in company operations, faster growth, larger size, running an optimal company sale process, etc.)

Of these three levers, managers can influence operations and finance most directly. It is useful for a search fund entrepreneur to analyze potential acquisition opportunities by considering the "calculated bets" to drive equity value creation. For instance, an acquisition opportunity may have incredibly high growth potential but also a high valuation multiple. Does the entrepreneur believe it is possible to hit the growth targets necessary to justify a high entry valuation multiple? Alternatively, another investment opportunity may have slower growth but high fixed asset intensity. Does the entrepreneur believe capital requirements can be reduced enough to generate a cash-on-cash return to be attractive to all involved?

There are neither right nor wrong answers to these questions. Rather, entrepreneurs should match their personal risk/reward profiles and operating strengths with the characteristics of the investment.

HYPOTHETICAL EXAMPLE OF SEARCH FUND ECONOMICS

To illustrate the potential economics of a search fund investment, we will take a representative search fund transaction and manager equity package and apply two different options for investor capital. To see the impact on returns to investors and searchers, we'll run three different operating scenarios:

Summary of Operating Scenarios

	Optimistic	Base Case	Pessimistic
Revenue Growth	20.0%	12.5%	--
Annual EBITDA Margin Expansion	0.50%	0.25%	--
Exit Multiple	7.0x	5.5x	4.0x
Increase in Net Working Capital	20% of Revenue Growth		
Cash Tax Payments	40% of Earnings Before Taxes		
Depreciation & Amortization	$500K in Year 0; fixed margin throughout		
Capital Expenditures	$250K per Year		

The representative transaction, with the capital structure at closing, follows:

Transaction assumptions:

- $15 million in sales and $3.0 million EBITDA
- 5.0x EBITDA purchase multiple ($15 million purchase price)
- 1.0x traditional Senior Debt
- 1.5x Seller Debt

Acquisition Capitalization

	$000s	EBITDA Mult.	% of Total
Senior Debt	$3,000	1.0x	19.4%
Seller Financing	$4,500	1.5x	29.1%
Investor Capital (a)	$7,950	2.7x	51.5%
Total (b)	**$15,450**	**5.2x**	**100.0%**

(a) Includes search capital of $300K at 50% step-up.
(b) Ignores transaction costs.

We will analyze the differences in returns to both investors and searchers under two different structures for the investor capital:

- Structure 1: 7% Nonredeemable Participating Preferred Stock
- Structure 2: 50/50 split of:
  - 16% Redeemable Preferred Stock
  - 0% Nonredeemable Participating Preferred Stock

Regardless of the structure of investor capital, the search fund principal will receive the following Manager Equity package:

- Potential of 30% of Common Equity
  - 1/3 (10%) vests at acquisition
  - 1/3 (10%) vests over four years (also commonly vests over five years)
  - Up to 1/3 (10%) vests according to net investor IRR performance hurdles
    - Straight line vesting is most common between 20% IRR and 35% IRR – i.e., 0% vesting at 20% IRR, 50% vesting at 27.5% IRR, and 100% vesting at 35% IRR

Following is a summary of the results in each of the three operating scenarios described above depending on whether Structure 1 or Structure 2 is used for investor capital:

Summary of Returns ($000s)

	Investors		Searcher	
	Structure 1	Structure 2	Structure 1	Structure 2
Optimistic Case	$ 46,877	$ 49,077	$ 11,909	$ 12,813
Base Case	$ 26,481	$ 27,108	$ 5,110	$ 5,400
Pessimistic Case	$ 11,150	$ 11,235	$ -	$ -

As illustrated, the greatest driver of economic returns to investors and searchers is the company's operating performance and total gain on the investment.

Note that the economics to the searcher would be split in a partnership scenario.

The following two tables provide more detail on the results of the three operating and two financing cases described. Financial models with more detail on each scenario can be found in **Exhibit 12**.

SUMMARY CASH FLOW MODEL & RETURNS - INVESTOR CAPITAL STRUCTURE 1

(US$ in 000s, except where noted)

	Optimistic Case	Base Case	Pessimistic Case
Operating Assumptions:			
Annual Revenue Growth	20.0%	12.5%	0.0%
Annual EBITDA Margin Expansion	0.50%	0.25%	0.00%
Exit Valuation Multiple	7.0x	5.5x	4.0x
Year 5 Sales	$ 37,325	$ 27,030	$ 15,000
Year 5 EBITDA	$ 8,398	$ 5,744	$ 3,000
Exit TEV	$ 58,787	$ 31,592	$ 12,000
Less: Net Debt	(4,125)	(1,780)	972
Total Equity	$ 62,911	$ 33,371	$ 11,028
Redeemable Preferred Equity	$ -	$ -	$ -
Nonredeemable Preferred Equity	11,150	11,150	11,150
Value of Common Equity	$ 51,761	$ 22,221	$ -
Returns:			
Investor Redeemable Preferred Equity	$ -	$ -	$ -
Investor Nonredeemable Preferred Equity	11,150	11,150	11,028
Investor Common Equity	36,233	16,666	-
Total Return to Investors	$ 47,383	$ 27,816	$ 11,028
Original Investment	$ 7,950	$ 7,950	$ 7,950
Return on Invested Capital	6.0x	3.5x	1.4x
Investor IRR	43.2%	28.8%	7.0%
Manager Common Equity Ownership %	30.0%	25.0%	20.0%
Manager Payout	**$ 15,528**	**$ 5,555**	**$ -**

SUMMARY CASH FLOW MODEL & RETURNS - INVESTOR CAPITAL STRUCTURE 2

(US$ in 000s, except where noted)

	Optimistic Case	Base Case	Pessimistic Case
Operating Assumptions:			
Annual Revenue Growth	20.0%	12.5%	0.0%
Annual EBITDA Margin Expansion	0.50%	0.25%	0.00%
Exit Valuation Multiple	7.0x	5.5x	4.0x
Year 5 Sales	$ 37,325	$ 27,030	$ 15,000
Year 5 EBITDA	$ 8,398	$ 5,744	$ 3,000
Exit TEV	$ 58,787	$ 31,592	$ 12,000
Less: Net Debt	3,558	6,017	7,247
Total Equity	$ 55,229	$ 25,575	$ 4,753
Redeemable Preferred Equity	$ -	$ -	$ 1,647
Nonredeemable Preferred Equity	3,975	3,975	3,105
Value of Common Equity	$ 51,254	$ 21,600	$ 0
Returns:			
Investor Redeemable Preferred Equity (a) (b)	$ 6,661	$ 6,933	$ 7,260
Investor Nonredeemable Preferred Equity	$ 3,975	$ 3,975	$ 3,105
Investor Common Equity	35,878	15,660	0
Total Return to Investors	$ 46,514	$ 26,568	$ 10,366
Original Investment	$ 7,950	$ 7,950	$ 7,950
Return on Invested Capital	5.9x	3.3x	1.3x
Investor IRR	45.9%	30.2%	6.5%
Manager Common Equity Ownership %	30.0%	27.5%	20.0%
Manager Payout	**$ 15,376**	**$ 5,940**	**$ -**

(a) Includes Investor Capital dividends during duration of investment.

(b) Cash from operations pays down Redeemable Preferred Equity over 5 year hold period.