THE EVOLUTION OF ENTREPRENEURSHIP THROUGH ACQUISITION

November 7, 2016

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I. Introduction

As 2016 draws to a close, the Entrepreneurship Through Acquisition (ETA) community is in a unique situation. ”Search funds”, the predominant model historically and the focus of this report, has had an amazing run under a mostly consistent model, through a relatively finite set of investors and drawing from a handful of elite business school programs. Now, new models and investors are funding more entrepreneurs than ever, and this trend is gaining momentum. The space has grown from a cottage industry in 1983 into what investors describe as a period of “explosion”, “take-off” and “proliferation” referring to the search fund space in 2016.

In order to better understand these trends, we conducted a study of the asset class by analyzing the available data and through conversations with a broad cross-section of investors. The data show a healthy sector with a robust pool of available companies, a plentiful source of capital, a growing pool of talented search fund entrepreneurs and a more experienced group of search fund investors. The conversations with these investors support much of the performance data and add color to recent trends that have not yet had an impact on performance.

The goal of this paper is to explore how growth and change will affect ETA going forward. We begin by reviewing the origins of the traditional model and the variations that have begun to emerge more recently. We then summarize our interviews with investors, where we outline the common themes that support, or in some cases add, to existing data. Later, we analyze the growth of ETA through different time periods, focusing on the primary drivers of success and incentives for different parties. We conclude by sharing the perspective we gained after analyzing all of this information.

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II. Entrepreneurship Through Acquisition Overview

Origin and History

The search fund model was developed in 1983, when Irving Grousbeck, then a professor at Harvard Business School ("HBS") and now the Director of the Center of Entrepreneurial Studies at Stanford GSB, assisted young entrepreneurs to acquire and operate small businesses. One of the first recognized examples is Nova Capital, founded by Jim Southern in 1984. After forming Nova with investments from former business associates and professors, Southern began to reach out to business owners looking to sell. He eventually came across Uniform Printing, the business forms division of a publicly traded printing company. At $40+ million in revenue with over 750 employees, it was a sizeable business for a first-time CEO. However, with mentorship and guidance from his investors, Southern was able to grow Uniform Printing substantially over the next 10 years. In 1994, Southern and his investors sold the business, generating an ROI of over 24x.

While Nova Capital was one of the better performers, it was not the only search fund to produce outstanding returns. The model was risky, but relatively straightforward and replicable. As Mr. Grousbeck had predicted, many owners of fundamentally sound businesses were approaching retirement age and seeking liquidity, but had not put a succession plan in place. The search fund concept offered a solution for each of these issues. Further, a large percentage of the owners had been content with the business for several years and had neither the desire nor the risk tolerance to invest in aggressive growth. Young, capable entrepreneurs with the right advisors had the potential to find, acquire and grow these businesses; thus, the search fund model was born.

Over 30 search funds were raised between 1984–1999. During that time, a small community of 15–20 individuals accounted for the majority of capital invested in search funds. To entrepreneurs, this group represented the ideal investor base for several reasons. First, they had access to capital and deep networks to assist in sourcing, advising and funding opportunities. Also, they understood the nuances of the model as their experiences investing in and operating businesses via the search fund model gave them an understanding of the types of businesses to look for and the operational levers to pull to create value. Finally, the group had a passion for mentoring young, talented entrepreneurs as they led companies into the next phases of growth. As nearly every searcher will attest, guidance and coaching are critical to success in ETA, and this group was qualified and willing to offer both.

As successful outcomes continued to occur, the model gained momentum and experienced exponential growth. Between 2000–2005, the number of search funds doubled the combined total of the previous 15 years. From 2005–2013, over 100 more search funds were raised. The number continues to grow: near 200 total search funds have been raised to date, of which 75% successfully acquired a company. As of 2013, search funds have produced a cumulative IRR of 34.9% and ROI of 10.0x.

There have been several consequences to the recent influx of people and capital into the asset class. First, the traditional search fund model, still the most common form of ETA, has become standardized—terms and structure are effectively the same for every entrepreneur. Furthermore, new and innovative strategies for pursuing ETA are being developed. From funds of funds and search fund accelerators to self-funded or even crowdfunded searches, there now exists an array of alternatives for entrepreneurs to consider

The Traditional Search Fund Model

The traditional search fund model is still nearly identical to the method Jim Southern utilized in 1983. Today, however, the process of raising a search fund is more standardized and typically entails four stages.

Stage 1: Raising and Structuring Search Capital

Search capital overview: The first major step is raising a pool of capital intended to fund expenses associated with searching for a business—the "search phase". Capital raised for the search phase is used to pay the searcher a salary and cover expenses such as office space, travel, diligence costs, etc. for a period that usually lasts up to two years. The amount typically varies between \$300K–\$400K for a solo search and \$600K–\$700K for a partnership (as detailed in Exhibit A below).

Exhibit A: Representative Search Fund Budgets

Search Fund Budget: Solo Search				
Budgeted Expense	**Monthly**	**Year 1**	**Year 2**	**Total**
Principal Draw	$8,333	$100,000	$100,000	**$200,000**
Payroll Tax & Insurance	$1,667	$20,000	$20,000	**$40,000**
Travel & Entertainment	$2,500	$30,000	$30,000	**$60,000**
Office Rent and Expenses	$2,000	$24,000	$24,000	**$48,000**
Diligence and Advisors	--	$10,000	$10,000	**$20,000**
Pre-Funding	--	$8,000	$0	**$8,000**
Contingency	$1,000	$12,000	$12,000	**$24,000**
Total	**$15,500**	**$204,000**	**$196,000**	**$400,000**

Search Fund Budget: Partnership Search				
Budgeted Expense	**Monthly**	**Year 1**	**Year 2**	**Total**
Principal Draw	$20,000	$240,000	$240,000	**$480,000**
Payroll Tax & Insurance	$2,167	$26,000	$26,000	**$52,000**
Travel & Entertainment	$3,750	$45,000	$45,000	**$90,000**
Office Rent and Expenses	$1,167	$14,000	$14,000	**$28,000**
Diligence and Advisors	$833	$10,000	$5,000	**$15,000**
Pre-Funding	--	$5,000	$0	**$5,000**
Contingency	$1,250	$15,000	$15,000	**$30,000**
Total	**$29,167**	**$355,000**	**$345,000**	**$700,000**

Fundraising: For the majority of searchers, the fundraising process begins long before they formally raise any capital. Raising a search fund is a major decision, both personally and professionally, and requires a significant amount of self-reflection and forethought. Part of the preparation process includes reaching out to investors, current searchers and former searchers that either acquired a business or abandoned the search. This provides a strong foundation of knowledge and, more importantly, helps build a support network within the search fund community that may assist in the fundraising process by providing guidance and making introductions. One highly effective way of accomplishing this is through internships. Working with search funds during the search phase, with search-fund-backed operating companies or with institutional investors are good options to consider.

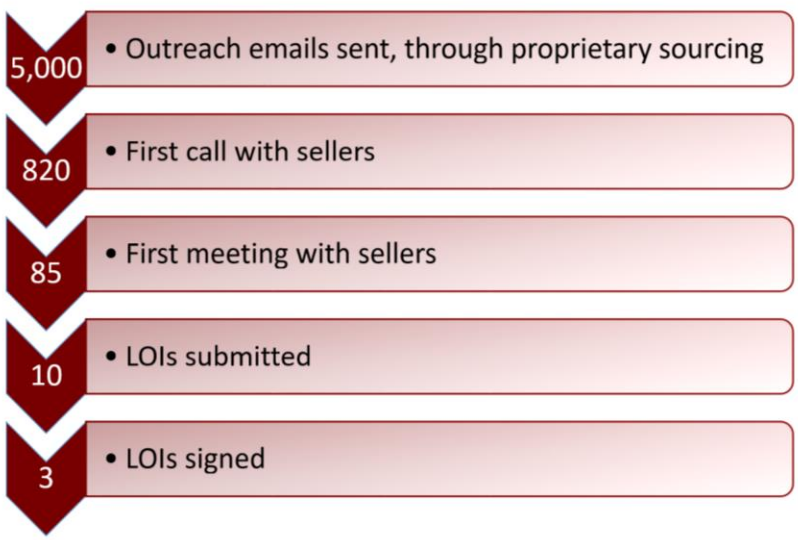
Once the foundation is built and the decision is made, the next step is to write a private placement memorandum ("PPM"). A PPM is a formal document that outlines the searcher's background, rationale for pursuing the search fund path and how the search fund will be structured. The completed PPM is then sent to investors and meetings are set up in order for both parties to evaluate each other, form a relationship and ultimately make a decision regarding whether or not they are a good fit. Fit is based on aligned goals (industry/geographic focus, structure, etc.), complementary experiences, the ability to communicate effectively, as well as a range of other factors.

Structuring a search fund: Searchers traditionally sell "units" of their fund of search capital. There are typically 10–20 units in each fund, each valued anywhere between \$20K–\$40K. In return, investors receive two primary benefits. The first benefit is preferred equity into the ultimate acquisition equal to 1.5x the value of their unit(s). The second is a right of first refusal to invest additional capital into the preferred equity of the ultimate transaction, up to the pro rata portion of the amount invested in the search fund. Once all units are sold and the fund is closed, the searcher enters the next stage.

Stage 2: Sourcing and Evaluating Targets

Sourcing: As soon as the fund is raised, searchers begin sourcing as many targets as possible, primarily through two methods: proprietary and broker deal flow. Nearly all searchers use business brokers and intermediaries in order to receive marketed deal flow. These opportunities tend to be more competitive, and therefore expensive, because of the number of potential buyers that see them. For that reason, most searchers focus on sourcing proprietary deals, which means they look to buy businesses that are not actively being marketed. Proprietary deal flow is the main reason why searching is so difficult. In most cases, searchers reach out to thousands of business owners before finding the target they eventually acquire. The graphic below shows a representative funnel with standard numbers and hit rates from just one quarter of searching. It is this process that makes searching such a grueling process—it requires a huge amount of effort for two years before the goal is finally accomplished, if it is accomplished at all (approximately 25% shut down before an acquisition).

Exhibit B: Illustrative Search Funnel



A common method of finding companies is conducting industry deep dives, during which a searcher identifies an attractive niche and begins contacting business owners within that industry. If they contact every business in the niche without closing a transaction, they switch to a different industry and repeat. Searchers often focus on 3–4 sectors at a time. When a business owner responds with interest and provides additional information, the searcher must decide if (i) the business has the right characteristics, (ii) the owner is truly willing to sell and transition out of daily operations, and (iii) valuation expectations are reasonable. If all of these requirements are met, the searcher will move forward into deeper due diligence and eventually try to convince the owner to sell to him/her.

Exhibit C: Characteristics of Ideal Industries and Targets

Industry	• Highly fragmented • Stable / low cyclicality • Growing at >2x GDP • Low external risk factors (i.e. regulation, technology obsolescence, etc.)
Company	• High percentage of recurring / repeatable revenue • Track record of consistent profitability • Diverse customer base • Strong middle management
Financial	• Revenue between $5 – 50 million • Stable cash flows of at least $1 million • EBITDA margins >10% • Low capex and working capital requirements
Context	• Owner seeking liquidity and wanting to retire / transition out of daily operations • No succession plan in place • Company in need of additional management, capital and board expertise to capture growth opportunities

Communicating with investors: According to most of the searchers we interviewed, investor communication occurred in two ways: formally (which was standard for every investor) and informally (which was highly variable and depended on both the searcher and his/her investor base).

Formal communication tended to occur in the form of monthly or quarterly updates. These documents typically outline the searcher's budget vs. amount spent, the search funnel with commentary around each stage, the status and rationale of deals that progressed to the letter of intent ("LOI") stage and goals for the next month or quarter. Outside of formal updates, communication with some investors rarely occurred until a transaction needed to be funded. On the other hand, there were usually 2–4 investors with whom a searcher would speak multiple times per week. They were viewed as coaches, mentors and sounding boards for deal evaluation, bidding strategy and any issues the searcher may have been struggling with at the time. These investors were considered invaluable to the process.

Stage 3: Funding the Transaction

In most cases, a formal investment memorandum is sent to investors prior to an LOI being signed. Assuming positive feedback, the searcher leads the due diligence process until all information is confirmed and all questions are satisfied, at which point a purchase agreement is negotiated and all that is left is funding the transaction. Investor communication would have been ongoing throughout the due diligence process in order to avoid surprises, but the last step is obtaining final approval and calling capital. As a reminder, investors in the search fund are not obligated to provide capital for any opportunity after the search; they simply have the right of first refusal. It is the searcher's job to keep them informed of diligence findings, strategic planning and capital requirements, so that investors are comfortable with the deal by the closing date. If any investors decline to participate, which is not uncommon, the searcher must obtain additional capital from the existing investor base or find new sources of capital.

In addition to the equity capital, most search fund acquisitions use some amount of debt, seller financing and/or management rollover equity. Exhibit D shows a representative cap table, sources and uses of a search fund acquisition.

Exhibit D: Illustrative Search Fund Acquisition

Illustrative Search Fund Acquisition

Entry Assumptions		
LTM EBITDA at Entry	$2,000,000	
Acquisition Multiple	5.00x	
Acquisition Price	**$10,000,000**	
Cap Table at Transaction		
Preferred Equity		
Search Investment	$350,000	
Step-Up	1.50x	
Total Search Investment	$525,000	9.5%
Total Transaction Equity	$5,000,000	90.5%
Total Preferred Equity	**$5,525,000**	**100.0%**
Common Equity at Close	**$0**	**0.0%**
Total Equity	**$5,525,000**	**100.0%**

Transaction Sources		
Senior Term Loan	$4,350,000	40.7%
Seller Financing	$1,000,000	9.3%
Total Debt	**$5,350,000**	**50.0%**
Search Capital	$350,000	3.3%
Investor Equity Commitment	$4,500,000	42.1%
Management Rollover	$500,000	4.7%
Total Equity	**$5,350,000**	**50.0%**
Total Sources	**$10,700,000**	**100.0%**

Transaction Uses	
Purchase Price	$10,000,000
Searching Costs	$350,000
Closing Costs	$350,000
Total Uses	**$10,700,000**

Stage 4: Operating and Exiting

The search is over. The transaction is funded. Now what? Many searchers get so engrossed in searching that they can lose sight of the fact that acquiring a business is only the first step. Transitioning into the CEO role is a separate task that requires an entirely different skillset. Oftentimes, the seller agrees to temporarily stay with the business to help the searcher-turned-CEO learn the business and develop customer/supplier/employee relationships. However, it is usually best for the founder to exit the business entirely after 6–12 months in order to avoid confusion amongst employees and to allow the new CEO to take charge. A Stanford study found that 36% of acquired companies that produced negative returns had major issues caused by the former owner not transitioning out of the business.

Stepping into the CEO position can be intimidating for young entrepreneurs. The following best practices were mentioned the most frequently by experienced people in the industry:

1. *Employees are just as nervous as the new CEO.* Most are primarily concerned with keeping their jobs and secondarily concerned about how it will affect the culture and overall health of the company. It is important for new CEOs to remember that change is scary for everyone involved, so they should do their best to make existing employees feel comfortable and secure.
2. *It is tempting for new CEOs to begin making changes immediately.* There is an element of searchers wanting to prove their worth (to investors, employees and themselves), as well as assuming they know more than they actually do. However, they should not make any significant changes for the first 12–18 months. This eases the anxiety of employees, customers, etc. and also provides sufficient time for the CEO to gain a nuanced understanding of the business.
3. *New CEOs should be coachable and should not be afraid to ask questions.* Asking employees about how and why things are done gives the CEO insight into the business while also making employees feel valued. Open communication with the Board and a willingness to listen to their guidance builds an early foundation of trust that will pay dividends throughout the holding period.

Exiting the transaction: The average holding period of a search-fund-acquired company is seven years, which is longer than typical private equity holding periods and reflects investors' willingness to hold strong assets for the long term. However, the timing of exit varies widely and is ultimately up to the Board of Directors and the new CEO. The most influential factors of this decision include market conditions and the profile of the investor base. Search funds heavy on institutional investors usually have some type of liquidity event within 5–7 years since they must return capital to limited partners within a certain timeframe; those with more flexible capital can be held indefinitely. Some of the highest performing search-fund-backed companies have been held well over 10 years.

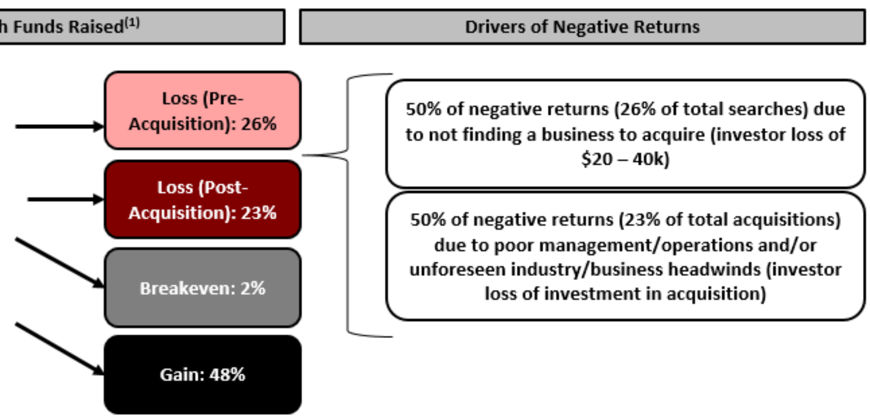
Historical Success Rates and Returns

Since inception, the traditional search fund model has generated a cumulative IRR of 34.9% and ROI of 10.0x (this data is from search funds raised between 1983–2013, according to Stanford GSB). These data account for 177 total search funds raised, of which 32 were still searching at the time and 11 had other/unknown outcomes. Of the remaining 134 search funds, 99 (74%) had successfully acquired an operating company. The distribution of returns can be found in Exhibit E below.

Exhibit E: Distribution of Returns and Outcomes of Traditional Search Funds

Historical Returns of Search Funds Raised(1)

ROI	% Total
Failed to Acquire a Business	
< 1.0x	26%
Acquire a Business	
< 1.0x	23%
Exactly 1.0x	2%
1.0 - 1.5x	15%
1.5 - 2.0x	3%
2.0 - 5.0x	17%
5.0 - 10.0x	8%
> 10.0x	5%
Aggregate Blended ROI	**10.0x**



(1) Search Funds – 2013: Selected Observations, Stanford Graduate School of Business, 2013.

It is important to note that, while not finding a company represents a loss to investors, it is considerably less costly than acquiring the wrong company. The former leads to investors losing $25,000 for a search unit while the latter leads to a loss of $500,000 per investment unit, plus the opportunity cost of 5–7 years by the search fund entrepreneur running an ailing company.

"*The risk to the entrepreneur is quite different,*" noted Prof. David Dodson of Stanford GSB. "*If they look for 2 years and don't find a company, nearly 75% of them find jobs as CEOs or COOs within a year. Not a bad outcome. But if they take $5M and lose it, over a five-year (miserable) period, that's quite different.*"

Alternative Forms of ETA

Historically, the traditional search fund model has been by far the most popular choice for people pursuing ETA. However, that has begun to shift in recent years and searchers now have several alternative options from which to choose to fund both the search phase and the acquisition of a target. The most common alternative models are: sponsored search, incubated search, self-funded search and crowdfunded search. Each ETA model has a unique set of advantages and disadvantages, and every searcher will value them differently. A subjective view on the major ETA models can be found in Exhibit F below.

Exhibit F: Side-by-Side Comparison of ETA Models

	Flexibility / Control	Infrastructure	Investor Base	Mentorship	Potential Equity for Searcher (Solo)
Traditional Search Fund	• Low: monthly reporting to disparate investor base; no committed capital; terms pre-negotiated	• Low: searcher must setup infrastructure individually; limited admin support, if any	• 10-20 investors, each with their own right of first refusal to fund transaction	• Medium: depends on availability of investors; frequency of interaction usually up to the searcher	• 25%
Sponsored Search	• Medium: monthly reporting to in-house investor base; committed capital	• High: office space, IT, admin support, HR and broker/lender relationships in place	• One committed fund; decisions made by investment committee	• Medium-to-high: daily interaction with investor base; incentives aligned; depends on sponsor	• 20 – 30%
Incubated Search	• Medium: monthly reporting to in-house investor base; committed capital	• High: office space, IT, admin support, HR and broker/lender relationships in place	• One committed fund; decisions made by investment committee	• High: daily interaction with investor base with relevant experience; designed to mentor searchers	• 25%
Self-Funded Search	• High: no outside time limits, reporting requirements, or investment mandates	• Low: searcher must setup infrastructure individually; limited admin support, if any	• No pre-determined agreement; terms dependent upon attractiveness and demand	• Low-to-Medium: depends on personal network of searcher; no search capital as incentive to investors	• 30 – 100%
Crowdfunded Search	• Low-to-Medium: reporting depends on investors; disparate investor base; no committed capital	• Low: searcher must setup infrastructure individually; limited admin support, if any	• Varies widely; too early for standard to be developed	• Low-to-Medium: depends on personal network of searcher	• 30 – 100%

1. Sponsored Search

A sponsored search involves a searcher partnering with an investment firm (private equity, family office, etc.). Instead of raising capital from 10–15 different investors, the investment firm provides all of the search and acquisition capital and is thus the controlling shareholder. The sponsor also usually allows the searcher to use their office space and infrastructure to conduct the search. Usually, the searcher has a prior working relationship with the sponsoring firm; for example, they worked as a private equity associate at the sponsor, left for business school, then returned post-graduation to conduct a search.

Infrastructure: The searcher will have office space, administrative support and other infrastructure already in place as soon as they begin the search. Traditional searchers spend a considerable amount of time setting all of this up and it can be a distraction from their true objective—finding a company to acquire. Additionally, more resources will be available from a larger firm than a traditional searcher can afford on their own, such as expensive software, research tools, service providers during due diligence, and established broker and lender networks.

Daily Interaction with Shareholders: Being on site everyday allows the searcher to get constant feedback and advice from his/her shareholders, as opposed to weekly or monthly communication with many shareholders that are spread across the country. While traditional investors are known to be available for mentoring and coaching, it still requires phone calls and coordination, and is not as effective as daily face-to-face interactions.

Committed Capital: Having a committed fund of capital gives a searcher more credibility as a legitimate buyer to business owners, intermediaries and lenders than does a disparate group of investors that have not technically committed capital to fund a transaction. Presumably, the searcher must still gain approval of any transaction by the firm's investment committee, but there is more security in that process than convincing 10–15 unaffiliated individuals, each with their own approval process.

Single Source of Capital: The downside of having one fund of committed capital is that the sponsor will own most of the equity and control the Board of Directors; therefore, they can make strategic decisions and changes to the senior management team, which includes firing the searcher as the CEO. Traditional searchers usually have no majority shareholders, with their Board made up of 3–5 different investors. While a Board of any company has the power to make the changes mentioned above, Board members from different firms may have a more diverse set of perspectives than those from the same organization.

2. Incubated Search

The concept of incubating entrepreneurs through the search phase is fairly new, with the first formal accelerator opening in 2015. The idea is similar to sponsored searches in that there is a committed fund of capital for both the search and the acquisition, strong infrastructure is in place and daily interaction between the investors and searchers. The primary difference is that search fund incubators focus solely on search funds, as opposed to a private equity firms that firms work with older executives with experience in an industry and generally looking at acquiring bigger companies. Typically, between 3–5 entrepreneurs search from an incubator at the same time.

Infrastructure: The infrastructure in place is similar to that of a sponsored search—office space, administrative support, etc. are already in place and available to the searcher from the start. The only difference is that these resources are all completely geared toward optimizing the search process. Intermediary relationships are handled at the fund level so that searchers have exposure to brokered deals but do not have to spend their time developing and maintaining those relationships. Interns are another important resource for searchers, and all recruiting, hiring and onboarding are handled by the incubator, removing another burden from the searcher. The goal is for the searcher to worry about nothing except sourcing proprietary deal flow and ultimately closing a transaction.

Another important piece of infrastructure in incubators is the CRM that is built up over time. Every industry and deal that searchers come across are recorded into the system, which grows. This may not have a significant impact on today's searchers, since the incubator model is so new, but the information will be extremely valuable to future searchers.

Daily Coaching and Guidance: Most managers of incubators have successfully pursued some form of ETA in the past. Their experience of sourcing opportunities, executing a transaction and operating a business is valuable for first-time searchers. The constant interaction and guidance around navigating the process can shorten the learning curve that all searchers must climb.

Collaboration vs. Competition: Having 3–5 searchers operating out of the same fund has several effects that can be viewed as positive or negative, depending on the preferences and perspective of the searcher. From a positive perspective, searchers can collaborate on methodologies and processes, share resources and provide support and coaching to each other. It also alleviates the loneliness that many solo searchers feel throughout the search phase. From a negative perspective, many argue that searchers will inevitably compete with each other over deals and eventually cross paths in the same sale process. While there is some merit to this argument, the other side of it is that searchers rarely cross paths in general because (i) most deals are sourced proprietarily, so the chances of contacting the same owner at the same time are small, and (ii) there are over 200K businesses of the right size in the U.S., so there is no reason why two searchers from the same incubator would need to target the same industries at the same time. However, this is the tradeoff entrepreneurs must consider before choosing the search incubator route.

Single Source of Committed Capital: The incubators/accelerators that exist at the time this research was conducted act as committed funds that provide the full amount of capital required for the search and acquisition. In this sense, they have the same advantages and disadvantages as the sponsored searches discussed earlier in this paper.

3. Self-Funded Search

Some searchers choose not to raise capital for the search phase and instead cover expenses with their personal savings. There are pros and cons to this method and the choice is dependent upon the searcher's personal finances, risk tolerance and network.

Better Economics: Typically, any search capital raised converts into the preferred equity of the ultimate transaction at a 1.5x step-up (i.e. $500K steps-up to $750K of preferred equity). In most cases, the preferred equity earns an annual PIK of 8%, making it expensive capital. Further, most of the terms of the eventual transaction are set prior to the search phase, so there is little room for negotiation once the deal is found. By self-funding the search, the entrepreneur can avoid the additional preferred equity and can find capital from a wide range of options, including other investors, an SBA loan, crowdfunding, and others. This flexibility allows the searcher to receive more favorable terms and own a higher percentage of the business (often over 50% of the equity).

Higher Personal Risk: In the traditional search fund model, the entrepreneur does not have to risk any of his/her own personal finances, as the entire search phase is funded by outside investors. This is obviously not the case in a self-funded search—if they fail to find a company to buy, any resources they used during that process are lost.

More Flexibility: A self-funded searcher has no reporting requirements, investment mandates or timing limitations, none of which are true in the traditional model. This flexibility relieves pressure and allows the entrepreneur to truly run their search however they prefer. That means they can work full-time or part-time, search in their spare time, look at industries that most search fund investors would not recommend, and so on. Of course, it takes a great deal of self-discipline to work diligently without the pressure and requirements an investor base provides.

Lack of Investor Base: A group of experienced investors can add tremendous value during the search phase. Most have invested in many other searchers, so they can provide advice and best practices to help an entrepreneur climb the learning curve quickly. They can also make introductions to people in their network that have industry experience relevant to the businesses the searcher may be considering. Finally, searching is a grueling process with many highs and lows, and investors can act as a sounding board and support system.

4. Crowdfunded Search

A brand new way of fundraising emerged in 2016: crowdfunding. At least one online platform now exists that connects searchers seeking capital (both for the search phase and acquisition) to accredited investors looking for exposure to the asset class. A crowdfunded search most closely resembles a self-funded search in that terms change on a deal-by-deal basis and the searcher may take on more risk. Search capital can be structured as preferred equity (just like the traditional model) and/or convertible debt (in the form of standard convertible notes or SAFE notes). Acquisition capital can be offered as common, preferred, or a combination of the two with different liquidation preferences, PIK rates, etc. Of all the recent change in ETA, this might be the most dramatic.

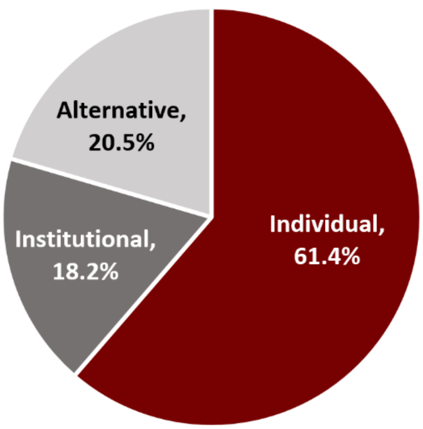
III. Conversations with Investors

Overview of Investors Interviewed for This Study

The purpose of this study is to explore the evolution of Entrepreneurship Through Acquisition. We set out to do this through a series of interviews with some of the most prominent and influential investors that represent a broad range of investor types and span the history of the asset class. These investors gave us a candid look at their investment theses, the challenges they face as the community evolves, and the prospects they see as the search fund asset class continues to prosper.

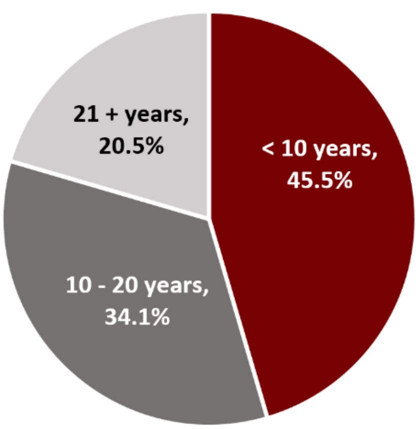
We interviewed 44 investors ranging from Irv Grousbeck, the founder of search funds and a traditional investor who invested in the very first search fund in 1983, to Tim Bovard, an alternative investor who founded the first search fund incubator in 2014 and is changing the traditional model.

Exhibit G: Distribution of Investors by Type



Our investor population is comprised of individual investors accounting for 61.4% of our sample, institutional investors representing 18.2% and a group we define as "alternative investors" (in which we include incubators, equity pools, family offices and international search fund investors) rounding out the remaining 20.5%. Exhibit G to the left displays the distribution of investors.

Exhibit H: Distribution of Investors by Years of Experience



The mean years of experience investing in search funds from our sample is 11.9, with 20.5% having 21 or more years of experience, 34.1% with 10–20 years and the remaining 45.5% having less than 10 years of experience. Exhibit H to the left shows the distribution of investors by years of experience.

Throughout this section, we will include relevant quotes to bring the data to life. Not all the quotes are attributed to named individuals because they either came from investors who chose to remain anonymous or because the nature of the quote is too sensitive for attribution.

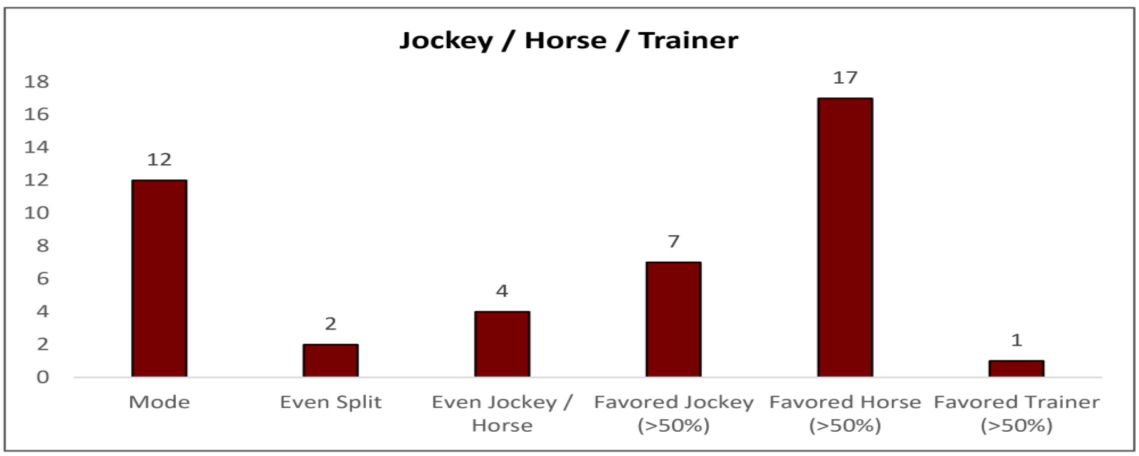
The Three Pillars and Their Relative Impact on ETA

The search fund model is predicated on the collaboration between talented entrepreneurs and experienced investors to manage solid businesses in growing industries. In order to understand the importance investors place on each of these, in terms of the contribution each made on the investment, we asked them to assign weight using the jockey/horse/trainer metaphor. Note that the jockey represents the entrepreneur, the horse represents the company (including the industry), and the trainer represents the investor.

Attractive companies remain at the heart of the model*: Individual investors overwhelmingly favored the company, with 73.1% of them giving the company a weight of 50% or greater and 11.5% giving the company 80% of the weight.*

The mode for all investor types was 30% jockey, 50% horse and 20% trainer. The mode for institutional investors was 40% jockey, 40% horse and 20% trainer. For individual investors, the mode was 30% jockey, 50% horse and 10% investor. Exhibit I below shows the breakdown of the weights assigned to each pillar by investors.

Exhibit I: Distribution of Weight Assigned to Each of the Three Pillars



Explaining why they chose the horse as the most important component, 22.7% of all investors either cited the Warren Buffet quote by name or described it in their own words. As a reminder to readers, the quote goes as follows: "*When a management team with a reputation for brilliance tackles a business with a reputation for bad economics, it is the reputation of the business that remains intact*," Warren Buffett. For example, Jeff Stevens points out that "*the best jockey in the world can't create a good outcome with an average company*." Jamie Turner states "*the quality of the business is paramount*" to drive this point home.

In addition to the importance of a strong company, 77.4% of investors expressed the importance of investors in this asset class. As Bill Egan explains, "*The uniqueness of the search fund model is that you have smart, hard-working searchers, but most importantly [is the role of] experienced investors to take the investment to the next level. It takes talent to find the right business, but the experience that investors bring is invaluable*." Rob Johnson adds that "*investors play a bigger role than people realize*." Finally, Tim Ludwig noted, "*investors prevent big mistakes*."

Despite the importance of the company and investor, as cited above, we cannot fail to give credit to the searcher. After all, they are at the center of the search process and key to the success of any acquisition. "*You're investing in people; if you don't have faith in the searcher's ability, you run into problems*" emphasized Sandro Mina.

Size and Dynamics of the Market Will Support ETA

Investors are optimistic about ETA for many reasons. Chief among them is the pool of available small businesses and the aging American demographic, which combine to create an extremely attractive opportunity for entrepreneurship through acquisition. There are over 220K businesses with between \$5–\$50 million in revenue in the U.S., where 51% of business owners over the age of 55. That means that approximately 100K businesses, representing over \$1 trillion of value (assuming an average total enterprise value of \$10 million), will need some form of management transition and/or liquidity event in the next 10–20 years.

The traditional search fund and other ETA models offer business owners both a way to achieve liquidity and to solve succession planning issues. Since most private equity funds require management teams to stay on after an acquisition, ETA is a unique alternative for business owners to consider. Further, as awareness of the model continues to grow, we believe more owners will be open to the concept and perhaps even seek it out.

Exhibit J: Total Addressable Market and Current ETA Resources

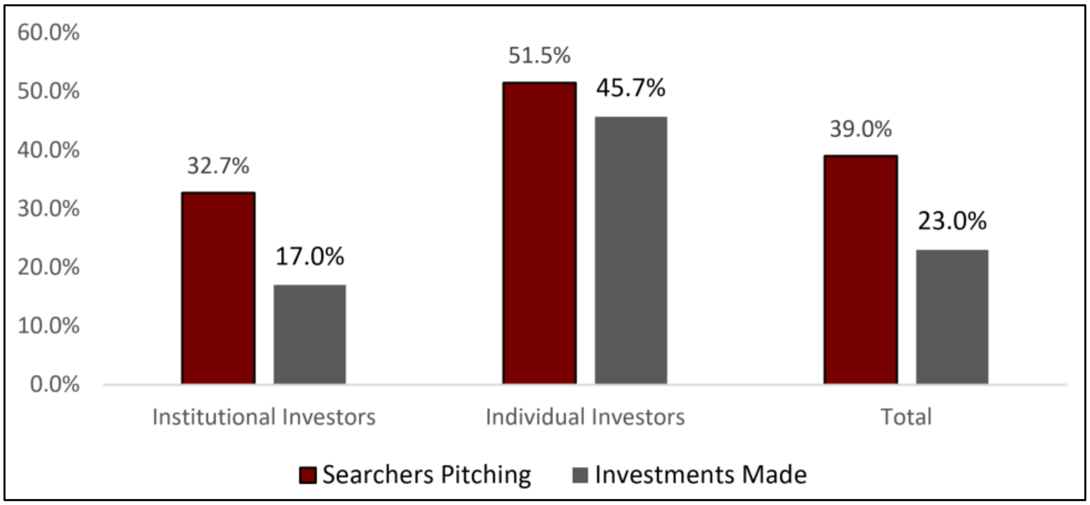
The entire ETA community is miniscule compared to the \$1 trillion in potential transaction value. Our best estimates are that approximately \$500 million is being actively invested in the space and that less than 100 total searches are currently being conducted. Therefore, there is plenty of runway left before the market becomes overcrowded and saturated by searchers. The most intense competition will come from lower middle market private equity funds as they continue to move down market.

Growth in Search Funds as the Potential Driver of Emerging ETA Models

The ETA community has experienced a significant increase in the amount of new aspiring CEOs entering the space, along with the amount of capital that investors are deploying. In order to get a sense of the magnitude of this increase, we asked investors to share the number of searchers that approached them in the past 2 years (2014 and 2015) and the amount of new investments they made during that period. This not only confirmed our suspicions that the asset class is gaining momentum, providing data to indicate the magnitude of this increase, but indicated that traditional investors are not the only source of capital anymore.

The investors we interviewed experienced a 39% increase in searchers pitching them for search fund capital, and only increased the number of investments by 23%. Institutional investors reported experiencing a 32.7% increase of new searchers pitching them and only increased their participation during that period by 17.0%. This is in stark contrast to the individual investors in our sample. This group indicated an increase of 51.5% in searchers pitching them for the search phase. Individual investors nearly kept pace with the volume of searchers entering the space by increasing their funding during this same period by 45.7%. However, individual investors still did not make up the difference. Exhibit J below shows the percentage increase in searchers pitching investors, as well as the percentage of those in which investors participated.

Exhibit J: Percentage Increase in Searchers Pitching vs. Investments Made



In conversations with investors, they believe the difference either led to those searchers seeking outside capital, acquiring smaller companies or turning to alternative types if investors entering the ETA space. When we asked investors if they are seeing new investors in their deals, Jeff Stevens told us "*Yes—the dominant portion is still search fund investors, but entrance of new types of investors has gone up, but not commensurate to the growth of the community at large*." Matt Estep agreed, "*Yes, but the number of new investors has not kept up with the number of new searchers*."

When we asked Tom Malloy if he was seeing new investors, he replied "*Yes, we are the new investors*", referring to his new firm, E-quire. Malloy launched E-quire in the summer of 2016 as an alternative funding channel for searchers who are looking to maintain a bigger ownership stake in search fund operating companies. E-quire gives the entrepreneur 50%–70% ownership, with an investor pool owning 20%–30%, and he helps searchers process SBA loans to complete the capital raise. "*The biggest difference is that we are providing fair capital for entrepreneurs while maintaining strong returns of >20% IRR for investors, all of which are accredited and experienced investors,"* noted Malloy.

Search Fund Accelerator (SFA) is another alternative fund. SFA is a sponsored fund model with access to entrepreneurs in residence, office space and committed capital. Tim Bovard explained that his investment objectives are to "*help [searchers] be successful by helping them buy better companies, that are a better fit for each searcher, with support and expertise from experienced investors and mentors*." He also wants to make money for his investors.

These alternative investors have clear points of differentiation relative to the traditional investors. What is not yet clear is whether searchers that seek out these alternative investors are different than searchers that seek traditional investors, and whether these profile differences could lead to differences in returns.

Investors are Busier Than Ever Before

Our investor sample has an average of 21 active searchers, 18 operating companies in their portfolio, and sit on an average of 4 boards. Institutional investors have an average of 49 active searchers, 35 portfolio companies, and sit on an average of 5 boards. Individual investors have an average of 18 active searchers and 19 portfolio companies, and sit on 3 boards on average.

If we recall from the jockey/horse/trainer portion, investors state that they play a crucial role in the success of the model. However, with the demands on their time, the growing complexity of the companies and the changing profile of the typical searcher (as we will cover in the next section) does this open the door for alternative models to flourish?

The Profile of the Typical Searcher is Changing

We wanted to get a sense if the profile of aspiring search fund entrepreneurs has changed over time. Half of our institutional investors, and a third of individual investors, believe that it has changed.

The talent profile is different across the board. While investors are seeing more searchers from non-traditional business schools or later in their careers entering search funds, they are also seeing elite searchers with extraordinary talent, plenty of career options and deeper knowledge of the search fund model entering the sector.

We define "typical searcher" as having:

1. Solid understanding of core criteria
2. Exposure to search funds
3. Relevant work experience
4. Graduate from top-ranked MBA

For those searchers that were on the higher end of the spectrum, most investors cited better preparation by aspiring search fund entrepreneurs as a key difference. These searchers are taking courses to learn the ETA model; they're doing internships (1) with institutional funds, (2) at operating companies and (3) with searchers who are actively looking for a company to acquire. Some aspiring searchers are even serving as TAs for search fund courses at top business schools or conducting research or writing cases with faculty. Some ambitious searchers are involved in more than one of these prior to launching their search, and that's what sets top searchers apart from the rest, according to investors.

Sandro Mina said he has witnessed an increase in "*quality, not in their background but in their experience*." He added that the quality he has seen has come from searchers who have "*interned at a search or operating company, have spoken to more searchers and investors and know what they're getting into*."

Bob Oster also believes the quality has increased. In addition to being better versed in the search fund model, Oster believes that the talent pool is better. "*There are more promising young executives going into business school*," he said, "*and these talented young people are doing their homework before they commit to a career in search funds*." In terms of the backgrounds of current searchers, he pointed out that "*Irv used to send me his case writers*", implying that the community had a narrower pool of talent in the beginning. He added that, not only are searchers coming from schools other than Stanford, but now more searchers are 3–5 years out of business school as often as newly-minted MBAs, and "*that's a good thing*."

The Industries and Characteristics of Target Companies Are Changing

Given that investors rated the company (and by default the industry) as the most important component of the jockey/horse/trainer metaphor, we asked whether the typical company proposed by searchers has changed. We learned that it has, so we probed further to find the reasons behind that change.

The biggest change investors shared with us was seeing more companies from industries outside of business services. The industries listed were technology, manufacturing and healthcare, with tech representing more companies pitched than the other manufacturing and healthcare combined. This should come as no surprise given the prevalence of tech firms across the entire US economy, but it is a fundamental shift from the traditional model. While some investors stated they will still not invest in technology companies, more investors said that they make these decisions on a case-by-case basis. It's important to note that the technology companies that investors are seeing are more tech-enabled than pure tech, meaning that these firms rely on technology to deliver their product as opposed to being a pure technology end-product.

Manufacturing is also a fundamental shift from the traditional model, particularly because higher capital expenditures in this industry leave less room for error. Another issue that investors mentioned regarding was the complexity of most manufacturing companies. Both factors combined don't eliminate manufacturing as a source for search fund-backed companies, but they do limit the options.

Regarding healthcare, investors were most concerned with the heavy regulation in this industry. This factor alone makes healthcare unattractive for most investors, with the exception of a few investors we interviewed, that favor this space because of other key benefits like recurring revenue and predictable cash flows.

Whether technology, manufacturing and healthcare companies become the new normal within the sector remains to be seen. What became clear from our research is that business services cannot continue to be the only source of companies in search funds. The sector is quickly being depleted by the search fund community and investors are asking searchers to get creative and find new sources. Searches have listened by getting into the three industries we mentioned above, along with many more that are just beginning to gain popularity. The takeaway for both investors and searcher is to not lose sight of what made the traditional model a success. The need to find new markets should not supersede the core criteria that has made the model such an attractive asset class for over 30 years.

"The need to find new markets should not supersede the core criteria that has made the model such an attractive asset class for over 30 years."

Investors are Optimistic About the Future of ETA

In this section, we wrap our analysis on trends through a creative way to assess investors' overall perception of the search fund asset class. We wanted to figure out if they were optimistic or pessimistic about the future. Knowing that asking this in a straight-forward way would have skewed the answers, we took a unique approach.

In order to uncover investors' outlook on the future of search funds, we asked them the following question: *What book title or newspaper headline would you give to these periods in search funds: 1983–1999 / 2000–2012 / 2013–today / today–2020?*

We analyzed the tone and trajectory of their answers, and found interesting insights that uncovers investor outlook of search funds. A full 75% of institutional investors are optimistic about the future. In contrast, only 40.8% of individual investors feel optimistic. A majority (59.3%) of individual investors feel that there will be a change to the underlying economics in the asset class, leading to lower IRR, higher purchase multiples or some other material change from the common metrics of the traditional model. Only 25% of institutional investors agree that there will be some fundamental shift that will lead to these types of changes.

It is noteworthy to point out that not a single investor was rated as being pessimistic about the asset class. While some individual investors feel there may be a change to the underlying economics (specifically IRR and purchase multiples) 100% of the current investors interviewed said they will remain investing in search funds for the foreseeable future. They either believe that search funds provide a more attractive risk-adjusted return than other asset class (despite any changes to the model), enjoy mentoring younger versions of themselves or relish the opportunity to grow small businesses with young talent, in both of which they see high potential.

Book titles or newspaper headlines describing Present Day (2016) in search funds:

- Irv Grousbeck: "*Influx of New Capital*"
- Jeff Stevens & Jamie Turner: "*Explosion*"
- Coley Andrews: "*Take-off*"
- Tim Bovard: "*Period of Proliferation*"
- Bill Egan: "*Explosive Growth in Searchers and Investors*…"
- Sandro Mina: "*Huge Growth Worldwide*"
- Matt Estep: "*Proliferation of the Search Fund Model*"
- M-K O'Connell: "*A Great Alternative Path to Get Rich*"
- Aaron Gabbart: "*Exponential Growth Phase*"
- Mike Smerklo: "*Critical Mass in Asset Class*"
- Paul Furlow & Aaron Mobarak: "*Search Funds as Career Option*"
- Andrew Saltoun: *"Mass Market"*
- Michael Miles: *"Emerging"*
- Doug Tudor: *"Model Begins Changing"*

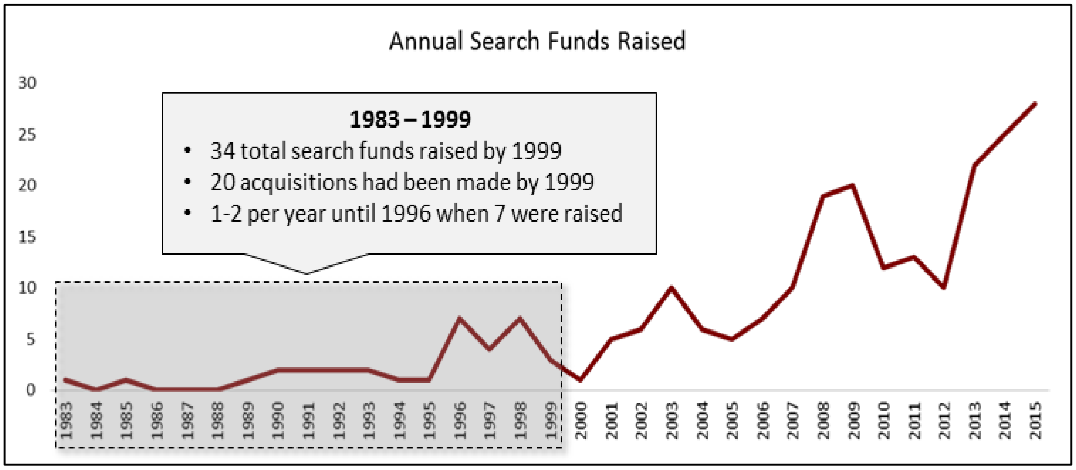
IV. The Evolution and Growth of ETA

1983–1999: Proof of Concept

This search fund model concept was first put to test in 1983, when Jim Southern formed the first search fund, Nova Capital, by securing investments from former business associates and professors. Despite his young age, Southern was able to acquire Uniform Printing within a year. Two years later, in 1985, Jamie

Turner and Kirk Riedinger formed a search fund that would later acquire Alta Colleges in 1987. After writing a case study on Turner and Riedinger, David Dodson raised the third search fund in 1989, which he used to acquire Smith Alarm Systems.

All three search funds ended up being extremely successful. Southern operated Uniform Printing for 10 years, returning investors approximately 24x their original investment. Turner and Riedinger grew Alta Colleges from $4 million to over $400 million in revenue over a span of 20 years. Dodson successfully exited Smith Alarm Systems and subsequently raised two more search funds, acquiring Auto Palace and Wind River Environmental in 1995 and 1999, respectively. Early success proved the viability of the model. Roughly two search funds were raised per year until 1996, when the first spike occurred.

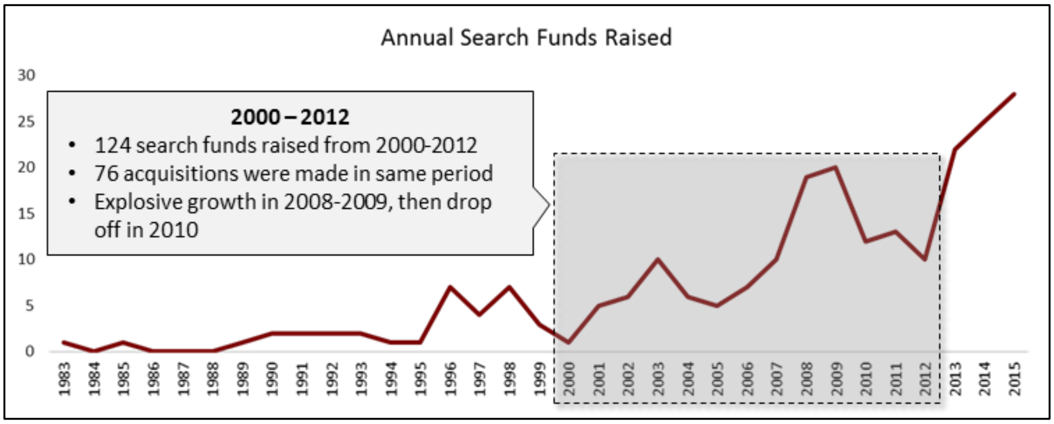


A slew of successful exits in the mid-1990's created publicity and excitement around the search fund model and was the primary reason for seven search funds being raised in 1996. Southern exited Uniform Printing in 1994; Dodson had exited Smith Alarm Systems and already acquired Auto Palace by 1995; Turner and Riedinger were still growing Alta Colleges rapidly. Further, searchers from the early 90's were showing success: Jeff Stevens had acquired Balkin Cable Holdings in 1991 and would eventually acquire his second business, Ancora Capital and Management Group, in 1997; Kevin Taweel and Jim Ellis acquired Asurion in 1995, which turned out to be the most successful search fund to date. There were also several others.

From 1995–1999, an average of five search funds was raised per year and a community was beginning to form. Former searchers were raising their second and third search funds, as well as investing in the search funds of others, and other investors became willing to put capital into more searches and their subsequent acquisitions. Stanford GSB began tracking search fund data, such as the number of search funds raised and aggregate returns to investors. The GSB's Entrepreneur Club started hosting search fund panels to spread awareness of the model and answer questions from interested students. These initiatives laid a foundation for the model to grow.

2000–2012: Growth and Maturation

With the foundation built and an active community in place, popularity grew. The number of annual search funds increased steadily from 2000–2012, with the exceptions during the Dot-Com Collapse and the Great Recession. During this time period, 124 search funds were raised and 76 acquisitions were made, nearly quadrupling the totals between 1983–2000. The dramatic growth had two primary drivers: (i) more people were simply aware that the model existed, and (ii) there was more excitement because highly successful outcomes continued to occur. The most significant event happened in 2007, when Asurion was acquired by three major private equity funds for $4.1 billion. Returns to investors exceeded 100x.



As the industry grew, it began a maturation process that is still ongoing today. It evolved in three primary ways: data was tracked, analyzed and made available to the public; investors formed institutional funds and terms were standardized; and awareness spread beyond Stanford and Harvard circles.

Due in part to Mr. Grousbeck, most search funds came out of Stanford GSB. The staff at Stanford requested and tracked information from those search funds, which they analyzed and summarized in their Search Fund Selected Observations, the first of which was released in 2001. The report included investment returns, industry trends and insights into search fund performance; the impact on the market was substantial. First, the study educated the public on how the model works—it was free to download for anyone interested. Second, it told a compelling story of generating attractive returns for investors and a path for young MBAs to become CEOs. Third, and importantly, it gave credibility to a concept that had previously been spread via anecdotes and hearsay. With the 2001 study (and subsequent editions), investors and entrepreneurs alike could point to evidence that search funds could work. To this day, the Stanford Search Fund Selected Observations are the standard (and only) source for market information.

Credibility drove demand, in the forms of financial capital and entrepreneurial risk. The increased investor appetite manifested itself in several forms, one of which was the formation of institutional search fund investors. Alongside individual investors that had been investing in search funds from the beginning, these new institutional funds quickly accounted for the majority of capital in the market.

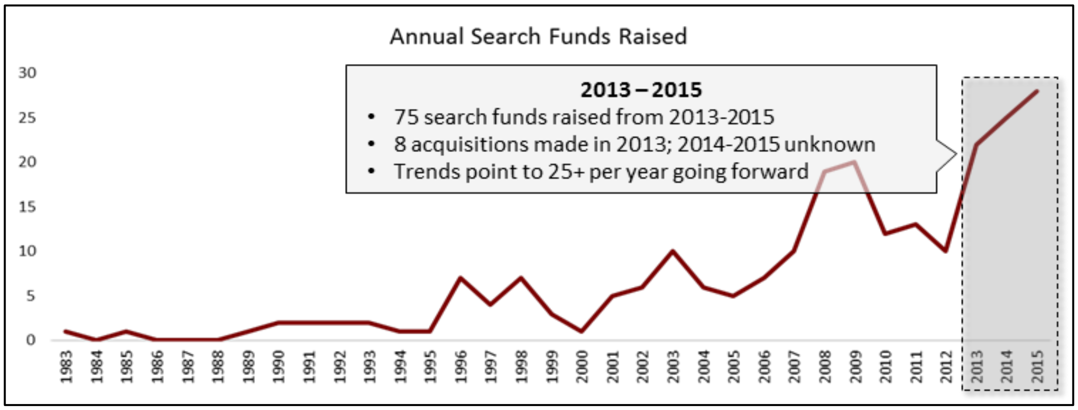
As the number of interested searchers grew, the process became more standardized. Only a handful of investors (i) knew the model existed, (ii) had a nuanced understanding of how the model worked, and (iii) could add value throughout the search and operating phases over the life of the deal. These factors tilted power further into the veterans' hands (and rightly so). Their negotiating power allowed them to implement a set of standard terms between searchers and investors. Agreements were no longer negotiated on a searcher-by-searcher or deal-by-deal basis; key terms were set prior to the search phase, based on a template that was identical for every searcher. The traditional search fund community remains like this today.

Another effect was that awareness spread beyond Stanford and Harvard. For the first 20–25 years, the search fund model had been available nearly exclusively to MBAs from these schools. As the model garnered publicity, MBA students at other highly regarded institutions took notice. One early example is Headland Partners, a search fund formed in 2003 by Dustin Sellers (Kellogg) and Ben Godsey (Booth).

In 2005, the two acquired ProService, Hawaii's largest HRO, which they ran through 2013 and generated investors a return of 11x. Similar to Stanford and HBS, success stories like this spread quickly and sparked interest at schools across the U.S.

2013–Present: Institutionalization and Differentiation

Roughly one-third of all known traditional search funds were raised in the past three years. In addition to the dramatic growth, new developments have taken place since 2013 that are transitioning ETA from the tightknit, cottage industry that it once was into a recognized alternative asset class. Investors' portfolios are bigger than ever before. Business schools are incorporating ETA into curriculums, ETA organizations are hosting conferences and events to connect searchers with investors, and variations of the traditional model are being created. In many ways, the stage that ETA is currently in is reminiscent of private equity and venture capital in the 1990's.



The first institutional funds were formed in the mid-2000's and, as previously mentioned, accounted for a large portion of all investments made in the search fund space. From 2013–2015, they significantly increased the size of their funds and, consequently, the number of search funds and operating companies in their portfolios. Also, with more capital to put to work, they became reliant upon continued growth in the space and a new pipeline of searchers each year. Several now actively marketing their firms and the search fund model at top business schools. They give presentations and host Q&A sessions on campuses across the country, beginning the recruiting process of new MBA students as early as fall of their first year. They also offer Internships with portfolio companies to give interested students perspective into the daily activities of search fund CEOs.

These efforts have had a major impact on awareness and excitement for search funds within schools like Booth, Kellogg, Wharton, and others ranked in the top 10. Students at each school have created search fund student organizations, hosted search fund events in which aspiring searchers offer programming for their members and interested students. The schools' administration has responded to the high interest level by introducing classes that teach the search fund model (and other forms of ETA). Some schools have even brought in Entrepreneurs-in-Residence (EIR) to lead the development of ETA programming. For example, Alex Hodgkin has developed an ETA ecosystem at Booth, with the support of the Polsky Center and Dr. Steve Kaplan. As Booth's ETA EIR, he established the first of its kind investor summit, he created the annual ETA conference in conjunction with Kellogg (which is currently the biggest of its kind), he hosts monthly gatherings with current searchers where they meet and exchange ideas and support each other, he helped develop the ETA curriculum taught by two distinguished alums, and works closely with student-led search fund clubs on programming throughout the year.

These initiatives have had several consequences. One is that most students at these MBA programs know the basic concept of a search fund / ETA—this was not the case just a few years ago. The second, and more impactful, is that many students now see ETA as a viable career path to consider. There are parallels to the rise in popularity of traditional entrepreneurship amongst MBA students when schools introduced more programming and support around the start-up community.

Several different ways to go about pursuing ETA were developed during this time (as discussed in Section I). While the traditional search fund model has become standardized to the point that every searcher receives nearly identical terms, new variations of ETA offer searchers different tradeoffs. One interesting observation is that searchers appear to be heavily influenced toward certain models based on which school they attend. For example, Stanford students tend to choose the traditional search fund route, likely because so many of the faculty and alumni are still actively involved in that community. HBS searchers tend to self-fund; more alumni have chosen that route and prominent faculty encourage it. We expect both these trends to have major impacts going forward.

V. Parting Thoughts

ETA has grown from a cottage industry in 1983 into a proliferation of new models in a span of 34 years, with most of that change taking place in the last 3–5 years. Prior to that, the asset class had an amazing track record under a mostly consistent model, through a relatively finite set of investors and drawing from a handful of elite business school programs. As we conclude 2016, ETA is more robust and exciting than ever, with new models and new investors funding more searchers than ever before, and this trend is gaining momentum.

The feedback we heard from investors is that more talented and better prepared search fund entrepreneurs, combined with a large and growing pool of available companies, and a robust capital structure will lead to continued growth in this asset class for the foreseeable future. The investor base is getting even more sophisticated and passing that knowledge onto aspiring search fund entrepreneurs through coaching relationships during the search and operating phase, and through internship opportunities in partnership with top business schools. And thanks to the size and success of the ETA sector, new models are taking hold that accommodate for more growth.

Whether ETA can handle the additional volume, expanded sectors of operation beyond the traditional focus on business services, and new ETA models, is beyond the scope if this study. What we can say based on the 44 interviews we had with investors is that the ETA sector will continue to grow and evolve as long as it continues to deliver the outsized returns that have made it one of the most attractive investment areas in recent times.

As Bill Egan suggested, when we asked him for parting words before concluding our interview, "*my advice to investors is to take a hard look at this*", referring to the results from this paper. We hope investors and searchers alike inform their decisions based on all the available data and we hope we provided an interesting—and albeit early– look at the evolution of the search fund model.