STANFORD
GRADUATE SCHOOL OF BUSINESS

CASE: E-386
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# SEARCH FUNDS—2009: SELECTED OBSERVATIONS

## EXECUTIVE SUMMARY

Since 1996, the Center for Entrepreneurial Studies (CES) at the Stanford Graduate School of Business has conducted a series of studies on the performance of Search Funds. This study, as well as its predecessors in 1996, 1998, 2001, 2003, 2005 and 2007, has endeavored to gather data about and gain insight into all known Search Funds.[1] Each of these studies portrays the aggregate characteristics of Search Funds and their principals, and evaluates the investment returns generated by first-time Search Funds to their original investors. Together, this series of studies reflects changes in the characteristics of Search Fund entrepreneurs and the performance of their funds over time. Using conservative assumptions, the aggregate pre-tax internal rate of return (IRR) across the known universe of Search Funds to-date is 37.3% and the aggregate multiple of investment returned is 13.5x.

## OVERVIEW OF THE SEARCH FUND CONCEPT

Since the first known Search Fund was formed in 1984, the Search Fund model, in which entrepreneurs raise a pool of capital from investors to cover expenses during their search for an attractive business to buy, has become relatively standardized. Since 1984, 129 known funds have raised search capital for the first time. Of those, 41 are currently still searching to acquire businesses, 33 are currently operating the companies they acquired and 55 are terminal (meaning

[1] For the purpose of this paper, "known Search Funds" refers to the universe of Search Funds of which the CES is aware and that have been surveyed for this series of studies. While it is possible that Search Funds have existed that are not known to the CES, it is likely that this number is fairly small given the tightly knit network of Search Fund entrepreneurs, investors and advisors.

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The CES would like to thank the Searchers who elected to participate in this study. Additional thanks goes to Doug Wells (1996 study), Josh Hannah (1998 study), Chris Flanagan (2001 study), Mu Y. Li (2003 study), Mike Harkey (2005 study) and Sean Harrington (2007 study) for pioneering and updating earlier versions of this study.

they either acquired and successfully exited [20] or shut-down their business [16] or ended their search without acquiring a company [20]).

There are a number of areas where Search Funds have a high degree of similarity, including the entrepreneurs' profiles, investment vehicle terms, amount of capital raised and types of acquisition targets pursued. The model is also sometimes referred to as "entrepreneurship through acquisition," highlighting the fact that Search Fund entrepreneurs (Searchers) share a similar set of experiences in managing and growing relatively small companies with those who pursue the more traditional path of entrepreneurship through the founding of new companies.

Most Search Funds are started by entrepreneurs who are viewed as having high potential (many are recent graduates from top-tier business school programs), though they typically have limited operational experience and often no direct experience in their target industry. Searchers tend to be drawn to the model for two principal reasons. First, the model offers relatively inexperienced professionals with limited capital resources a quick path to managing a company in which they have a meaningful ownership position. Second, Search Funds have historically generated significant financial rewards for a small, but growing, number of principals. The core thesis of the Search Fund model is that placing well-educated, high caliber, strongly motivated managers into an environment that is under-managed or lacking a professional management approach will yield attractive risk-adjusted returns for Search Fund investors as well as compelling experience (owning and managing a business) and financial returns for Searchers.

The relatively small universe of Search Funds may be explained, at least partially, by the perceived opportunity cost and inherent risk for Searchers. While other compensation packages available to Searchers might include a high starting salary and a signing bonus, the Search Fund model offers a relatively low income through most of the process. The financial upside to the principal, if it comes, occurs upon exit.

Following is an overview of the four stages in the lifecycle of a Search Fund.

## STAGE ONE: RAISING THE SEARCH FUND

The creation of a Search Fund typically involves one or two aspiring entrepreneurs who draw up an investment thesis then call upon a network of investors (repeat Search Fund investors, angel and other high net-worth investors, friends and family) to raise a pool of capital to pay the Searcher(s) a salary and to cover operating and diligence expenses during the search for an attractive company to acquire. Typically, ten or more investors each purchase one or several units of the initial capital of the Search Fund, at about $20,000 to $35,000 per unit; the historical median amount raised has ranged from $290,000 to $450,000. In exchange for the initial search capital, each investor receives 1) the right, but not obligation, to invest pro-rata in the acquisition and 2) conversion of the search capital, typically on a stepped-up basis (e.g. 150% of the actual investment), into the securities issued for the acquisition capital. The period of time to raise the search capital has historically averaged 3 – 6 months.

Some key decisions that any potential Searcher must make include whether to have a partner or not, how much search capital to raise, how many investors to have in the fund, and whether to have a geographic, industry or other focus. While the 2007 survey reflected a decrease in the percentage of funds that were raised and operated by two principals (the partnership model), the majority of Search Funds raised since then have been partnerships. Of the Search Funds raised since 2007, 64% of were raised as a partnership between two Searchers (up from 25% of funds raised in 2006-2007). The median amount of search capital per fund raised since the 2007 survey was $450,000 (up from $385,000 in the 2007 survey), however, with the increased number of dual-partner funds, the median amount of capital raised per individual Searcher was $262,500 (down slightly from previous years). The median time taken to raise search capital was 4 months, the median number of investors per fund was 15 (average of $30,000 per unit) and 79% indicated that they focused their search upon a select group of target industries. Of the 79% of funds that were focused by industry, 94% said that they targeted service industries and 6% were seeking companies they described as being a combination of manufacturing and services.

Given their relative lack of significant professional experience (the median age of Searchers who raised funds between 2007 and 2009 was 31 years), Searchers commonly look for investors who can also serve as high-quality advisors or “smart money.” The best investors are viewed to be those that also offer expert guidance, assist in generating deal flow and provide leverage with lawyers, accountants and bankers.

As the returns to investors in Search Funds are widely distributed, similar to those of venture capital investments, serial Search Fund investors have emerged who assemble portfolios of these fund investments. These serial investors and funds-of-Search Funds seek to diversify their risk and to increase their chances of being invested in any “homeruns” that emerge within the asset class. For example, within a portfolio of ten investments, they might expect some to fail, some to break even, some to be modestly successful and they hope that one or two will provide outstanding returns. This year we asked known Searchers about their sources of funding. Of the 81 Search Funds that responded to this question, 91% reported that they had raised money from serial Search Fund investors and 37% said that they had put in their own money to fund a portion of the search capital.

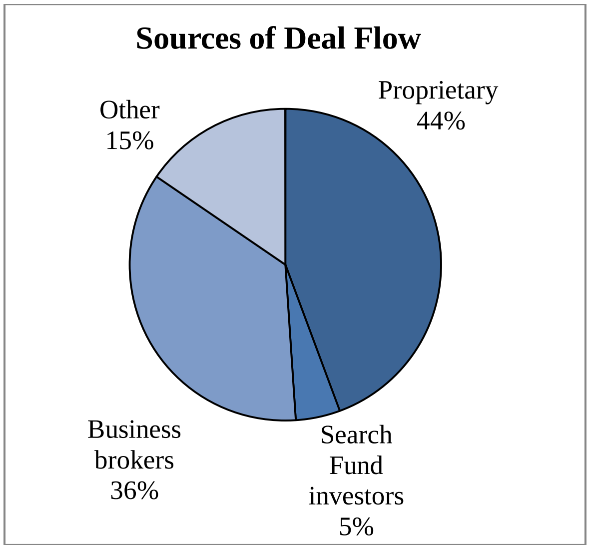
In previous versions of this study it has been stated that, “In many cases investors are drawn to invest in Search Funds by more than simply the potential financial returns, but also by the psychic benefits of being involved with and providing advice to the Search Fund entrepreneurs.” While this may be true for angel investors and for friends and family members who invest, it should be noted that the serial investors and funds-of-Search Funds primarily invest based on their belief that the model works and their expectation that they will make money investing in it.

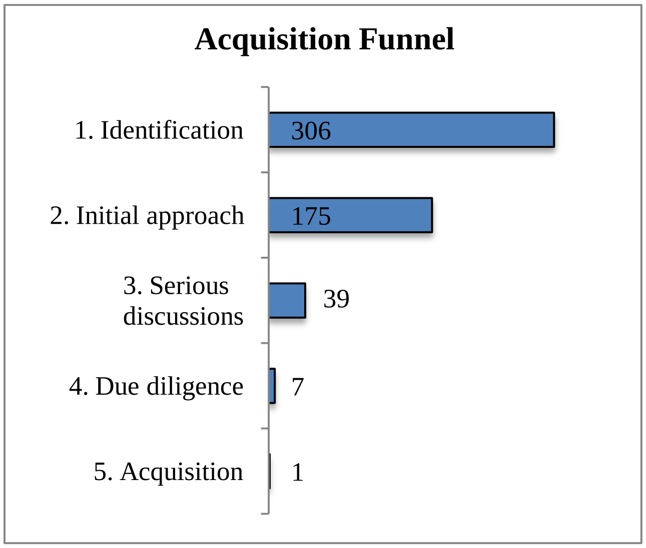
**Comparison of Search Fund Profiles**

| *Categories* | Pre-2001 | 2001-2003 | 2003-2005 | 2005-2007 | Post-2007 |
|---|---|---|---|---|---|
| **Number of Principals:** | | | | | |
| Single | 68% | 41% | 42% | 75% | 36% |
| Partners | 32% | 59% | 58% | 25% | 64% |
| | | | | | |
| **Amount of Initial Capital Raised:** | | | | | |
| Minimum | $40,000 | $125,000 | $150,000 | $200,000 | $200,000 |
| Median | $290,000 | $350,000 | $395,000 | $385,000 | $450,000 |
| Maximum | $1,000,000 | N/A | $750,000 | $550,000 | $750,000 |
| | | | | | |
| **Amount of Initial Capital Raised per Principal:** | | | | | |
| Minimum | N/A | N/A | $106,250 | $175,000 | $143,750 |
| Median | N/A | N/A | $276,250 | $350,000 | $262,500 |
| Maximum | N/A | N/A | $750,000 | $540,000 | $450,000 |
| | | | | | |
| **Number of Search Fund Investors:** | | | | | |
| Minimum | 2 | 1 | 3 | 10 | 5 |
| Median | 12 | 13 | 12 | 14 | 15 |
| Maximum | 25 | 20 | 24 | 23 | 28 |
| | | | | | |
| **Number of Months Fundraising:** | | | | | |
| Minimum | N/A | 1.0 | 2.0 | 0.8 | 0 |
| Median | N/A | 4.5 | 5.0 | 3.0 | 4.0 |
| Maximum | N/A | 9.0 | 12.0 | 10.0 | 20.0 |
| | | | | | |
| **Targeted Industries:** | | | | | |
| Service | 50% | 30% | 35% | 69% | 74% |
| Manufacturing | 19% | 30% | 25% | 14% | 0% |
| Manufacturing/Service | 12% | 0% | 5% | 0% | 5% |
| Distribution | 8% | 5% | 3% | 0% | 0% |
| Retail/Service | 8% | 3% | 0% | 0% | 0% |
| Retail | 4% | 0% | 0% | 0% | 0% |
| Media | 0% | 13% | 0% | 0% | 0% |
| Utilities | 0% | 6% | 0% | 0% | 0% |
| No Preference | 0% | 13% | 32% | 17% | 21% |

## STAGE TWO: IDENTIFYING AND MAKING AN ACQUISITION

For the purpose of this study, we have divided the acquisition process into five steps: 1) identification, 2) initial approach, 3) serious discussions, 4) due diligence and 5) acquisition. The first step, creating a stream of potential deals, may involve attending industry trade shows, "cold-calling" companies listed in trade directories, working with industry experts and reviewing deals generated from third parties such as brokers or bankers. The Searchers surveyed for this year's study were asked to identify what percent of the deals they looked at were generated by each of the following sources: business brokers, Search Fund investors, proprietary sourcing and "other." Their responses indicated that 44% of the deals they looked at were sourced through proprietary means, 36% came from brokers, 5% of their deal flow came from Search Fund investors and 15% were sourced through other means. We also asked Searchers to estimate the number of companies or potential investments they considered at each step in the investment funnel. The median number of companies that Searchers reported looking at during the identification phase was 306. They then pursued initial approach with an average of 175 companies and engaged in serious discussions with an average of 39 potential investments. Searchers reported that they engaged in due diligence on an average of seven companies before acquiring one.




Typically, principals narrow their search either geographically or by industry, while also reviewing deals opportunistically (e.g., looking at deals outside of their primary scope of interest). The median price range for Search Fund target companies tends to fall between $5 to $10 million (though there have been acquisitions as large as $30.6 million and as small as $600,000), and these deals typically require $2 to $5 million of equity capital. The median acquisition price paid by Search Funds that made an acquisition since 2007 was $6.5 million, compared to the median price of $9.4 million for funds that acquired between 2005 and 2007 and the $5.7 million median purchase price for those occurring prior to 2005. Search Funds tend to acquire companies in fragmented industries and with sustainable market positions, histories of stable cash flows, and long-term opportunities for improvement and growth. Service and light manufacturing companies (outside of high technology industries) are popular targets.

A Search Fund may or may not successfully identify a suitable target company. If it does, the initial Search Fund investors can then elect to invest a pro-rata share in the acquisition. In this way a Search Fund is similar to the pledge fund (or "fundless sponsor") model employed by some private equity funds, former private equity professionals or entrepreneurial dealmakers, in which investors provide capital on a deal-by-deal basis (as opposed to committing a predetermined amount of callable capital). The lack of committed capital is a key element of the Search Fund model. For investors, the Search Fund essentially represents a call option to invest in the acquisition found by the Searcher. For the Searcher this makes the selection of initial investors all the more important as getting the follow-on investments is essential for making the acquisition.

Once a target company has been identified, the initial investors are offered the option to provide the capital necessary to fund the equity portion (and in some cases a subordinated debt piece) of the acquisition. At this point, if necessary, it is not uncommon for additional investors to be brought into the deal if some initial Search Fund investors elect not to participate or if additional capacity/capital is required. The original investors (who funded the search process) typically receive a step-up in basis (e.g. 50%) on their initial investment in this round, irrespective of whether they participate in the acquisition financing. Often the acquisition is also partially funded with debt and seller financing. Investor debt, commonly in the form of subordinated debt, may also be added to the capital structure.

The process of identifying and acquiring a company is different for each Searcher. There are, however, common themes, typical time frames and rules of thumb which are seen across of a majority of the Searchers' experiences. As shown in the table below, the median length of time a fund has spent searching for an acquisition is 18 months and the median purchase price of the acquisitions made by all known Search Funds has been $8.0 million.

**Comparison of Search Fund Acquisitions** (median values)

| ***Categories*** | **All Acquisitions** | **Acquisitions 2005-2007** | **Acquisitions since 2007** |
|---|---|---|---|
| Length of Search (months) | 18 | 19 | 14 |
| Purchase Price | $8.0 M | $9.4 M | $6.5 M |
| Equity Invested at Purchase | $2.4 M | $4.2 M | $3.6 M |
| Investors' Debt | $0.3 M | $0.0 M | $0.7 M |
| Company Revenues at Purchase | $7.8 M | $9.1 M | $5.3 M |
| Company EBITDA[2] at Purchase | $1.6 M | $2.0 M | $1.3 M |
| EBITDA Margin | 20.5% | 18.2% | 20.5% |
| EBITDA Growth Rate at Purchase | 12.0% | 16.5% | 9.3% |
| Purchase Price / EBITDA | 5.1x | 5.2x | 4.9x |
| Purchase Price / Revenue | 1.0x | 0.9x | 1.5x |
| Company Employees at Purchase | 50 | 60 | 38 |

[2] EBITDA stands for Earnings before Interest, Taxes, Depreciation and Amortization.

If the initial capital is exhausted before a successful acquisition can be made, Searchers may choose to either close the fund or solicit additional funding to extend the search period. For the purpose of this study, "search capital" or "initial investment" includes all investments made prior to acquisition or termination of the search.

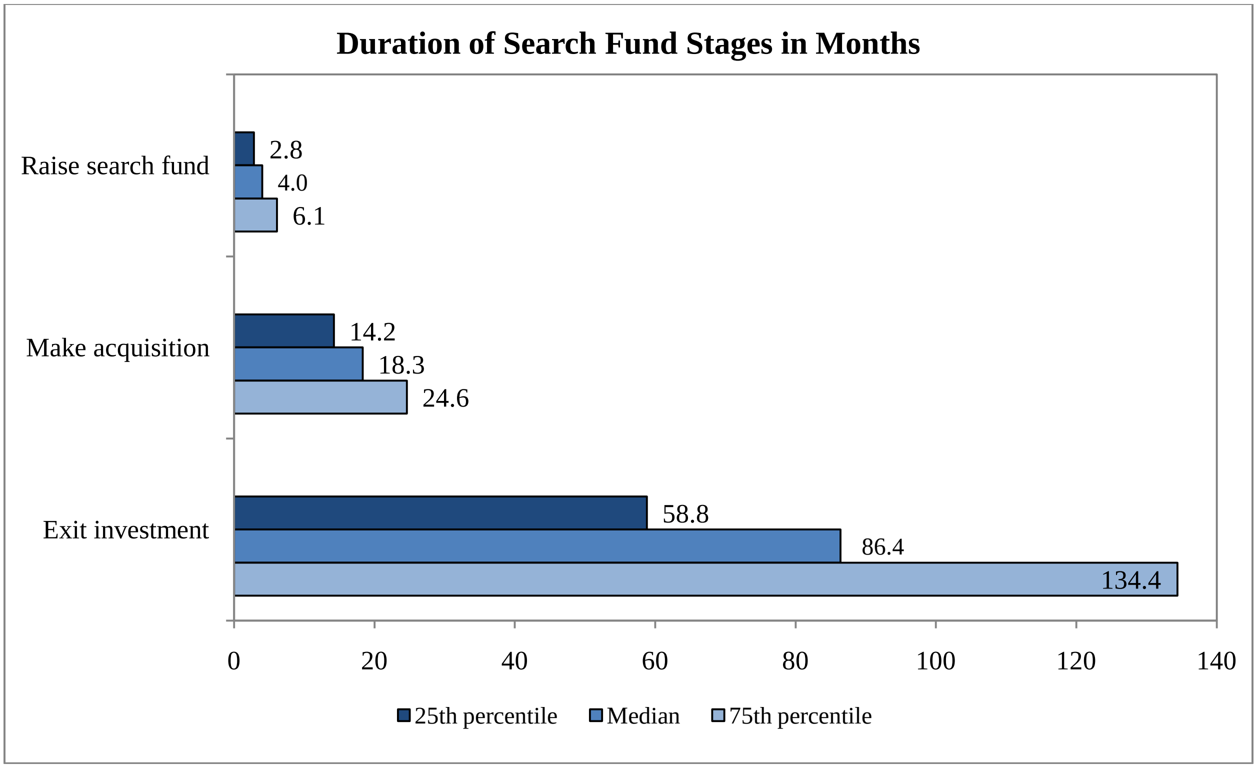
**Selected Statistics for All Search Fund Acquisitions**

| **Total Number of Months From Start of Search to Deal Close** | **All Acquisitions** |
|---|---|
| Minimum | 3 |
| Median | 18 |
| Maximum | 51 |
| <10 months | 13% |
| 11-20 months | 42% |
| 21-30 months | 25% |
| 31+ months | 20% |
| | |
| **Purchase Price Statistics** | **All Acquisitions** |
| Minimum | $0.6 M |
| Median | $8.0 M |
| Maximum | $30.6 M |
| <$4 M | 22% |
| $4 M to $8 M | 30% |
| $8 M to $12 M | 17% |
| >$12 M | 32% |

| ***Categories*** | **Minimum** | **Median** | **Maximum** |
|---|---|---|---|
| Company Revenues at Purchase | $0.4 M | $7.8 M | $43.0 M |
| Company EBITDA at Purchase | -$1.6 M | $1.6 M | $6.1 M |
| EBITDA Margin | -3.7% | 20.5% | 50.0% |
| EBITDA Growth Rate at Purchase | 0% | 12.0% | 250% |
| Purchase Price / EBITDA | NM | 5.1x | 18.0x |
| Purchase Price / Revenue | 0.3x | 1.0x | 3.4x |
| Company Employees at Purchase | 5 | 50 | 740 |

### STAGES THREE AND FOUR: OPERATION AND EXIT

Unlike associates or partners in other private equity models, Searchers take key operating roles in the companies they acquire (such as CEO or President) and generally remain in those positions until they achieve a successful exit for their investors. Thus a Search Fund is a complete professional commitment for the Searchers extending for many years. In looking at available data reported by all the Search Funds that have acquired and successfully exited their investment, the median amount of time that a company is owned by a Search Fund is 7.2 years (86 months). When added together with the time spent raising the fund and the time spent searching for and making the acquisition, a typical successful Searcher spends 9 years at his/her Search Fund.[3] Most unsuccessful Searchers who do not find an attractive acquisition target commit roughly two years toward searching before exhausting their search capital and moving on to their next endeavor. Similarly, within this two-year time frame, investors will either be presented with an opportunity to invest their pro-rata share into an acquisition or they will write-off the (relatively minor) search capital, which they invested at the beginning of the search.

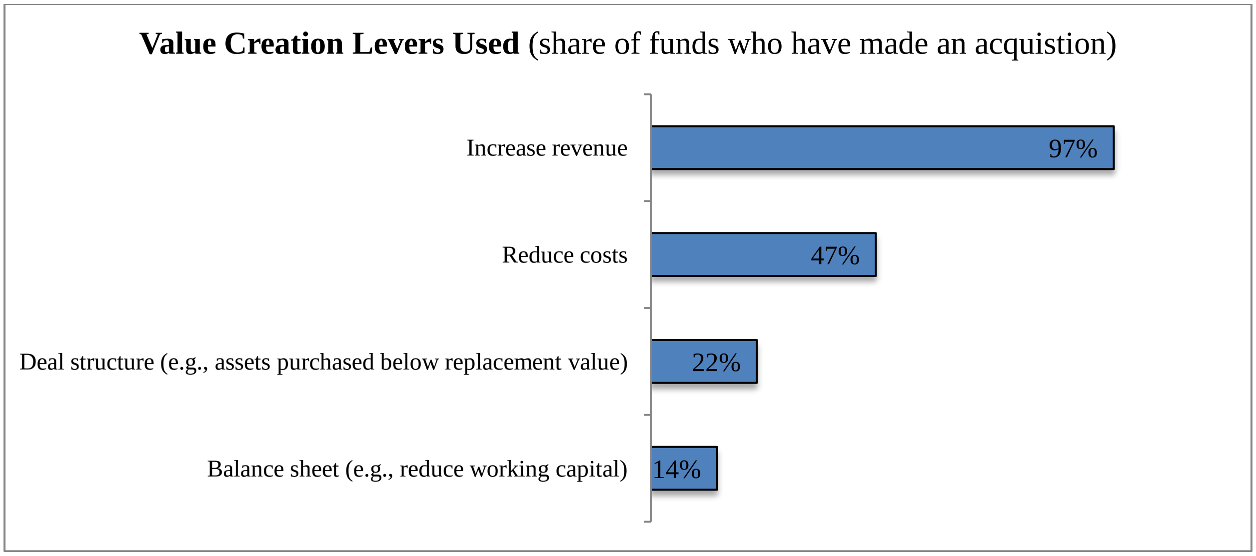



For raising the Search Fund, making the investment and managing the company, successful Searchers generally receive between 20% and 40% of the upside on the investment (in addition to annual salary and other compensation), typically structured in such a way as to vest upon achievement of specific hurdles (e.g., a common vesting schedule vests one third when the acquisition closes, one third over time and one third upon hitting IRR targets). This mimics the carried interest many private equity firms earn.

As with other private equity deals, searchers seek to create value within the companies they buy either through operational improvements (e.g., reducing costs, increasing revenue and/or reducing working capital) or through financial engineering (by structuring the deal in an efficient way). In this year's survey, we asked Searchers to identify the top value creation levers they

[3] For purposes of the *Duration of Search Fund Stages in Months* chart and the *Value Creation Levers Used* chart, the sample size is limited to the 88 Search Funds that participated in the 2009 survey as prior surveys did not directly collect this data.

used in the companies they had acquired. Almost all of them (97%) said that they created value by increasing revenue and nearly half (47%) cited cost cutting measures. Only 14% added value through more efficiently managing the balance sheet and 22% felt that they had captured value through the way they structured the deal.




## 2009 Search Fund Universe

*Search Funds – 2009: Selected Observations* was conducted in the first half of 2010 and primarily concerns data generated during the period between the 2007 study and the end of 2009. We reached out to a total of 154 Searchers for the 2009 Survey, including some resurveying of Searchers who had been surveyed in the past in order to gather additional data or clarify their responses. Of these, 115 Searchers completed and returned Part 1 of the survey; these 115 represent 88 funds. Of those 88 funds, 40 indicated they had had a material event since the 2007 survey and therefore were sent Part 2. We were able to collect Part 2 responses from all 40 of these. Of those surveyed, 61 Searchers (across 44 funds) were new to the survey and had launched their fund since the 2007 study. Five of those 44 were still in the process of raising their search capital as of December 31st, 2009 leaving 39 new funds raised by 56 new Searchers since the 2007 survey.

## Searcher Profile

In this year's survey we collected a variety of demographic information in an attempt to sketch a rough image of the current "typical Searcher." While every Searcher is unique and each vintage of Searchers has its own characteristics, on a whole the known Search Fund universe comprises a fairly homogenous group. Of the 56 Searchers who responded to our survey for the first time this year, 100% were male, 66% hold MBAs from either Stanford GSB, Harvard Business School or Wharton (collectively down from previous surveys), 78% were under the age of 35 when they raised their Search Funds (down from previous surveys) and 54% listed private equity, investment banking or management consulting as their primary prior professional experience (prior private equity experience is significantly higher than in previous surveys).

Although the typical Searcher is often thought to be a freshly-minted MBA, only 18% of those who raised a Search Fund since the 2007 survey were less than one year out of business school (16% of Searchers did not have MBAs, though 5% had a non-MBA graduate degree - PhD, MS or JD), 20% raised their funds between one and three years after graduating from business school and 46% had graduated from business school more than four years before raising their Search Funds. This represents a shift away from what was seen in previous surveys. While we are analyzing very small sample sizes, the 18% who raised their funds in the year after they graduated from business school can be compared to the 33% of those in the 2007 survey and 47% in the 2005 survey. A serial Search Fund investor, who we interviewed in order to gain additional insight into the asset class, said that, "While this is purely anecdotal, over the past few years, we have seen a broadening of the school base or academic background and have seen a number of older candidates, including people in their 40s, raising Search Funds." This investor posited that these changes might respectively be attributed to a broader dissemination of the Search Fund concept and increased job displacement due to the recent economic crisis.

**Comparison of Searcher Profiles**

| ***Categories*** | **Pre-2001** | **2001-2003** | **2003-2005** | **2005-2007** | **Post 2007** |
|---|---|---|---|---|---|
| **Age at Start of Search:** | | | | | |
| Minimum | 26 | 28 | 28 | 27 | 26 |
| Median | 30 | 31 | 32 | 32 | 30 |
| Maximum | 35 | 60 | 47 | 50 | 51 |
| Under-30 | N/A | 12% | 30% | 33% | 37% |
| 30-35 | N/A | 65% | 53% | 47% | 41% |
| 36-40 | N/A | 12% | 10% | 10% | 16% |
| Over-40 | N/A | 12% | 7% | 10% | 6% |
| | | | | | |
| **Number of Post-MBA Years before Search Fund:** | | | | | |
| Minimum | N/A | 0 | 0 | 0 | 0 |
| Median | N/A | 2 | 1 | 1 | 4 |
| Maximum | N/A | 10 | 18 | 16 | 20 |
| No MBA | N/A | N/A | 0% | 13% | 16% |
| <1 year post-MBA | N/A | N/A | 47% | 33% | 18% |
| 1-3 years post-MBA | N/A | N/A | 17% | 27% | 20% |
| 4-7 years post-MBA | N/A | N/A | 23% | 20% | 22% |
| >8 years post-MBA | N/A | N/A | 13% | 7% | 24% |
| | | | | | |
| **Gender:** | | | | | |
| Male | 96% | 100% | 100% | 100% | 100% |
| Female | 4% | 0% | 0% | 0% | 0% |

### Comparison of Searcher Experience

| Professional Background: | Pre-2001 | 2001-2003 | 2003-2005 | 2005-2007 | Post 2007 |
|---|---|---|---|---|---|
| Management Consulting | 26% | 23% | 10% | 26% | 7% |
| Investment Banking / Finance | 23% | 10% | 16% | 27% | 20% |
| Sales | 12% | 1% | 3% | 7% | 4% |
| Venture Capital | 8% | 3% | 5% | 1% | 0% |
| Line/General Management | 5% | 27% | 7% | 15% | 11% |
| Marketing | 5% | 2% | 4% | 0% | 4% |
| Law | 4% | 0% | 2% | 0% | 0% |
| Operations | 4% | 7% | 16% | 1% | 7% |
| Entrepreneur | 2% | 13% | 8% | 7% | 13% |
| Accounting | 2% | 0% | 3% | 0% | 0% |
| Engineering | 2% | 0% | 5% | 2% | 0% |
| Military | 2% | 1% | 8% | 1% | 0% |
| Insurance | 2% | 1% | 0% | 2% | 0% |
| Private Equity | 1% | 5% | 11% | 4% | 27% |
| Others | 0% | 7% | 2% | 8% | 7% |

## KEY SEARCH FUND METRICS: SUCCESS RATES AND RETURN DATA

As of December 31, 2009, of the 129 known first-time Search Funds that have been raised, 41 funds (32%) are still currently searching, 69 funds (53%) have made acquisitions and 19 funds (15%) ended their searches without making an acquisition. Of the 69 funds that made an acquisition, 33 of these were still operating their company as of December 31, 2009 and 36 were considered terminal (having either closed or exited their business). Of the 36 funds that were considered terminal, 16 funds (44%) failed after making an acquisition[4] and 20 funds (56%) had a successful exit. The 20 funds that have acquired, run and successfully exited their investments represent 29% of all known Search Funds that have made acquisitions over the history of the asset class. The history is still to be written for the 33 funds that are operating companies and the 41 funds that are still searching for acquisitions.

[4] For the purpose of this study a failed Search Fund is defined as a fund that made an acquisition but then shut-down the business for a total loss or exited the investment without returning at least ¾ of the Search Fund investors' capital.

### Stage Transition Matrix

| | **Total** | Still Searching | **Quit Search or Acquired** | Quit Search | Acquired |
|---|---|---|---|---|---|
| **Funds that have been raised** | **129** | 41 | **88** | 19 | 69 |
| Share of all funds raised | *100%* | *32%* | *68%* | *15%* | *53%* |
| Share of Quit Search or Acquired | | | *100%* | *22%* | *78%* |

| | **Total** | Still Operating | **Shut-Down or Successful Exit** | Shut-Down | Successful Exit |
|---|---|---|---|---|---|
| **Funds that have made an acquisition** | **69** | 33 | **36** | 16 | 20 |
| Share of all funds raised | *53%* | *25%* | *28%* | *12%* | *15%* |
| Share of Acquired | *100%* | *48%* | *52%* | *23%* | *29%* |
| Share of Shut-Down or Successful Exit | | | *100%* | *44%* | *56%* |

In this study, the investment returns analysis portion includes 79 first-time search funds that had either terminated or had been in operation for at least one year post-acquisition[5]. The internal rates of return (IRRs)[6] and multiples of investment[7] were calculated from the perspective of the Search Fund investors on a cash flow basis, including both debt and equity, invested in the search and as part of the acquisition. As in prior years' studies, the timing of the cash flows for each Search Fund has been adjusted to a common start date[8]. For funds that had either sold or liquidated their companies or closed down without acquiring a company, the terminal value was straightforward and we used the capital table as of the terminal event (e.g., exit, sale, recapitalization, etc.) as reported by the principals. However, for the 33 companies, where the original investors had not exited and the company was still being operated by the Searcher(s), we had to estimate the enterprise value as of December 31, 2009 and make certain assumptions about the capital structure and cash flow waterfall. Where as in previous years this study took the EBITDA data reported by the Searchers and conservatively applied the purchase multiple of EBITDA paid at acquisition to estimate the terminal value, this year we asked the principals to estimate the current enterprise value of their company and to provide supporting information as to how they arrived at that estimate. While it is not possible to confirm the current valuation of the companies being run by Searchers and either of these methodologies allows for inaccurate

[5] 50 of the 129 search funds we tracked were not included in the investment return portion of the study: 41 search funds were still searching for a company to buy, 7 had purchased companies within 12 months of the 12/31/09 cutoff date, and 2 did not provide sufficient financial information to be included.

[6] Internal rate of return (IRR) represents the annual compounding rate that is derived from the adjusted dates and actual amounts of search and acquisition capital invested and returned by an investment. For investments returning nothing, or only a fraction of the investors' original investment, IRR is not a meaningful metric.

[7] Multiple of investment represents the multiple of initial cash invested that is returned to investors. For example, if the group of initial investors invested $5 million and received back $10 million, this would be described as a 2.0x multiple of investment. Getting back only $1 million would be a 0.2x and $60 million would be a 15.0x return. A complete loss of capital is denoted as a 0.0x multiple of investment.

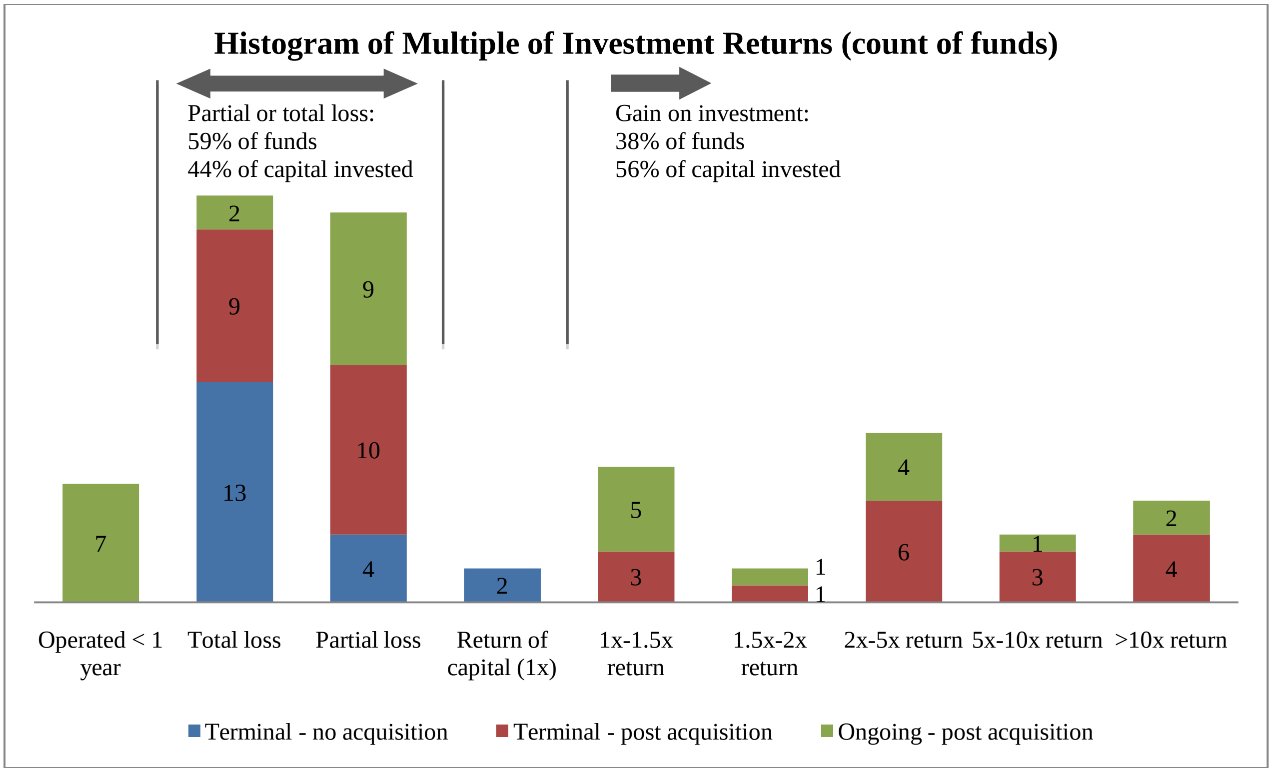
[8] The IRR for Search Funds as an asset class was calculated by shifting dates for all cash flows such that all funds are assumed to have raised search capital on the same "day one" with subsequent infusions from, and distributions to, Search Fund investors occurring at the intervals reported by each fund. Thus the asset class IRR is a hypothetical return an investor would have realized if all funds were started at the same time and the investor participated in each fund in proportion to the amount of capital raised by each fund.

data due to principals' estimates of either what multiple the company could sell for or what the current enterprise value is, we felt that we were able to get more reliable data using comparables and other estimations of current value.

In all cases, we assumed that all debt was repaid, that searchers fully vested their carried interest portion[9] and that funds were distributed to the original Search Fund investors in proportion to the percentage of equity and/or subordinated debt owned by them. All returns were calculated on a pre-tax basis to investors. Although we made every effort to accurately calculate returns, it is difficult to obtain precise information for every single cash infusion or distribution over the life of each fund, especially for Search Funds with longer operating histories and/or more complex capital structures. As such, it is critical that investors and entrepreneurs interested in the Search Fund model take these limitations into account when considering the IRR and multiple of investment results presented in this study.

Return data was calculated for 79 funds (excludes seven funds that made an acquisition within 12 months of the cutoff date of December 31, 2009, shown separately in the following chart). Of these 79 funds, 59% suffered a partial or complete loss of capital. However, about a third of these were instances where no acquisition was made, so only the initial search capital was lost. Because of these "low-cost" failures, these 59% of funds represent only 44% of capital invested (search capital and acquisition capital provided by Search Fund investors). Similarly, 38% of funds (representing 56% of capital invested) produced a gain for investors. Two funds shut down and returned all capital invested after the principals elected to pursue a different model.

[9] In all cases where we estimated a terminal value, we assumed that the investors' equity shares were fully diluted. This results in a more conservative IRR to investors since funds typically include both time-based vesting and performance hurdle rates which must be exceeded before the searchers vest at least a portion of their equity.

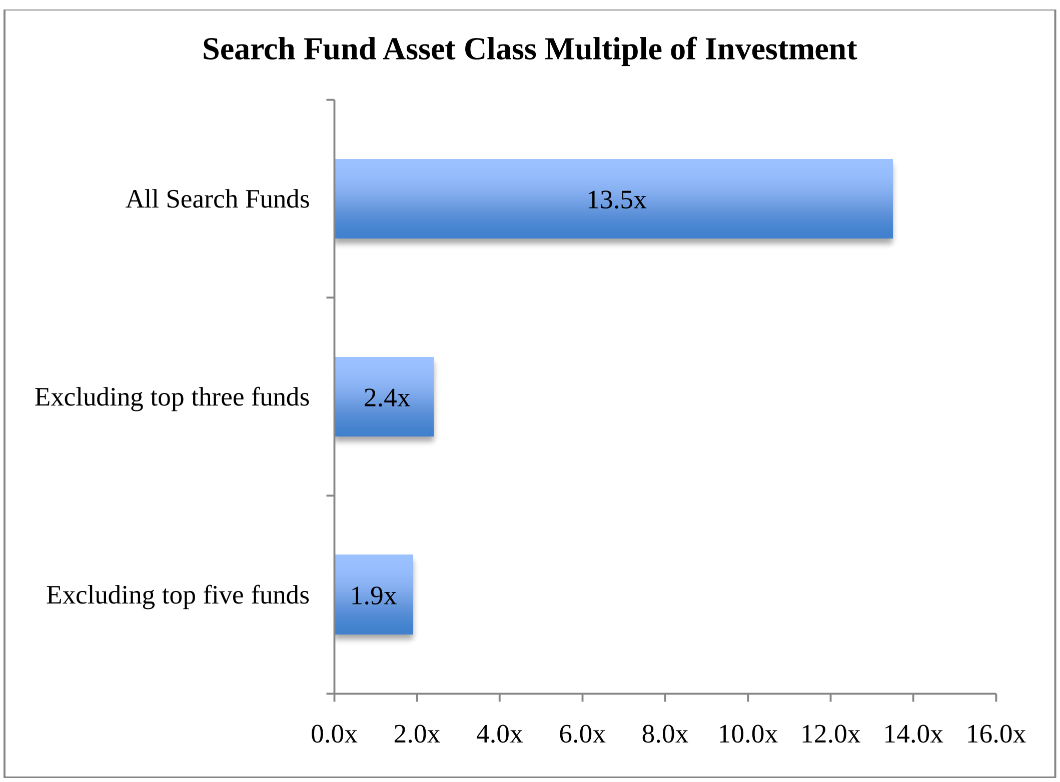



The distributions of the IRRs and multiples of investments for individual funds show the vast gulf between the median and top performing funds. The median fund returned only 0.5x (50%) of investors' capital, whereas the top-performing fund returned well over 200 times the capital invested. As an asset class, Search Funds have achieved a 13.5x multiple of investment and a 37.3% IRR. However, when the top three funds are excluded[10], the remainder of the asset class returned a 2.4x multiple of investment and a 20.2% IRR. When the top five funds are removed, the asset class multiple of investment and IRR drop to 1.9x and 19.0%, respectively.

[10] Performance was ranked by the multiple of investment returned.

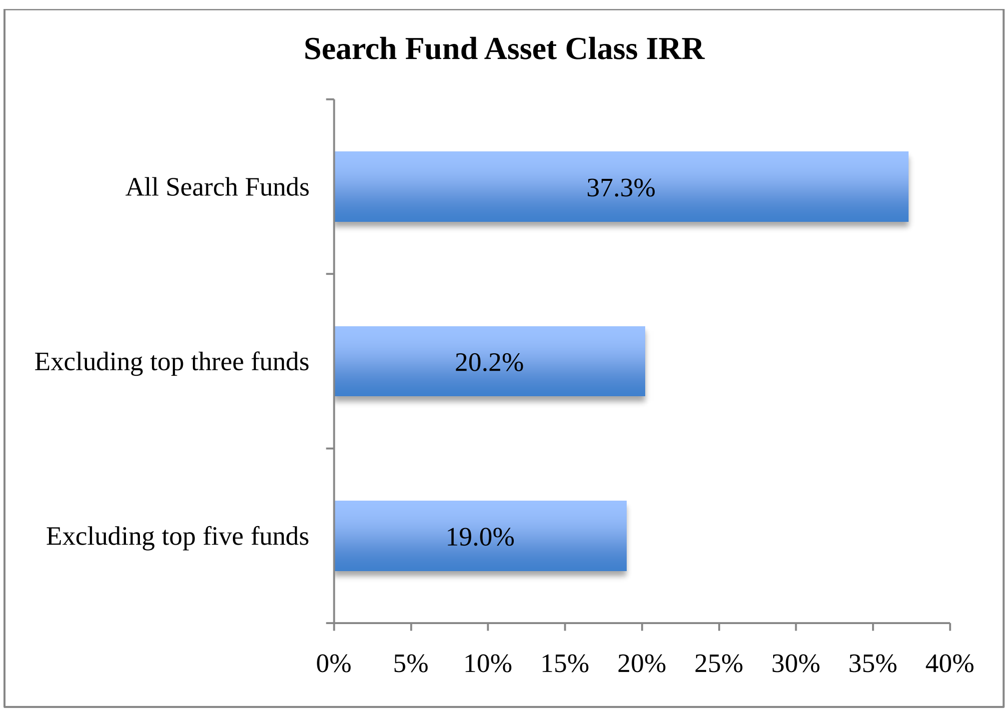
### Comparison of Search Fund Returns: Multiple of Investment

| | **2009** |
|---|---|
| **Individual multiples of investment:** | |
| Minimum | 0.0 x |
| 25th Percentile | 0.0 x |
| Median | 0.5 x |
| 75th Percentile | 1.9 x |
| Maximum | >200 x |
| | |
| **Distribution of individual multiples of investment:** | |
| 0.0 x (total loss) | 30% |
| < 1.0 x (partial loss) | 29% |
| Exactly 1 x (return of capital) | 3% |
| 1.0 x – 1.5 x | 10% |
| 1.5 x – 2.0 x | 3% |
| 2.0 x – 5.0 x | 13% |
| 5.0 x – 10. 0 x | 5% |
| > 10.0 x | 7% |
| | |
| **Aggregate blended multiple of investment** | 13.5 x |



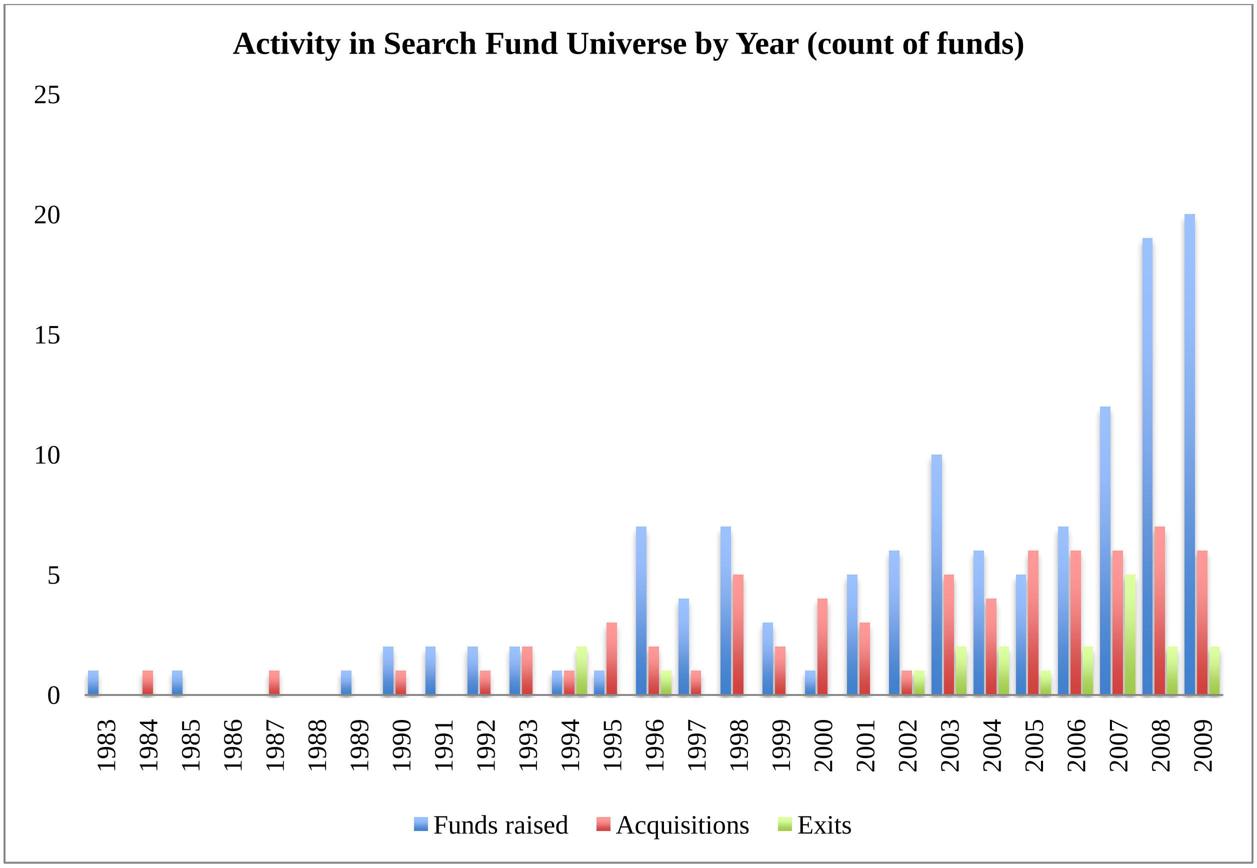
## Comparison of Search Fund Returns: IRRs

| | **2001** | **2003** | **2005** | **2007** | **2009** |
|---|---|---|---|---|---|
| **Individual IRRs:** | | | | | |
| Minimum | NM | NM | NM | NM | NM |
| 25th Percentile | | NM | NM | NM | NM |
| Median | 18% | NM | NM | NM | NM |
| 75th Percentile | | 22% | 25% | 25% | 11% |
| Maximum | 98% | 85% | 215% | 189% | 189% |
| *Note: Not meaningful (NM) is reported in situations of partial or complete loss of capital over a period of years where the IRR metric is not useful* | | | | | |
| | | | | | |
| | **2001** | **2003** | **2005** | **2007** | **2009** |
| **Distribution of individual IRRs:** | | | | | |
| Not meaningful (NM) | | | 53% | 49% | 60% |
| 0% to 25% | | | 22% | 25% | 19% |
| 26% to 50% | | | 14% | 18% | 14% |
| 50% to 75% | | | 4% | 2% | 3% |
| 76% to 100% | | | 2% | 2% | 2% |
| >100% | | | 4% | 5% | 2% |
| | | | | | |
| | **2001** | **2003** | **2005** | **2007** | **2009** |
| **Aggregate blended IRR** | 38% | 32% | 37% | 52% | 37.3% |



## CONCLUSION

As seen below, both 2008 and 2009 were record years for the number of Search Funds raised. The Search Fund model is benefiting from greater awareness, both among prospective Searchers and investors. However, the past two years did not bring with them a record number of acquisitions or exits for Search Funds or their investors.




It is likely that the next several years will see an acceleration of events in the Search Fund universe (acquisitions, failed searches, company closures and successful exits), as the funds that were raised over the past few years continue to progress through their lifecycles. How these events unfold, and in what proportion they occur, will have a large impact on the perception of the Search Fund model. These events and other changes within the Search Fund universe will be reported through future editions of this study.