How profitable are search funds?

What is the purpose of this article?
Help investors think about whether to invest time and money into the search fund asset class.

This article does not provide legal, tax, financial, or investment advice.

What are the critical learnings in this article?
1) The IRR for traditional search funds in Canada and the US has been 35.2%.
2) Traditional search fund investors provide far more than capital. They also provide coaching, mentoring, board directorships.
3) You need to fund between 30 to 45 searchers, in order to have a high chance of approaching the IRR for the asset class as a whole.

What is a search fund?
What is a traditional search fund?[1]
An investment vehicle formed by one or two entrepreneurs (i.e. “searchers”) along with investor mentors. They search for, acquire, and lead a privately held company for the medium to long-term. The searcher and investors exit at that time. Investors fund the search costs and the acquisition costs. The entrepreneur becomes the CEO after the acquisition.
1) These investors are very actively involved as: coaches, mentors, advisors, and board directors. The investors do far more than provide capital.
2) The searchers typically have an MBA.
3) The searchers search for a private company to acquire, lead, grow, and sell.
4) It takes 2-6 months to find the investors and capital to launch the search fund.
5) The search takes 12-24 months.
6) Growing the value of the company takes 4 to 7 (or more) years.
7) The exit process takes 6 months.

What are alternative search fund models?[2]
1) Self-funded search: the searcher funds the search themselves, without investors.
2) Single investor model: only one investor e.g. single professional investor, family office, private equity firm, etc.
3) Long-term hold: hold for more than 10 years. Growth is a combination of organic and acquisitions.

How profitable has the search fund asset class been
The following metrics are for the U.S. and Canada
1) 526 traditional search funds formed from 1984 through to Dec 31, 2021[3]

The IRR has been:[4]
1) 35.2% for all investments made, and 32.1% if the top 5 companies were excluded.
2) These IRR returns have been relatively constant from 2008 to 2021.

20% of the funds were still searching, 80% had concluded their search.[5]

Of the concluded searches:[6]
1) 34% ended without an acquisition. 66% did an acquisition.

Of funds that did an acquisition (both operating and exits):[7]
2) 27% were a loss, and 73% had a gain

Of the funds with a gain (both operating and exits) [8]
1) 27% had a 1-2 ROI (Return on investment)
2) 36% had a 2-5X ROI
3) 27% had a 5-10X ROI
4) 10% had a 10X ROI

What were the results if only looked at exits?[9]
1) 30% of exits were negative. 70% were positive

How many search funds do you need in your portfolio?
You need a large number of search funds in your portfolio. Why? Many funds lose money with their acquisitions or have poor returns. These outcomes occur with investors who are actively involved, driving success, and reducing the risk of failure. You need a large number to reduce the risk of too many poor performing funds.

A Monte Carlo simulation of search fund performance suggests a portfolio size of 20 to 30 funds with acquisitions. [10] Given that 34% of search funds don't make an acquisition, you'd need to fund between 30 to 45 searchers, in order to have a high chance of approaching the IRR for the asset class as a whole.

What is the capital you require?
The following is my brief analysis of the capital you require for your search fund portfolio to approach the IRR returns of the asset class as a whole.
1) As an investor, your initial search fund investment might range from $25,000 to $50,000. Funding 30 to 45 searchers would require from $750,00 to $2,225,000.
2) Additional funds would be required to support acquisitions.
3) In the traditional search fund model, you must provide much more than capital: you need the skills and knowledge to: coach, mentor, advise, and deliver value on the boards of search funds.

If you have a small portfolio, you have a high chance of returns below the asset class as a whole.

What are your next steps?
1) Review your investment thesis, asset allocation, and investable assets to determine if you have the capital to create a portfolio of search funds.
2) Assess your skills, experience, relationships, capabilities, and time availability to determine your potential to coach, mentor, and provide value as board director.
3) Consider if you'll create and manage a portfolio of search funds OR if you'll invest in a fund which has a portfolio of search funds.
4) If you're considering investing in a fund with a portfolio of search funds, you should: Build a financial model which takes into account the fees and exit times of the fund; and create a due diligence process to assess the fund's: talent, processes, business model, and historical results.
5) Regardless if the path you decide to take you must also assess the talent of the other investors. Why? The success of the traditional search fund model depends on the ability of the other investors to provide value via coaching, mentoring, and board directorships.

Footnotes
[1] Sara Heston and Peter Kelly, "2022 Search Fund Study – Selected observations", Stanford Graduate School of Business. Page 3
https://www.gsb.stanford.edu/faculty-research/case-studies/2022-search-fund-study-selected-observations
[2] Ibid., 29
[3] Ibid., 4
[4] Ibid., 8
[5] Ibid., 10
[6] Ibid., 10
[7] Ibid., 10
[8] Ibid., 10
[9] Ibid., 4
[10] Andrew Locke, Diversification in search fund investing: The only free lunch?
https://www.linkedin.com/pulse/diversification-search-fund-investing-only-free-lunch-andrew-locke/

What further reading should you do?
Stanford Graduate School of Business - search fund primer
https://www.gsb.stanford.edu/experience/about/centers-institutes/ces/research/search-funds/primer
Search Funds – What has made them work? Rob Johnson, IESE
https://media.iese.edu/research/pdfs/ST-0357-E.pdf