

How profitable are search funds? V2

What is the purpose of this article?

Help investors think about whether to invest time and money into the search fund asset class.

The audience for this article includes: investors considering search fund investments, and search fund founders.

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

You must do your own research and fact-based analysis using current and relevant information.

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, 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.

How profitable has the search fund asset class been

The following metrics are for the U.S. and Canada

- 1) 681 traditional search funds formed from 1984 through to Dec 31, 2023³

The IRR has been: ⁴

- 1) 35.1% for all investments made, and 33.0% if the top 5 companies were excluded.
- 2) These IRR returns have been relatively constant from 2008 to 2023.

66% of search funds with an investment return lost some or all their investor money.

The following analysis is based on the data in “2024 Search Fund Study – Research Overview”

524 search funds have concluded

358 search funds have an investment return to investors. This excludes search funds that were still operating.

196 lost all investor money, due to no acquisition

162 exits 40 of which were negative

236 search funds (of the 358 with an investment return) lost some or all their investor money

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. 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 that have made acquisitions.⁶ Given that 37% of search funds don't make an acquisition, you'd need to fund between 32 to 48 searchers, 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 32 to 48 searchers would require from \$800,000 to \$2,400,000.
- 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 large 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 considers 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 of 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, "2024 Search Fund Study – Research Overview", Stanford Graduate School of Business. Page 3

<https://www.gsb.stanford.edu/faculty-research/case-studies/2024-search-fund-study>

² Ibid., 27

³ Ibid., 4

⁴ Ibid., 8

⁵ Ibid., 5

⁶ 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>

International Search Funds – 2024 – Selected Observations, IESE Business School, University of Navarra

<https://www.iese.edu/media/research/pdfs/ST-0658-E>