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Sea Breeze Capital (A)

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It was spring 2011. As Jordi Alves looked out over the Barcelona skyline, he reflected on the last year. One year earlier he had graduated from business school in the United States and returned home to start the first search fund in Spain. It had taken longer, and had been much tougher, than he had expected. Now that Spain was facing more serious and more lasting economic problems than previously anticipated, would he still be able to deliver the returns his investors expected? Was this the right time and was Spain the right place?

Search Funds

The concept of a search fund was first developed in the United States in the 1980s. The model, geared toward ambitious and entrepreneurial MBA graduates, enables would-be entrepreneurs to earn an equity share in a business that they will later operate (entrepreneurs typically take a CEO or equivalent position). This "acquire versus build" approach to entrepreneurship has become increasingly popular over the last twenty years and the majority of the roughly 200 funds undertaken have been raised over the past ten years. Despite the model's growing popularity, nearly all search fund activity has been in the United States – less than 15% of all funds have been focused on markets outside the United States.

The growing popularity of the model can be attributed, in part, to the spread of information among entrepreneurs concerning how to become a very young CEO via a search fund and to the strong associated returns. According to the 2011 Stanford Search Fund Study, the average search fund CEO is 32, and search funds, as a group, have delivered an IRR of 34.4%. This figure compares well with alternative investments and has attracted a growing number of investors and entrepreneurs.

This case was prepared by Ian Nieboer, MBA 2012, Lenka Menden, MBA 2011, Professors Heinrich Liechtenstein and Rob Johnson, and Peter Kelly, Professor at the Stanford Graduate School of Business. April 2013.
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Specifics of the Model

Phases

A successful search fund will go through four phases in its life. The first phase involves raising the search fund. In this stage, the entrepreneur(s) raise search capital for their search fund, destined to pay the entrepreneur(s)' salary for a period of approximately two years (allowing for a dedicated effort, which is more likely to succeed) and to cover the expenses related to the search (such as overhead, due diligence on potential acquisitions, etc.). Typically, the initial search fund consists of 10-20 units at a price of $20,000 to $30,000 (€15,000 to €20,000) per unit. According to the most recent study on search funds, the total search capital raised is typically around $300,000 (€230,000) per searcher (one or two searchers).[1]

The second phase involves searching and acquisition. In this stage, the entrepreneur(s) identify potential acquisition targets and attempt to make an acquisition if a suitable target is found. Potential acquisition targets should fall within a specific set of criteria defined by the searcher(s) and agreed upon by the search fund investors. Several common criteria include: country or region, EBITDA margin and enterprise value. These criteria are designed to identify stable and profitable businesses that an inexperienced manager will be able to successfully understand, lead and grow. In colloquial terms, a searcher can "learn to be a jockey on a good horse." For example, typically targeted businesses operate in a growing industry, have some competitive advantage, recurring revenues (with the associated stable and predictable financials), high EBITDA margins (often greater than 15%) and provide a product or a service that is valuable to customers yet is not in a hot or technology-driven industry. Before making an acquisition, a typical search fund may identify more than 300 potential targets. However, the strictness of the search criteria and the process of due diligence and negotiations create a demanding acquisition funnel. Once the due diligence is complete and the deal is negotiated, the final acquisition is funded with equity (usually from the original investors, though sometimes supplemented by others) and debt (usually a combination of bank and seller debt).

The third phase is referred to as operation and value creation. In this stage, the entrepreneur(s) take a key operational role in the acquired company – typically as the CEO or equivalent – and generally remain in this role until an exit is achieved. During this stage, the entrepreneur(s) develop and execute their plan to grow the business and create value, usually with mentorship from several investors.

The final phase is the exit. Here, the entrepreneur(s) provide themselves and their investors with a liquidity event. This may take the form of a sale, recap, IPO, etc.

Capital Structure

A search fund typically undergoes two stages of funding: in phase one, search capital is raised to fund the search; in phase two, once a deal is lined up, acquisition capital is raised to fund the acquisition. For both investors and entrepreneurs, it is critical to understand how each of these funding rounds is typically structured.

In the search capital round, investors acquire units in the search fund entity. Investors who participate in this round are given several important privileges in the second round, when acquisition capital is raised. First, investors in the search capital round have a right of first refusal

[1] Stanford Graduate School of Business. Search Funds–2011: Selected Observations. 2012.

during the acquisition capital round (pro rata to their investment in the search capital round). This ensures that search investors are the first to have the option of participating in any ensuing deal and are often the only ones able to do so.

Second, the search capital investments are carried into any acquisition, usually on a stepped-up basis (typically a 50% step-up). For example, a €20,000 search capital investment would be carried into the acquisition at €30,000 (typically structured in the same way as the acquisition capital). Thus, if a fund raises €300,000 in search capital, at acquisition this becomes €450,000 of equity in the acquired company. It is additional capital on which a return must be generated for investors. This step-up occurs regardless of whether the investor participates in the acquisition round.

Finally, an investment in the search capital round provides the investor with the opportunity to work closely with the entrepreneur during the search, allowing the investor to assess the searcher’s management potential and judgment, and to influence the search and acquisition process.

In the acquisition round, investors provide capital to finance the purchase of a company. The structure of this financing round may take many forms; the investor capital is senior to the common equity earned by the entrepreneur. Financing instruments are often a combination of preferred equity (with or without a coupon) and subordinated debt – investors may receive a preferred rate of return before value is accrued to the common equity (in which the entrepreneur also receives ownership). This ensures that investor capital is returned first and that entrepreneurs only participate in the incremental value generated.

An equity scheme for a search fund typically gives the entrepreneur the opportunity to earn more than 20% of the common equity in the acquired company. The equity stake is usually based on three metrics. At acquisition, the entrepreneurs generally earn the first portion of their stake. The second portion is frequently earned over time, and the final portion is often earned based on achieving a target exit IRR.

Most search funds have relied on a substantial portion of senior debt, often supplemented by a vendor loan, to finance their acquisitions.

Organizational Structure

The search fund entity usually consists of an individual entrepreneur (about half the time) or a pair of entrepreneurs. A formal or informal Board of Advisors, usually consisting of several of the fund’s investors, serves to provide support to the entrepreneur(s). This Board is meant to provide advice, mentorship and expertise that will support the entrepreneur throughout the search process. It is important to note that the entrepreneur(s) involved with the search fund do not change over the course of the fund's life: they are present throughout the process and are responsible for all of its phases. As such, successful entrepreneurs must be multidisciplinary; they must be competent in all four phases of the search fund process.

Risks and Rewards

Search funds offer both investors and entrepreneurs a unique combination of risks and rewards. On the one hand, there are the strong historical returns (in the United States) and the risk mitigation inherent to the search fund structure. Specifically, because it involves acquiring an existing profitable enterprise, the commercial risk of the investment is significantly reduced (the business model is essentially proven). Moreover, the entrepreneur is no longer required to