

Search Funds: Community Impact through Employment Growth.

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The phrase ‘impact investing’ is generally acknowledged to have emerged in 2007, and over the course of its first decade in use has been used, and in some cases abused, to define a set of laudable goals over and above the return of a financial gain. As data sets available for analysis have been amassed during that time, many impact investors have been disappointed in the actual tangible societal benefits that have been achieved, and have begun searching for strategies that actually deliver the improvements that they are trying to realize.

For the purposes of this article, we are focused on one of the specific societal benefits that impact investors are trying to achieve, namely employment expansion.

The creation of new, well-paying, career track jobs can dramatically alter the lives of those who are hired, the families they support, and the communities in which they live. Economists have detailed unemployment’s adverse economic impact on every layer of government structure, and psychologists have provided an equal amount of research showing its damage to every aspect of the psyche of those for whom jobs do not exist.

There can be no doubt of the broad societal and personal benefits realized by moving the unemployed into employment, and for double bottom line investors, that goal is an easily measurable metric to track and determine how efficiently their impact investing capital is being deployed. Increasingly, within the context of private equity investing, Limited Partners interested in the impact of their investments, particularly non-profit investors such as foundations and endowments, are asking their General Partners for the numbers of jobs created and cut.

For the private equity industry, which has often been unfairly accused of being a force for job destruction, it has proved to be an unexpected opportunity to showcase the positive impacts of its business-building skills. And within the overall industry, one niche investment strategy has demonstrated particularly remarkable job creation results, all focused on the small businesses that form the backbone of many local communities. That strategy uses a deal structure known as Search Funds.

An overview of Search Funds

The initial articulation of the Search Fund investing strategy is generally attributed to Irv Grousbeck, a highly successful entrepreneur who began sharing his business experiences as a lecturer at Harvard Business School before moving to Stanford’s Graduate School of Business, and ultimately establishing the Center for Entrepreneurial Studies. It was at Stanford that Sandro Mina, Martin Steber, and Jim Edmunds, all co-authors of this paper, first encountered Search Funds and were inspired to embark on the entrepreneurship-through-acquisition path themselves.

Search Funds are typically Limited Liability Companies (“LLCs”) formed by one or two individuals, who are focused on acquiring stable, profitable companies in the lower middle

market, generally at an enterprise value below the typical point for triggering a formal auction process. Search Funds are structured in a unique two-stage investment process: the ‘Search’ in the name represents the first stage in which young, energetic managerial talent (the “Search Managers”) raises a small amount of capital to fund the hunt for an attractive acquisition target.

The second stage is the acquisition of the target, in which the Search Managers raise additional capital from a combination of the initial investors (the “Search Funds”), which convert their previous capital contributions into equity in the new entity at a premium (usually 50%), and other outside investors depending on the purchase price. The Search Managers then become the management of the acquired company and, with the assistance of the Search Fund investors who typically will constitute the acquired company’s Board of Directors, increase the value of the company through growth in the size and scope of the business.

Job Creation Highlights

To quantify the employment generation impact of Search Fund investing, we created the “Relay-Search Fund Partners Survey”, which contacted companies acquired by Search Funds over a period of ten (10) years and collected their job growth. The pool of companies included in the survey included 64 such companies, of which 63 reported their job creation numbers (the 64th company had closed its acquisition recently and was still in its initial first 100 days’ review; its headcount changes will be included in next year’s survey). Key findings from the updated data include:

- 60/63 have created new jobs;
- 24/63 have more than doubled their headcount;
- In total, almost 8,000 new jobs were created by the 63 companies.

New, Permanent Jobs Created

The central thesis of Search Fund investing is that inserting motivated, well-trained, energetic, new management into a stable, small company will result in value creation through growth of the enterprise. The goal from the very beginning is to build a bigger, better company through the introduction of new products, the targeting of new markets, and the upgrading of the business’s technology and delivery systems.

As reflected in the data tables attached as Annex I, the job gains begin almost immediately: among the 12 surveyed companies whose acquisition had been completed within the past two years, fully 10 of them had added new jobs, with half of those having increased their headcount by more than 50%.

Sample Survey Company: Neuro International Healthcare, LLC Acquisition Completed: 04/14; Date Reported; 06/16; Headcount Growth: 60 New Jobs Company provides high-end assisted living services to people with traumatic brain injuries.

Search Fund investing creates knowledge and technical jobs, both at the entry level as new sales are secured, and at the senior level as new products are designed and deployed. Search

Fund investors, having both more investment experience and a fiduciary obligation to its Limited Partners, guide the searchers toward acquisitions of companies that are solid, profitable, and generally focused around the delivery of business services. As a result, the jobs created are permanent, and require the sort of training that gives the new hires an improved skill set, and the opportunity to develop a career path within the company and the related industry.

One of the key elements of building a bigger, better company is to move the acquired entity up the value chain. This transition usually means the introduction of new technologies and/or the requirement of more elaborate delivery systems. The more complicated tasks invariably require more, higher trained employees. As a consequence of this acquisition and management strategy, Search Fund investing does not create seasonal, retail, agricultural, or manual labor jobs.

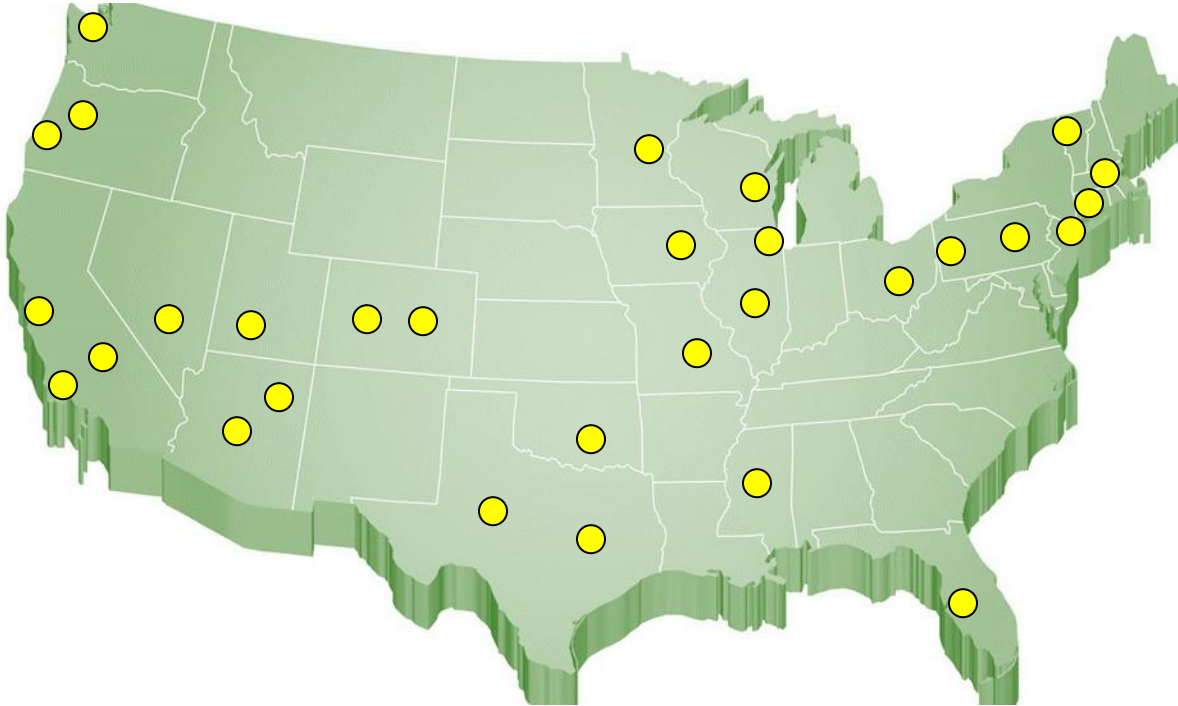
Sample Survey Company: UCIT Online Security, Inc.

Acquisition Completed: 05/11; Date Reported; 06/16; **Headcount Growth: 121 New Jobs**

Company is the premier provider of video surveillance in Canada.

Another key understanding among the participants is that the searcher will move to wherever the best opportunity is found, and more often than not, the most attractive companies with the most growth potential are found in cities different from where the search is located or the searcher went to business school. The result is that Search Fund-acquired companies are found and grown across the US in communities large and small and in areas industrial and rural. Also, as indicated in the note below the following map, the Search Fund model has expanded internationally in recent years, resulting in new job creation in parts of the world where there has not historically been a pull toward entrepreneurialism.

US Cities Included in the Relay – Search Fund Partners Survey



Other Countries Included in the Survey:
Canada, Mexico, Spain, Germany, and Kenya

Job Creation is Built into the Search Fund Model

Search Fund investing is successful when jobs are created, because that means the company is succeeding in growing. Search Fund investors focus on generating value through addition instead of through cost reduction and financial engineering. And to ensure that the acquired company is managed for growth rather than for capital maximization, Search Fund acquisitions are completed with much less leverage than usual private equity transactions; the new managers are thus free to run the company for its own benefit, not for the bankers.

The job gains are built into the asset management plan: as new markets are targeted, additional sales and customer service personnel are required; as product and service enhancements are sought to upsell current customers, more engineers and support personnel are needed; and as new technologies and systems are implemented to improve the company's operations, more developers and technical personnel have to be hired. As opposed to pure financial investors who are consumed by cost cutting, Search Fund investors welcome this staffing gain because it reflects the ascension of the portfolio company up the value ladder in its target sector.

Sample Survey Company: T-Base Communications, Inc.
Acquisition Completed: 10/14; Date Reported; 06/16; **Headcount Growth: 17 New Jobs**
Company uses proprietary software to help large companies communicate with the blind.

Conclusion: Search Fund Investing Satisfies Impact Investing's Double Bottom Line

Search Fund investing, through its focus on entrepreneurialism and growth, is an excellent creator of new, permanent, quality jobs – and those new employment opportunities are spread throughout the country. Since the Stanford bi-annual study of the investment strategy has demonstrated an IRR of 34%-37% for more than 20 years, Search Fund investing offers compelling results for double bottom line investors.

Current Results of the Relay-Search Fund Partners Job Growth Survey

Time Owned	Company	Headcount		Growth		Timeframe	
		Start	End	Number	%	Begin	End
Less than 2 years	Company 1	16	18	2	12.50%	Apr-14	Jun-16
	Company 2	25	31	6	24.00%	Oct-14	Jun-16
	Company 3	93	153	60	64.52%	Mar-14	Dec-14
	Company 4	162	292	130	80.25%	Mar-14	Jun-16
	Company 5	0	15	15	N/A	Jun-16	Dec-14
	Company 6	80	81	1	1.25%	Sep-14	Dec-14
	Company 7	60	67	7	11.67%	Oct-14	Jun-16
	Company 8	17	13	-4	-23.53%	Dec-15	Jun-16
	Company 9	60	215	155	258.33%	Aug-14	Jun-16
	Company 10	43	47	4	9.30%	Jul-15	Jun-16
	Company 11	5	9	4	80.00%	Jul-15	Jun-16
	Company 12	N/A	N/A	N/A	N/A	N/A	N/A
	Company 13	17	17	0	0.00%	Apr-16	Jun-16
Totals/ Averages		578	958	380	47.12%		
2 - 5 Years	Company 14	9	13	4	44.44%	Oct-13	Jun-16
	Company 15	43	45	2	4.65%	Apr-13	Jun-16
	Company 16	33	49	16	48.48%	Dec-13	Jun-16
	Company 17	55	110	55	100.00%	Dec-10	Feb-13
	Company 18	430	575	145	33.72%	Oct-12	Jun-16
	Company 19	0	1016	1016	N/A	Jan-10	Jun-16
	Company 20	12	47	35	291.67%	Oct-10	Feb-14
	Company 21	0	630	630	NA	Nov-10	Jun-16
	Company 22	140	190	50	35.71%	Oct-10	Jun-16
	Company 23	23	50	27	117.39%	Dec-11	Jun-15
	Company 24	35	47	12	34.29%	Feb-12	Dec-14
	Company 25	80	80	0	0.00%	Dec-12	Dec-14
	Company 26	51	172	121	237.25%	Apr-11	Jun-16
	Company 27	37	189	152	410.81%	Apr-12	Jun-16
	Company 28	35	50	15	42.86%	Apr-13	Apr-14
	Company 29	70	120	50	71.43%	Dec-10	Jun-16
	Company 30	165	215	50	30.30%	Jan-14	Jun-16
	Company 31	32	137	105	328.13%	Jun-11	Jun-16
	Company 32	68	130	62	91.18%	Mar-97	Dec-99
	Company 33	7	14	7	100.00%	May-11	Dec-14
	Company 34	110	250	140	127.27%	Nov-11	Dec-14
	Company 35	5	44	39	780.00%	Feb-12	Jun-16
	Company 36	360	430	70	19.44%	Jan-14	Dec-14
	Company 37	90	150	60	66.67%	Jun-05	Jun-09
	Company 38	196	344	148	75.51%	Dec-12	Jun-16
	Company 39	16	26	10	62.50%	Oct-10	Dec-14
	Company 40	23	60	37	160.87%	Dec-12	Jun-16
	Company 41	25	62	37	148.00%	Dec-10	Jun-16
	Company 42	22	44	22	100.00%	Dec-13	Dec-14
	Company 43	210	165	-45	-21.43%	Jan-12	Dec-14
	Company 44	19	47	28	147.37%	Jun-11	Dec-14
	Company 45	39	20	-19	-48.72%	Dec-10	Jun-16
	Company 46	58	92	34	58.62%	Dec-94	Feb-96
	Company 47	105	549	444	422.86%	Aug-97	Dec-00
Company 48	75	90	15	20.00%	Jun-15	Jun-16	
Company 49	20	23	3	15.00%	Feb-15	Jun-16	
Company 50	28	48	20	71.43%	Jan-15	Jun-16	
Company 51	225	637	412	183.11%	Dec-12	Jun-16	
Company 52	18	20	2	11.11%	May-15	Jun-16	
Totals/ Averages		2969	6980	4011	119.51%		
Over 5 Years	Company 53	35	3200	3165	9042.86%	Dec-03	Dec-14
	Company 54	15	90	75	500.00%	Nov-09	Jun-16
	Company 55	48	125	77	160.42%	Nov-04	Dec-14
	Company 56	49	45	-4	-8.16%	Dec-09	Dec-14
	Company 57	0	20	20	N/A	Mar-09	Dec-14
	Company 58	12	60	48	400.00%	Jun-03	Jul-08
	Company 59	4	9	5	125.00%	Feb-09	Dec-14
	Company 60	3	135	132	4400.00%	Sep-10	Jun-16
	Company 61	85	425	340	400.00%	Jan-06	Jun-16
	Company 62	26	32	6	23.08%	Feb-10	Jun-16
	Company 63	34	50	16	47.06%	Jul-08	Jun-16
	Company 64	46	305	259	563.04%	Oct-07	Jun-16
Totals/ Averages		357	4496	3317	3234.42%		