Search for an alternative source of funding

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What do you do if you aspire to entrepreneurship but lack practical experience and a killer business plan? That was the challenge for Simon Webster in 1991.

Until then he had been an engineer at IBM in London, watching enviously as colleagues left Big Blue to set up on their own. “I took a long, hard look at my career,” says Mr Webster, who was then aged 31.

The solution presented itself during an MBA course at London Business School. Instead of raising **private equity funds** to start his own business, Mr Webster would get people to back him to buy an existing company, probably in the doldrums, that he could reinvigorate to turn into a high-growth entrepreneurial venture.

The means to do this would be a search fund, a pot of money provided by wealthy individuals that would pay Mr Webster to find the right company to buy.

The investors could then put money into a much bigger fund that would enable Mr Webster to acquire the target company. He spent seven months raising £80,000 ($127,000, €86,000). “This was the hardest part, because it was just a concept,” he says.

Search funds have been operating in the US for 25 years or so, generating significant returns for a small but growing number of investors. They are typically run by one or two MBA graduates looking to buy a company in the $4m-$20m (€2.7m-€13.5m, £2.5m-£12.6m) revenue range. A common target for a search fund is a family business where the heirs do not want to take control of the company, says Bill Egan, founder and managing partner at Boston-based private equity business Marion Equity Partners, who has been one of the most prolific investors in search funds.

“I think one of the reasons these young search funders do well is because for a lot of the sellers they like the idea that these people remind them of when they started their business,” he says. “They are full of energy.”

Yet the number of aspiring entrepreneurs in the US who are backed by search funds remain rare – and rarer still in the UK and the rest of Europe. Mr Webster is an exception – but his own experiences, he says, convince him that the UK in particular could be more promising for search funds, thanks to rules on disclosing financial information and the investment community networks.

The first known search fund was formed in 1984 by Jim Southern, a Boston investor, who bought a printing company turning over $40m and ended up providing his investors with 35 times their original stake. Mr Southern has since become a serial search fund entrepreneur. He claims his search funds have generated 14 times the capital he placed in 20 companies over an average holding period of eight years.

The strength of good search funds is their board of directors, says Mr Southern. “In almost every search fund, the board [comprises] people who have skin in the game,” he says. “Most of those will be successful entrepreneurs themselves.”

Europe should be ripe for search fund entrepreneurs, because it has so many family businesses with succession problems. The differences between the Anglo-Saxon enterprise model and continental European ways of doing business, however, often make such deals impossible.

It was Rob Johnson, an American, who first introduced Mr Webster to the idea of search funds, when he was a lecturer at London Business School. He has since moved to Paris and also teaches business students in Spain. He claims there are several countries in continental Europe where search funds could never work, because families would be unwilling to relinquish control of their enterprises. “In Spain, there is a whole issue of families not wanting to give up their businesses,” he says. “It is true to an extent in Germany too.”

British business owners are more accustomed to selling their ventures, although even here the concept is considered an odd way to operate, Mr Johnson adds. “In the UK, most investing grew up in the buy-out area, so there is a mentality that people want someone who has run a division before. This is the opposite of what search funds try to do.”

Narrow appeal of search funds

A search fund is a pool of capital raised to support the efforts of an entrepreneur, or team of entrepreneurs, to locate a privately held company for acquisition. Such acquisitions made by search fund principals are financed using additional sources of capital. In a typical search fund, however, the bulk of this capital is raised from the investors that contributed initially.

Since the first known search fund was formed in 1984, would-be entrepreneurs have been attracted for two key reasons.

First, they offer relatively inexperienced professionals with limited capital resources a quick path to owning and managing a small business. Second, search funds have proved to generate significant financial returns for a small but growing number of investors. In spite of this, few business school graduates, even in the US, raise search funds each year.

In Mr Webster's case, once he had the search fund backing, he embarked on the process of finding a company to buy, which took three-and-a-half years. He bought RSL, a family-owned prosthetics manufacturer, for about £3m, with £1m provided by the search fund. Two of the search fund investors joined the board.

Perhaps surprisingly, Mr Webster, who has used other funding methods, claims that the wait to find an acquisition made him more, not less, enthusiastic about being a search fund entrepreneur. "For me, it was 'Wow, we are really making a difference to people's lives'," he recalls. "If we did our job properly, it would be something to feel good about."

Success did not come easily. Three months after the purchase, RSL lost a big contract that wiped out a third of the search fund's investment. "It was very painful," Mr Webster says, but adds that he had been lucky to have built personal bonds with his investors during the search process.

The narrow appeal of search funds may be explained at least partly by the non-traditional financial outlook for search fund principals. While many post-MBA compensation packages include a high starting salary and a signing bonus, the search fund entrepreneur commands a relatively low income through most of the process.

The financial upside to the search fund entrepreneur comes, if it comes, upon exit.

"They were fantastic," he says. "They had been in these situations many times before and they weren't panicking. They learnt how to support, not where to kick."

Mr Webster discovered his skill was in sharpening up the financial and marketing side of RSL. As a result, he quickly doubled turnover in the business to £7m, enabling him to buy a complementary business he had looked at during the search process. He sold RSL in December 2005 and stayed as chief executive until October 2007.

Mr Webster believes part of the reason the UK is failing to achieve its potential in search funds is that top business schools are not backing the idea. In the US, Harvard and Stanford are cheerleaders for search funds, helping to give the concept validation among serious investors.

Mr Webster believes, however, that British search fund investors could have a big advantage over their US counterparts, because the UK makes a lot more financial information about companies publicly available. He adds that raising search funds should also be easier in the UK because it has a more tightly knit investor community than in the US.

So, in addition to maintaining an interest in a couple of businesses, he has just started the **British Search Fund Association**, which aims to spread information about search funds. "One of my frustrations is that this thing has taken off in the US but is still embryonic over here," he says.

Meanwhile, Mr Johnson believes the UK could well follow a similar path to the US, and even catch up with it in the medium term. As he acknowledges, however, "it is going to take a few more visible successes".