

## **CES Search Fund Event November 8, 2004**

### **Guest speakers:**

Janet Dunlap, Attorney Goodwin Procter, Boston  
Lew Davies, Founder and Managing Principal the Cambria Group, Investor  
Christian Lawrence, Principal Liffey-Thames, Search Funder  
Pratap Mukherjee, CEO Beacon Fire & Safety, Search Funder

**\*\*\*\*Disclaimer: Notes below are paraphrased and not verbatim.\*\*\*\***

### **Janet Dunlap:**

#### **Trends she is witnessing from her perspective as an attorney representing search funders:**

- 1) Seeing more business schools represented in SF pool. Still about 70% Stanford, 20% Harvard and then some Penn, Chicago and Babson. It is difficult for students from the other schools to start building a new network, but it's good for all search funders in that it is educating and bringing new investors into the SF fray.
- 2) There are more solo searchers. Among those solo searchers, many are self-funding their searches. They also tend to be more restrictive in their search.
- 3) A new breed of search funders is arising with less management experience before business school than typically seen in the past. It is too early to say if this impacts success. The youngest search funder I have seen was about 24/25. The range seems to be around 24-45.
- 4) Searches are taking longer, now about 18 months-2 years. Janet recommends raising enough to sustain you for 2-3 years.

#### **Common questions Janet receives from clients/potential clients:**

##### **Q: What information should I put in my private placement memorandum (PPM)?**

A: most search fund PPMs look like everyone else's b/c you copy each other. That said, writing the PPM is an important exercise b/c it makes you think about that you are doing. Key points include:

- ☐ Don't make any promises re. Returns, time frame, etc. No promises, only what you will try to do.
- ☐ Watch out where you send this document. If you do a blanket campaign, you may be violating SEC laws by doing what is called a "general solicitation"
- ☐ Focus on the fact that this document is to raise money for the search, so you need to focus on your methodology/approach, not so much on what company you will buy. At this point, you won't know what the deal structure for acquisition will be or other details about the company.

##### **Q: Whom should I raise money from?**

A: You need to think about whom you are taking money from. What characteristics do they have with respect to their ability and desire to fund you and what kind of valuable advice and experience do they have to share. Because of SEC disclosure requirements, your investors must be accredited investors. You *can* take money from non-accredited investors, but when you do your acquisition you will be required to produce volumes of disclosures that would not be necessary with accredited

investors. As accredited investor standards are subject to change, please check. The current standard is at least \$1MM in net worth and income greater than \$200,000 for the past two years.

**Q: Why do I need a legal document for the search?**

A: You don't absolutely need one, but here's why I recommend one: A document will spell out all the details of the step-up, pro-rata shares and other important components of your agreement. When you do complete an acquisition, you will need a Limited Liability Corporation (LLC) operating agreement. In the midst of negotiating a company and raising the money, you don't want to also be hammering out an additional legal document. This document will also set expectations with your investors regarding your equity portion, so this won't become a surprise at the time of acquisition. Finally, at least in my practice, I will cap fees during the search stage, so it's good to do your LLC agreement then. At the time of the acquisition, fees are not capped.

**Q: Regarding the actual acquisition, at what point do I need to get a lawyer involved?**

A: BEFORE you sign a letter of intent. When it's starting to look like a deal will really get done, that's a good time to bring in your attorney. The attorney can help you raise issues and perform the legal due diligence. Make sure that you have a deal before you get a lawyer or other professionals involved, though, or else you may waste money and time. A rule of thumb is when the deal is 75% done you should involve your investors and an attorney. In your LOI make sure that 1) it is not binding, and 2) there is exclusivity.

**Lew Davies, Cambria Group:**

**Q: What do you look for in an investment?**

A: We look at 4 things in the fundraising stage:

- 1) Management
- 2) The approach to the search
- 3) The investment group
- 4) Terms

Regarding management, we look for significant management and/or operating experience. Working in an operating company is also important as well as having experience managing people. We want someone who is genuinely interested in running a business. We don't want people who want to make deals instead of operating a company. If we are considering a team, we want to make sure they have good chemistry, mutual respect and complimentary backgrounds. During the search stage we really get to know the managers. How do they think, how thorough are they with due diligence, do we work well with them, how do they cull deals, etc. These things are important to us as we consider whether or not to fund an acquisition.

Regarding the approach to the search, we want people who are proactive in their search, not opportunistic. We think it's best if they are not working with intermediaries but instead are creating and working through their own channels. It helps if the candidates have thought through some industries and if they have an idea of what size of company they'd like to buy. We have seen break-points in company cash flow and the impact on pricing: <\$1MM in cash flow, <\$2-\$2.5MM in cash flow and \$3MM plus. We prefer the deals that are under \$3MM in cash flow as there are too many strategic buyers above that point, driving prices too high.

Regarding the investment group, we want to see good advisors and directors. Generally 10-18 people in the investment group are fine. Over 18 are usually too many. We want to invest a minimum of \$500K at the acquisition stage. We expect to make 5 times our money in 5 years.

Finally, regarding terms, each acquisition is a new investment decision, so funding a search does not necessarily mean we'll fund the acquisition. We consider terms such as whether or not the investors will receive a full return on capital before the management and investors share in any upside and what type of dilution we'll see.

### **Christian Lawrence:**

#### **On fundraising:**

Keep in mind that you are not just raising a few hundred thousand dollars, but when you are raising your search fund you are looking for acquisition capital. Those who buy units in your fund should be capable of funding your acquisition.

As you sell units, your fundraising efforts will gain momentum. Everyone wants to know who else is in before they will commit. Build on this momentum; advertising to people on the fence each time you sell units. This puts more pressure on them to commit. Our strategy was to say that we would close the fund when 75% had been raised. This is a risky tactic, but it worked for us to get people off the fence, and we ended up oversubscribed. It took us from June to Christmas to sell ½ our total units, and then we were oversubscribed by March. Overall, fundraising can be frustrating, but keep in mind that almost everyone who has chosen to raise a fund and is serious about it will, and the search fund model works.

When fundraising you are really selling yourself. You need to demonstrate that you've thought about the risks, and should build out a network of advisors. The more you can liven up your pitches talking about successful deals that have been done, the better.

Do not underestimate the power of referrals. We asked every person we met with for referrals to others. It is a numbers game.

#### **On finding a company:**

You basically ramp up to be a small-scale private equity firm. You have to build deal flow and credibility in a crowded market. There has been an increased awareness among sellers of the exit options, so you need to find a less competitive business to buy (e.g., don't go through intermediaries).

So that you will not waste time, qualify your sellers quickly. Find out if they are serious, if you are in the same ballpark regarding valuation, and other key points early.

#### **Our approach:**

Have a search methodology to give credibility and potentially make you less likely to make mistakes.

Potential lead sources include cold calls, trade shows, letters, industry networks/referrals, consultants, brokers and intermediaries. We found that building our own network and keeping them informed was the most useful. We also suggest using finder's fees, like \$50K for a deal that works. Chase your deals and don't waste time. Quickly sketch out deals to see if there's a chance of getting them done. Finally, as a search funder you have some advantages. The seller may be more interested in selling to you b/c you have a dream to make their company even more successful. You are not a big corporation or a private equity firm that will just make the company part of the portfolio.

**Pratap:**

**Our approach:**

We started our search fund with 3 partners, all of us good friends from business school. In retrospect, this was a mistake. One or two people is probably the right number for a search, and we are now down to 2. It was a painful process.

We decided to do a roll-up of an industry for 3 reasons:

- 1) we had seen another search funder who had success this way
- 2) we were location inflexible, focusing only on California
- 3) a roll-up had the appeal of an acquisition and a start-up, in that we would need to build infrastructure and put processes in place like a start-up. It was the best of both worlds in terms of meeting our interests.

We raised \$175,000 for three people, made a list of our criteria and brainstormed industries eventually narrowing things down to fire and safety.

**Re. After the acquisition:**

To give people some idea of what to expect, I'd like to share our challenges after the acquisitions, which were for the most part organizational.

1. Partners. As I mentioned, we lost one partner. You should choose your partners very carefully and it's best if the skills of the business match the skills of the partners. If you argue with your partner that's probably better than having someone you always agree with.
2. Removing old leadership. With these types of companies the owner tends to be the business. You will notice that the culture, the customers, and just about every aspect of the business tends to model the owner. In addition, the owner typically does a lot of work for the company, so if he or she goes, you have a lot of work to cover.
3. Creating good middle managers. In our industry, there are no middle managers. It has taken a great deal of time and effort to train employees for management. Everything from computer skills to people management must be taught.
4. Board of directors. You will have conflicts and changing minds. It is your job to demonstrate your leadership and deal with this.

**Summary:**

**Three major themes:**

1. Think through your investor base very carefully. They will be supplying your acquisition capital and become your board of directors.
2. The network is key. You are selling yourself, and your network is the best source of cash and companies.
3. You must have the energy and passion to be an entrepreneur or you shouldn't be doing this.