

PART III: SEARCH FUND ECONOMICS

OVERVIEW

This section addresses the basic economics for the entrepreneurs and investors in search fund investments.

The two key components impacting the split of proceeds in a search fund are the structure of the investor capital and the search fund entrepreneur's earned equity (referred to as "Manager Equity" in this *Primer*; also often called "Carried Interest").

Search fund investors typically structure their investments to have preference over the equity received by the searcher. By doing this, the investors maintain protection in downside scenarios by having preference on the return of their capital (and often a guaranteed minimum return on the capital) while still keeping the potential for uncapped gains. Manager Equity is usually issued as common equity; as such, only once some or all of the investor capital has been returned (often with a preferred return) does the search fund entrepreneur begin to realize value in his equity ownership in the company.

This section on economics is intended to emphasize that the primary drivers of economic return are the performance of the company and the absolute dollar gain on the investment. However, it also illustrates that the form and structure of the investors' capital has a meaningful impact on the split of proceeds between investors and search fund entrepreneurs.

INVESTOR CAPITAL

Search fund investor capital is provided in two stages: (1) to fund the search (the "search capital") and (2) to fund the company acquisition (the "acquisition capital"). Upon an acquisition, the search capital converts into the same securities issued for the acquisition capital investment; typically, this conversion is done at a stepped-up value, often 150% of the original investment, to compensate investors for the riskiest stage of the search fund.

Once an acquisition is completed, the post-closing capital structure will include some or all of the following:

- Traditional debt (e.g. revolver, senior term debt, and potentially mezzanine debt)
- Seller financing
- Investor preferred capital (e.g. subordinated debt and/or preferred stock)
- Common equity.

Investor capital can come in various forms. In 2009's financing environment, investors have structured acquisition capital to provide preference, in the form of capital structure seniority and

preferred rate of return, over the Manager Equity. This can be accomplished using various securities, including, but not limited to those addressed below.

Subordinated debt - Subordinated debt typically has a high coupon of 12-25% and is senior in the capital structure to any equity securities; the subordinated debt principal and accrued and unpaid interest must be repaid before there is any value to junior equity securities. In a search fund, the subordinated debt typically has no rights to equity (e.g. warrants), and therefore returns are capped at the coupon rate. Investors therefore structure Subordinated Debt in combination with equity securities (described below).

Preferred equity – There are many variations, and therefore room for creativity, in structuring preferred equity. Preferred equity is junior to all debt securities but senior to common equity. In search fund, preferred equity is most often issued as participating preferred stock or convertible preferred stock:

- *Participating preferred stock* offers the holder the right to BOTH (a) the initial value plus accumulated and unpaid preferred dividends (if any); PLUS (b) 100% of the common equity less vested Manager Equity (described below) upon sale or liquidation. Participating preferred stock can be issued as redeemable participating preferred stock or non-redeemable participating preferred stock:
 - *Redeemable participating preferred stock* can be redeemed in whole or in part prior to a sale, recapitalization or liquidation. However, the stockholders' common equity ownership does not decrease with early redemption.
 - *Non-redeemable participating preferred stock* cannot be redeemed prior to a sale, recapitalization or other liquidity event as defined by the terms of the agreement.
- *Convertible preferred stock* offers the holder the right to EITHER (a) the initial value plus accumulated and unpaid preferred dividends (if any); OR (b) a predetermined number of common equity shares. If the underlying common equity value of convertible preferred stock is less than the accreted face value, the investors keep the preferred stock and are paid out before the common equity has any value. In this scenario, the investors' return is capped at the dividend rate of the convertible preferred stock and the return is substantially similar to subordinated debt. In an upside scenario where the underlying common equity value is greater than the accreted value, the investors convert into common equity and have the ability to receive uncapped capital gains (along with the searcher).

For the sake of simplicity, the following analysis focuses on just two potential structures of investor capital:

- Structure A: Nonredeemable Participating Preferred Stock with Preferred Return (usually ~6-10%)
- Structure B: 50/50 split of
 - Subordinated Debt (~12-25% coupon)
 - Nonredeemable Participating Preferred Stock with No/Low Preferred Return (~0-5%).

Structure A and Structure B can be substantially equivalent at certain interest rates and preferred returns. For instance, Structure A using a 10% preferred return and Structure B using a 17% coupon on subordinated debt and 0% preferred return on non-redeemable preferred equity yield almost identical principal accretion (assuming the subordinated debt remains outstanding):

Structure A vs. Structure B

	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7
Structure A:								
10% Non-Redeemable Preferred Equity	\$ 5,000	\$ 5,500	\$ 6,050	\$ 6,655	\$ 7,321	\$ 8,053	\$ 8,858	\$ 9,744
Face Value of Investor Capital	\$ 5,000	\$ 5,500	\$ 6,050	\$ 6,655	\$ 7,321	\$ 8,053	\$ 8,858	\$ 9,744
Structure B:								
17% Subordinated Debt	\$ 2,500	\$ 2,925	\$ 3,422	\$ 4,004	\$ 4,685	\$ 5,481	\$ 6,413	\$ 7,503
0% Non-Redeemable Preferred Equity	2,500	2,500	2,500	2,500	2,500	2,500	2,500	2,500
Face Value of Investor Capital	\$ 5,000	\$ 5,425	\$ 5,922	\$ 6,504	\$ 7,185	\$ 7,981	\$ 8,913	\$ 10,003
<i>Structure A vs. Structure B</i>	\$ -	\$ 75	\$ 128	\$ 151	\$ 136	\$ 71	\$ (55)	\$ (260)

Similar equivalencies can be calculated across a range of coupon combinations. So, why choose one structure or the other? Based on investor interviews conducted in February to April 2009, investors representing private equity funds preferred structuring their investments as Structure A. Many high net worth individuals who have invested in search funds and/or had successfully run their own search funds advocated Structure B.

The advantages/disadvantages of each structure for the investor and the entrepreneur are depicted in the following chart.

	Structure A (Preferred Equity)	Structure B (split of Subordinated Debt and Preferred Equity)
Investor	<p><u>Pros</u></p> <ul style="list-style-type: none"> • Maintains uncapped returns on entire investment • Original investment plus preferred return on investment is senior to searcher's equity • Provides downside protection <p><u>Cons</u></p> <ul style="list-style-type: none"> • May lead to misalignment of interests between searchers and investors in mid-growth scenarios • May promote excessive risk-taking by searcher to create outsized growth in equity 	<p><u>Pros</u></p> <ul style="list-style-type: none"> • Focuses managers on cash flow generation and early return of capital • Provides opportunity to take “chips off the table,” and therefore opportunity to reinvest redeemed capital in other growth investments while still preserving upside potential <p><u>Cons</u></p> <ul style="list-style-type: none"> • Caps return on half of investment to coupon rate • Early return of capital can boost IRR which allows searchers to vest into common equity and dilute investors
Searcher	<p><u>Pros</u></p> <ul style="list-style-type: none"> • Cheaper capital over longer investment horizons versus Structure B if company does not generate free cash flow in early years <p><u>Cons</u></p> <ul style="list-style-type: none"> • No ability to pay down expensive component of capital structure • In mid-growth scenarios, accretion of preferred equity prevents growth to common equity 	<p><u>Pros</u></p> <ul style="list-style-type: none"> • Allows pay down of expensive component of capital structure • Paying down subordinated debt creates value for common equity • Early return of capital can boost IRR so searcher vests into common equity <p><u>Cons</u></p> <ul style="list-style-type: none"> • Better suited for companies that generate meaningful free cash flow

Some investors warned that Structure A could be “massively de-motivating to managers” and could have “a devastating effect on the entrepreneur.” These negative consequences are more acute in equity growth scenarios that approximate the coupon of the participating preferred equity. In these cases, the value of the entrepreneur’s common equity is reduced due to the compounding preferred security continuing to accrete in value senior to his/her common equity stake. Ultimately, investors all noted that the equity capital should be structured to align the interests of investors and entrepreneurs.

MANAGER EQUITY

A typical search fund entrepreneur will vest into 20-30% of the common equity ("Manager Equity") of the acquired company in three equal tranches:

- Tranche 1: Upon acquisition of a company;
- Tranche 2: Over time, as long as searcher remains an employee of the acquired company (commonly, a 4-5 year vesting schedule with acceleration upon liquidity event); and
- Tranche 3: By achieving performance benchmarks (e.g. IRR hurdles).

Partnerships typically earn 30% of the common equity while solo searchers earn 20-30%.

Performance benchmarks generally start at 15-20% IRR to investors and max out at 30-40% IRR, net of Manager Equity. Performance vesting can be on a sliding scale or in increments upon achieving minimum thresholds (e.g. 15%, 20%, 25% and 30% IRR hurdles). In some instances, the performance vesting may be based upon achieving key performance hurdles such as cumulative EBITDA, number of new product launches, customers or new services offered, paying off investor's subordinated debt, etc. Investors may also set benchmarks based on Return on Invested Capital (i.e. cash-on-cash return) rather than IRR.

In many instances, the entrepreneur can negotiate that if a liquidity event has not occurred after five years, a third-party valuation of the company is performed and the IRR calculated at that point for purposes of vesting the performance equity.

VALUE CREATION

There are three primary levers used to create equity value in any company:

Operations

- Revenue growth through sales and marketing efforts or strategic initiatives (e.g. new products/services, geographic expansion, pricing)
- Margin expansion through cost reduction or operating leverage
- Add-on acquisitions to enhance scale, product/service offerings, or capabilities

Finance

- Capital structure decisions
- Cost of capital
- Capital intensity reduction – fixed assets, working capital, and/or capital expenditures

Valuation Multiple

- Buy at lower multiples, sell at higher multiples

Of these three levers, managers can influence operations and finance most effectively. It is useful for a search fund entrepreneur to analyze potential acquisition opportunities by considering what “bets” he is making to drive equity value creation. For instance, an acquisition opportunity may have incredibly high growth potential but also a high valuation multiple. Does the entrepreneur believe he can hit the growth targets necessary to justify a high entry valuation multiple? Alternatively, another investment opportunity may have slower growth but high fixed asset intensity. Does the entrepreneur believe he can reduce capital requirements to generate a cash-on-cash return to be attractive to investors and him?

There is no right or wrong answer to these questions. Rather, the entrepreneur should match his/her personal risk/reward profile and operating strengths with the characteristics of the investment.

HYPOTHETICAL EXAMPLE OF SEARCH FUND ECONOMICS

To illustrate the potential economics of a search fund investment, we will take a representative search fund transaction and manager equity package and apply two different options of investor capital. To see the impact on returns to investors and searchers, we’ll run three different operating scenarios:

Summary of Operating Scenarios

	Optimistic	Base Case	Pessimistic
Revenue Growth	15.0%	5.0%	--
Annual EBITDA Margin Expansion	50 bps	25 bps	--
Exit Multiple	5.0x	4.5x	4.0x
Increase in Net Working Capital	20% of Revenue Growth		
Cash Tax Payments	40% of Earnings Before Taxes		
Depreciation & Amortization	\$500K in Year 0; fixed margin throughout		
Capital Expenditures	Equal to Depreciation & Amortization		

The representative transaction, with the capital structure at closing, follows.

Transaction assumptions:

- \$15 million in sales and \$3.0 million EBITDA
- 4.5x EBTIDA purchase multiple (\$13.5 million purchase price)
- 1.0x traditional Senior Debt
- 1.5x Seller Debt

Acquisition Capitalization

	\$000s	EBITDA Mult.	% of Total	Rate	
				Cash	PIK
Senior Debt	\$3,000	1.0x	21.5%	8.0%	--
Seller Financing	\$4,500	1.5x	32.3%	--	10.0%
Investor Capital (a)	\$6,450	2.2x	46.2%	n/a	n/a
Total (b)	\$13,950	4.7x	100.0%		

(a) Includes search capital of \$300K at 50% step-up. Acquisition cash investment of \$6,000K.

(b) Ignores transaction costs.

We will analyze the differences in returns to both investors and searchers under two different structures for the investor capital:

- Structure A: 10% Nonredeemable Participating Preferred Stock
- Structure B: 50/50 split of:
 - 17% Subordinated Debt
 - 0% Nonredeemable Participating Preferred Stock

Regardless of the structure of investor capital, the search fund principal will receive the following Manager Equity package:

- Potential of 30% of Common Equity
 - 1/3 (10%) vests at acquisition
 - 1/3 (10%) vests over 4 years
 - Up to 1/3 (10%) vests according to net investor IRR performance hurdles
 - 2.5% if IRR > 20%
 - 5.0% if IRR > 25%
 - 7.5% if IRR > 30%
 - 10.0% if IRR > 35%

Following is a summary of the results in each of the three operating scenarios described above depending on whether Structure A or Structure B is used for Investor Capital:

Summary of Returns (\$000s)

	Investors		Seacher	
	Structure A	Structure B	Structure A	Structure B
Optimistic Case	\$ 27,385	\$ 26,078	\$ 6,447	\$ 7,186
Base Case	\$ 15,410	\$ 14,832	\$ 1,256	\$ 1,346
Pessimistic Case	\$ 9,528	\$ 9,096	\$ -	\$ -

As illustrated, the greatest driver of economic returns to investors and searchers is the company's operating performance and total gain on the investment. However, the structure of investor capital impacts the split of the proceeds between investors and searchers in a meaningful way.

Note that the economics to the searcher would be split in a partnership scenario.

The following two tables provide more detail on the results of the three operating and two financing cases described. Financial models with more detail on each scenario can be found in Exhibit 12.

SUMMARY CASH FLOW MODEL & RETURNS - INVESTOR CAPITAL STRUCTURE A

(US\$ in 000s, except where noted)

	<u>Optimistic Case</u>	<u>Base Case</u>	<u>Pessimistic Case</u>
<u>Operating Assumptions:</u>			
Annual Revenue Growth	15.0%	5.0%	0.0%
Annual EBITDA Margin Expansion	50 bps	25 bps	0.00%
Exit Valuation Multiple	5.0x	4.5x	4.0x
Year 5 Sales	\$ 30,170	\$ 19,144	\$ 15,000
Year 5 EBITDA	\$ 6,788	\$ 4,068	\$ 3,000
Exit TEV	\$ 33,942	\$ 18,307	\$ 12,000
Less: Net Debt	109	1,641	2,472
Total Equity	\$ 33,833	\$ 16,666	\$ 9,528
Redeemable Preferred Equity	\$ -	\$ -	\$ -
Non-Redeemable Preferred Equity	10,388	10,388	9,528
Value of Common Equity	\$ 23,445	\$ 6,278	\$ (0)
<u>Returns:</u>			
Investor Redeemable Preferred Equity	\$ -	\$ -	\$ -
Investor Non-Redeemable Preferred Equity	10,388	10,388	9,528
Investor Common Equity	16,998	5,022	-
Total Return to Investors	\$ 27,385	\$ 15,410	\$ 9,528
Original Investment	\$ 6,300	\$ 6,300	\$ 6,300
Return on Invested Capital	4.3x	2.4x	1.5x
Investor IRR	33.9%	19.4%	8.4%
Manager Common Equity Ownership %	27.5%	20.0%	20.0%
Manager Payout	\$ 6,447	\$ 1,256	\$ -

SUMMARY CASH FLOW MODEL & RETURNS - INVESTOR CAPITAL STRUCTURE B

(US\$ in 000s, except where noted)

	Optimistic Case	Base Case	Pessimistic Case
<u>Operating Assumptions:</u>			
Annual Revenue Growth	15.0%	5.0%	0.0%
Annual EBITDA Margin Expansion	50 bps	25 bps	0 bps
Exit Valuation Multiple	5.0x	4.5x	4.0x
Year 5 Sales	\$ 30,170	\$ 19,144	\$ 15,000
Year 5 EBITDA	\$ 6,788	\$ 4,068	\$ 3,000
Exit TEV	\$ 33,942	\$ 18,307	\$ 12,000
Less: Net Debt	6,762	7,247	7,247
Total Equity	\$ 27,180	\$ 11,059	\$ 4,753
Subordinated Debt	\$ -	\$ 1,105	\$ 1,977
Non-Redeemable Preferred Equity	3,225	3,225	2,776
Value of Common Equity	\$ 23,955	\$ 6,729	\$ 0
<u>Returns:</u>			
Investor Subordinated Debt (a)	\$ 6,085	\$ 6,224	\$ 6,320
Investor Non-Redeemable Preferred Equity	3,225	3,225	2,776
Investor Common Equity	16,768	5,383	-
Total Return to Investors	\$ 26,078	\$ 14,832	\$ 9,096
Original Investment	\$ 6,300	\$ 6,300	\$ 6,300
Return on Invested Capital	4.1x	2.4x	1.4x
Investor IRR	35.3%	20.0%	8.2%
Manager Common Equity Ownership %	30.0%	20.0%	20.0%
Manager Payout	\$ 7,186	\$ 1,346	\$ -

(a) Includes early paydown of Subordinated Debt and accumulated interest where applicable.