Inclusive Search Fund Concept Paper

An increasing number of business owners are looking to retire and transition ownership. Estimates suggest over 3 million businesses across North America are owned by Baby Boomers, employing approximately 35 million people[1]. According to recent surveys, more than 40% of these owners plan on retiring in the next 5 years, creating a risk to employees and communities across North America.

Most small businesses don't have a succession plan, which limits their exit alternatives. Less than a quarter of business owners see succession within their family, or to key employees, as a viable exit strategy. As a result, the most attractive option is to sell the company to a third party.

Search funds are positioned to be a leading purchaser of the best small businesses. As business owners have edged closer to retirement, search funds have proliferated. Our analysis of Searchfunder.com shows that there are now over 130 search funds in North America searching for acquisitions, up 160% from 2013. We estimate that these search funds have dry power in excess of $1 billion and are one of the only buyers for small business with under 25 employees.

Search funds are an investment vehicle through which an entrepreneur raises capital to acquire a business they plan on operating. Typically, "searchers" raise capital to cover their living expenses while they pursue acquisition opportunities. Investors are high net worth individuals, while there are now some funds dedicated to supporting search funds. These investors will finance both the search and the eventual acquisition cost, and grant equity to searchers according to the return the investors receive.

We're concerned that search funds lack diversity, industry experience and appropriate incentives. According to research from Stanford, approximately 95% of searchers are men and 80% are MBA educated. Very rarely do searchers have prior experience in the industry or the community they buy into. Moreover, the economics of the search funds promote risk-taking and almost always require the business be sold after 5-7 years. This is because investors require both a 30% annual return before searchers receive their full equity compensation and also have contractual rights to force a sale.

Social Capital Partners ("SCP") is seeking like-minded partners to design and launch a more inclusive search fund model. We believe there are fundamental issues with the search fund model that will increase inequality and decrease economic stability. A new model for search funds would be accessible to diverse populations, and prioritize individuals who have prior experience in the industry and community they're acquiring into. In addition, it would include economics that enable entrepreneurs to build equity faster, enhance business stability, and deliver fair returns to investors without requiring an exit. We have some ideas on how this can be done, but are looking for a lead partner to take ownership of this initiative.

About Social Capital Partners

Social Capital Partners is a non-profit that designs projects to create economic opportunity. We're independently funded, so we try to take risks that others can't. Our team comes from the private sector, bringing a range of experiences as executives, entrepreneurs and investors. We're currently rethinking how private company ownership can be designed to broaden access to wealth.

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[1] Aggregate of information available from StatsCan and US Census, with supporting analysis from Project Equity.

Social Capital Partners

	Process	Barriers
STAGE 1: Raise Initial Capital *2-6 MONTHS*	• "Searchers" raise funds from investors typically familiar with the search funds, to fund living related expenses while pursuing acquisitions • At this stage, searchers will negotiate and agree to certain economic terms* with investors	• **Investor Bias:** typical funders are high net worth investors with a bias towards MBAs, consultants, Investment bankers and private equity professionals. • **Access to Investors:** without certain educational or professional backgrounds it can be tough to access funding network
STAGE 2: Search *12-24 MONTHS*	• Searchers typically pursue transactions through established brokers (i.e. investment bankers) • Sometimes searchers contact business owners directly to negotiate on a proprietary basis	• **Access to Brokers**: relationships with investment bankers can be difficult to form especially if not viewed as "credible" • **M&A Deal Terms**: communicating with brokers and issuing non-binding offers requires an understanding of the market and deal terms
STAGE 3: Acquisition *3-4 MONTHS*	• A searcher receives exclusivity from a business owner after having agreed to deal terms • The searcher typically has 3-4 months to complete due diligence and finalize financing	• **Due Diligence**: due diligence is a necessary but challenging process requiring specific skills and experience •**Access to Debt**: lenders often have similar biases to brokers and investors • **Document Negotiation**: completing a transaction requires many complex legal agreements
STAGE 4: Operation *4-7+ YEARS*	•Searcher becomes the president/CEO and operates the company after a transitionary period with the prior owner •Often times search funds consider additional "bolt on" acquisitions •The original investors form the board of directors	• **Standard Owner/Operator Challenges**: most searchers will have never been the "CEO" and managed a business before • **Board of Directors and Investor Pressure**: the Board and investors can create added pressure on performance, especially if there are different exit expectations
STAGE 5: Exit *6 MONTHS*	•Investors require liquidity and therefore can force a company sale •Preference is often to sell the company to a private equity buyer or a strategic buyer • Searchers receive additional payout based on investor returns	•**Limited Exit Options:** search fund investors usually require a company sale even if the searcher would prefer to continue operating the company •**Managing Sale Process**: sale processes are complex and take time away from running a business

* Searchers obtain 8.33% upfront, an additional 8.33% vesting over 4-5 years, and a final 8.33% based on returns – minimum 20% fully vested at 30%

Intermediary Design

Designing an intermediary to create a more inclusive search fund model requires a holistic and flexible approach to eliminating barriers. In order to achieve this, we believe a solution would need the following elements in order to be successful:

1. **Flexible Pipeline:** In addition to being capable of helping searchers find an acquisition opportunity, an intermediary could also help searchers and owners navigate unique situations, for example a situation where an owner would like to transition to a high performing employee.
2. **Integrated Partnerships:** Connecting into the existing ecosystem for small business acquisition can limit the resource burden on an intermediary. Important partners would provide access to sources of capital, businesses, and potential searchers, and could include, but are not limited to, traditional financial institutions, brokers, aligned investors, and entrepreneurship support organizations.
3. **Comprehensive Support Services:** An inclusive search fund model requires an intermediary that provides more than just access to capital. This intermediary would need to provide a range of in-house services to serve as a trusted partner and advisor to both searchers and business owners.
4. **New Financial Structure:** The intermediary would also need to rethink how the capital provided to search funds is structured in order to lessen the pressure on "exits".

An example of an initial intermediary design could include the following components: