

FIRST FIVE YEARS OF IMPLEMENTATION OF THE SEARCH FUND MODEL IN FRANCE



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As the Search Fund model is about to celebrate its 5th anniversary in France, it is time to look at how it has been unfolding in the French small/smids MBI market and see whether trends can be drawn from this diagnosis.

As a flash reminder or very quick glance, the search fund model, created almost 30 years ago in the US to address specific local issues, has become increasingly popular in France as a viable alternative to traditional entrepreneurship and private equity investing and stages:

- ▶ A community of investors characterized by an absence of affirmed lead investor, originally all entrepreneurs in their past lives but whose typology has diversified (i.e., family offices, venture capital firms and even some institutional investors), ready to accompany and mentor a searcher;
- ▶ A young international MBA future CEO, closing a successful first step of his or her career and willing to discover the world and adventure of entrepreneurship despite scarce personal resources;
- ▶ The former funding the latter during a two-year-search-period;
- ▶ Looking for a target booking a minimum of 1.5 million EBITDA, generating recurring revenues and with high expansion potential, including internationally;
- ▶ With an incentive on the searcher to recover up to 25% of the exit value on a 100% performance basis (30% for a duo search, i.e., a search vehicle including two searchers).

At the search-level phase, the Search Fund model can probably so far be considered as a success to the extent that no French searcher has yet officially interrupted his or her search without having acquired a target.

Considering that the success in exit returns cannot, however, be analysed since no exit has yet occurred since the first acquisition in France via the Search Fund model in 2018, we hereby aim at confronting the main characteristics of the model with the French small/smids cap market, to identify its main assets as well as its liabilities.

► ***Brief overview of the French small/smids market***

The French small/smids cap market is a market where, certainly like in many other countries, the most interesting transactions come from a hidden market.

Such hidden market being evidently much harder to access, hence rendering target identification and sellers's conviction to sell an averagely long and delicate process.

Having said that, the market seems to be currently slightly less in tension when looking at the purchasers/sellers ratio.

With a number of sellers increasing and a number of purchasers for the first time decreasing in the last 10 years.

Practitioners hence tend to conclude nowadays, with great care considering the lack of statistics, that the market has been turning slightly more in favour of purchasers since Q2 2022.

Which is obviously a green light for searchers, which has proven effective if we look at the number of SF acquisition closed in 2022 and very early 2023, at a number of 6 versus 2 in 2021.

Remains, of course, the question of the market capacity to absorb many actors of the model. In that respect, statistics are, as far as we know, inexistent.

But the community tends to assert that more than 10/15 searchers searching at the same time is probably the high figure in terms of French market absorption.

And this figure has never been reached concurrently in France, as far as we know.

► ***Has the SF model proven effective in market approach?***

Essentially, SF acquisitions are classic MBIs bearing two main specificities: a different and much more generous management package on the manager, as well as a composition of investors which differs from usual private equity structure including a lead investor and one or several following investors, the number rarely being higher than 3 to 5 in small/smids cap deals.

The manager/searcher's profile

The searchers' age, background and personalities can be both assets and liabilities to address this market.

Small cap target sellers are often founders or at least reference shareholders as well as CEOs of their companies, in a process of electing their successors.

The key success factors often pointed at by the sellers for their successors range from strategic and operational maturity (which the often wrongly connect to an age 40 or above), management maturity and the capacity to adapt to field and headquarters employee profiles, and obviously also capacity to finance the deal.

This is in our view a point of attention searchers should keep in mind when addressing the market to avoid behaviours which convey excess of self-confidence or inability to adapt to the sellers' tone and intentions...

The investor's profile and the cap table composition

SF investors are all serial entrepreneurs, having shifted to the investment world, be it directly or through investment vehicles, including funds of funds.

Their number in the cap table (between 15 to 20) and their strong involvement in the SF community across borders improves the likelihood of required equity to be gathered and thereby fairly easy financing of the deals, including in a market where even with structured financing, only very cash positive and low leveraged deals (55% max, aside from a few exceptions) do get financed.

Their history, profile and the role some of them actively want to play, provide very qualitative mentorship to searchers, both at the CEO posture and strategic reflexes level and at the business field level if the concerned investor has experience in this field.

► ***Does the model philosophy and characteristics match the characteristics of the current French SME market acquisition process?***

The current market is in our view characterised by a major importance of the high trust and transparency to be set up by the purchaser/searcher with the seller during the acquisition process and more specifically during the pre-due diligence process, with a view to maximise chance of being granted exclusivity.

Transparency turns out even more crucial in the current market in order to make the most of the due diligence process, including on prospective business elements such as major contract renewals or market evolution perspectives.

The transparency ensures better forecasts and better risk mapping in relation to the target.

Trust, aside from its usual assets in an acquisition process, may lead, in our experience of SF acquisition, to at least three highly valuable events.

It sometimes goes as far as enabling the searcher to be integrated in the company prior to the effective closing of the deal. Which obviously is a very powerful insight, be it for finalization of the forecasts, improvement of the first hundred days and more generally for the post closing success.

It also materialises in sellers reinvesting in the acquisition vehicle, thereby showing the trust they place both in the new manager and on the strategic project he or she has been projecting.

Last but not least, it leads to sellers choosing their entrepreneurial "heir", thereby many times option to favour a more qualitative strategic project and manager for their employees.

► *Post acquisition key elements and issues*

At a post-acquisition level, some key elements are both general to any small/smids MBIs and applicable or even specific to SF.

It is hard in our view to rank these issues in terms of importance and/or priority since small cap deals include a high part of human risk, which renders the post-acquisition risk mapping way different from a more sheerly financial/business mapping as it could and would be undertaken in the mid/large sector.

Most importantly: management stance transition and team speed adaptation.

Searchers, like other ex-corporate MBI managers, tend to underestimate the importance of observing and assessing the seller's management levers with his or her team and the necessity to adapt first, before imposing their leadership posture.

Equally, they often take for granted that the teams' speed will resemble the rhythm they may have encountered in their previous corporate or private equity experiences.

And in that respect too, observing and adapting is a priority, before any new pace can be set up...

Secondly and unsurprisingly, cash level and management.

Hence the importance of the warranty of the warranty negotiation in the representations and warranty contract. Priority should systematically be given to an automatic or at least secured cash in case of damage occurring on the company in relation to pre-sale triggering factors.

Thirdly of course, the aggregation and build up issues.

They are key to strengthening the existing activity and setting up a group which the market will value upon exit as a critically sized actor worth a transaction.

With this logic/strategic target often comes the necessity to hire a general manager to second and/or complete the President's role (which ought to evolve after a few years towards a more strategic and less day-to-day business scope).

And almost systematically the need to constitute a first circle undoubtedly decisive in terms of small cap target/group valuations, i.e. an employee plan to enable key employees - or sometimes more widely employees in general - to access a shareholder status, whether immediate or deferred.

► *The specificities of search fund governance*

From as much as we can see, the search fund governance, composed of a rather traditional Board of Directors or assimilated body, seems to be particularly efficiently addressing all these issues.

Some investors may have specific knowledge of the business and its different markets, being both precious strategic helpers but also practically sometimes in a position to help the company expand from a sale point of view.

All investors share this state of mind very typical of search fund, i.e., a mix of large autonomy and trust on the CEO combined with proportional and growing over reasonable time reporting demands.

They are very attentive to the CEOship development of the searcher and always looking at very precise points where they can help, support, challenge or obviously contradict when needed.

The Search Fund model hence seems to be particularly adapted to small/smids cap MBIs on the French market and its current development may be considered as validly illustrating this match.

Although the coming years will, of course, be decisive; the first exits will be either confirming or infirming such present empirical analysis and informing the community as to whether the high levels of SF performance in Europe and in the world can also be found on the French market.

