The Journal of Entrepreneurial Finance

Volume 16
Issue 1 *Spring 2012*

Article 2

December 2012

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Recommended Citation
Hunt, Richard A. and Fund, Bret (2012) "Reassessing the Practical and Theoretical Influence of Entrepreneurship Through Acquisition," *The Journal of Entrepreneurial Finance*: Vol. 16: Iss. 1, pp. 29-56.
Available at: http://digitalcommons.pepperdine.edu/jef/vol16/iss1/2

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The Journal of Entrepreneurial Finance Volume 16, Number 1, Spring 2012 **29-56**
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ISSN: 1551-9570

Reassessing the Practical and Theoretical Influence of Entrepreneurship Through Acquisition

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Abstract

This paper presents a long overdue reassessment of entrepreneurship through acquisition (ETA). Traditionally considered simply a niche occurrence of small company leveraged buyouts (LBO), ETA is actually a meaningful contributor to a nation's entrepreneurial capacity and business revitalization. Scholarly understanding of ETA has been severely limited by three factors: the paucity of data related to entrepreneurial acquisitions, the tendency to equate entrepreneurship primarily with new venture creation, and the reliance upon explanatory models for buyouts that are grounded in narrowly conceived notions of 1980s-era, large-scale, hyper-leveraged LBOs. Prior efforts to conceptualize all buyouts based on the large LBO model and through the lens of agency theory have severely restricted the ability of scholars to look past the buyout model motivated by financial reengineering gains to see instead the entrepreneurial aims and outcomes often associated with buyouts, particularly ETA. In order to situate ETA more fruitfully in the domain of entrepreneurship finance, we take issue with the conventional agency theory framing and offer instead an explanatory model for ETA involving entrepreneurial intent and novel financing. To overcome the data scarcity problems and to bring the characteristics of ETA into sharper relief, we present testable propositions side-by-side with data from search funds, a specific ETA investment vehicle that substantively replicates the entrepreneurial intents and outcomes of ETA. By examining the theoretical streams of LBO and entrepreneurship finance in practical context of search funds, we build a more coherent conceptualization of ETA.

Key Words: Entrepreneurship through acquisition, entrepreneurial finance, search funds, buyouts, buyins.

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"*Neither fish, nor fowl, nor good red herring*."
- German Proverb

Are leveraged acquisitions of small and medium-sized businesses best conceptualized through the lens of entrepreneurship or the lens of finance? Either? Neither? Both?

Through questions like these, entrepreneurship through acquisition (ETA) poses unique challenges and opportunities for the domain of entrepreneurial finance because ETA is a boundary-spanning phenomenon and, in some respects, boundary-breaking. Few topics more convincingly underscore the importance of gathering scholars and practitioners under the entrepreneurial finance tent. Boundary-spanning topics typically experience one of two fates: they either attract considerable attention by virtue of their numerous intersections with various fields, or they are largely ignored, having been unceremoniously subsumed by explanations for parallel phenomena. ETA has suffered the latter, more ignoble, fate. We assert in this paper that, in isolation, the dominant conceptions from entrepreneurship and leveraged buyouts (LBO) have a limited capacity to illuminate the ETA phenomenon. However, through the compound lens of entrepreneurial finance, ETA can be better understood in its own right, and as an exemplar of the entrepreneurship-finance nexus. As the first comprehensive theoretical and practical treatment of entrepreneurial acquisitions, we will in this paper provide ample reason to propound that ETA is indeed "fish" and "fowl" and most certainly, "good red herring."

I. Introduction

For more than 30 years, agency theory (Jensen & Meckling 1976; Jensen 1986) has served as the dominant framework for explicating the antecedents and outcomes associated with leveraged buyouts (LBO). Through the heyday of large-scale, multi-billion-dollar LBOs in the 1980s and 1990s, agency theory substantively captured the essence of those efforts to break "the tyranny of imprisoned assets" (NYT, 1987) sitting dormant in a host of underachieving companies locked morosely in declining industries (Jensen 1989a, 1989b). As Eisenhardt noted, there has been broad use and misuse of agency theory (1989) but in all its various forms the theory is best encapsulated by two principles: the costs for business owners to monitor business managers and the divergent risk preferences among owners and managers (Eisenhardt, 1989). Grounded in these key tenets, LBOs blossomed in the 1980s as a "revolutionary" (Jensen, 1989a) vehicle to place the actions of management more squarely in the service of an owner's best interests (Friedman, 1962; Jensen & Ruback, 1983; Jensen, 1986). By Jensen's own admission, mega-LBOs were controversial, even while he argued for their indispensability (1989). The controversy, he wrote, was understandable given the tectonic effect of LBOs on corporate governance, owner-agent relations, equity ownership by management, and optimal utilization of a company's free cash flow, but these dislocations were temporary and necessary (Jensen 1986). Other commentators were less sanguine. "LBOs are likely to be messy affairs," Fox and Marcus warned (1992). Lauded by some (Jensen 1989b; Kaplan, 1991), criticized by others (Lowenstein 1985; Andrews, 1987; Reich, 1989), LBOs were an undeniably fitting laboratory for testing the basic premises of agency theory.

Time has allowed that LBOs and its explanatory bedfellow, agency theory, were neither wholly successful nor abject failures (Kaplan & Stromberg 2003; Guo, Hotchkiss & Song, 2011). In fact, within the specific context of mega-LBOs, an accumulating body of empirical work supports the premise that agency theory has consistently described the conditions giving rise to leveraged acquisitions and the resultant outcomes. (e.g. Jensen, 1989b; Kaplan, 1991; Kaplan &

Stromberg, 2003) However, the relative success in applying agency theory to large LBOs has had the unintended collateral effect of obfuscating the significant heterogeneity in the various forms buyouts can assume. From the very beginning, public company LBOs have constituted a small fraction of the entire buyout market. In 1988, the peak year for LBOs, 410 LBOs were consummated at terms totaling $188 billion (Olsen, 2003). Yet, these headline-gabbing transactions constituted less than 1% of the total deal volume, once the full population of buyouts is considered, including: management buyouts (MBO), management buyins (MBI), divisional buyouts (DBO), hybrid buyin/management buyouts, miscellaneous investor-led buyouts (IBO) and largest of all, the deals associated with ETA. We join Wright, Hoskisson, Busenitz, Dial (2001a, 2001b) and others (e.g. Meuleman, Amess, Wright, & Scholes, 2009) in noting that there is ample reason to believe that the motivations for these non-LBO buyouts are radically different from the rationale underlying large-scale LBOs. Nowhere is this theoretical mismatch more apparent than in the case of entrepreneurship through acquisition.

Though seldom mentioned in the scholarly literature, entrepreneurship through acquisition is an important facet of any nation's entrepreneurial ecosystem because it fundamentally involves the revitalization of existing systems of wealth and contributes to the well-documented interplay between entrepreneurship and economic growth (Wennekers & Thurik, 1999; Audretsch, Keilbach & Lehman, 2006). Despite its scale, ETA has experienced the dubious fate of being doubly eclipsed: first, in the entrepreneurship literature where the scholarly focus is on new venture creation, and second, in the finance literature where conceptions of leveraged transactions traditionally involve financial reengineering entailing billions of dollars and thousands of employees. Challenging to categorize, entrepreneurial buyouts have "largely been neglected in previous research" (Meuleman, et al., 2009:216). This relative neglect is at odds with the fact that the ETA segment is actually much larger than venture capital in terms of aggregate investment, employees affected and communities impacted (SBA Office of Advocacy). The scholarly scotoma that has relegated ETA to a marginal presence in the literature is unfortunate, underscoring the need for a comprehensive articulation of the ETA model.

For the purposes of this paper, we define ETA as *the acquisition of an existing small or medium-sized business* (i.e. SMEs with annual revenues up to $50 million) *by an entrepreneur for the purpose of expanding and enhancing the business through transformational strategies that fundamentally reshape market processes*. There are three key components of this definition. First, the activity under examination is the acquisition of a "small or medium-sized business." Second, the acquisition is carried out by an entrepreneur (or small team of entrepreneurs) rather than a large corporation. Third, the purpose of this acquisition is entrepreneurially motivated. Being entrepreneurially motivated means that the purpose of the acquisition is to grow and enhance the business, not carve it up or sit on it, as is sometimes the case with LBO firms (e.g. Baumol, 1993; Covin & Miles, 1999).

As noted above, traditional conceptions of LBOs portray buyouts as a potent solution to agency problems (Jensen & Meckling, 1976; Jensen 1989c), particularly agency-owner issues involving the optimal deployment of free cash flow. While ETA is not utterly anathema to this conception of buyouts, neither can it be said that the classic LBO model provides a strong foundation for understanding the transformational strategies and entrepreneurial mechanisms that are central to ETAs. These important similarities and marked differences between LBOs and ETAs are captured in Table I. The differences are further highlighted in a comparison of the candidate selection criteria commonly employed by LBO associations versus those employed by entrepreneurs in identifying high-potential entrepreneurial acquisitions (see Table II).

Interestingly, both LBOs and ETA start with the goal of identifying underperforming, undervalued assets in low-growth or even no-growth industries. From this common starting point, however, the divergence is pronounced.

Given the common starting point of seeking to wrest value from stagnant business assets, the fundamental divergence between the processes and outcomes of LBOs and ETAs draws forth several basic questions of interest to entrepreneurial finance: How is this extreme divergence possible? Why is ETA driven by the pursuit of innovation and growth rather than the value capture and operational efficiency focus of traditional LBOs? How do entrepreneurs create value through growth by acquiring businesses that others would target for a "milking strategy"? (Porter, 1980) And finally, what are the prospective implications of ETA for the study of buyouts in entrepreneurial finance?

The remainder of this paper addresses these questions while proceeding in four sections. First, ETA is defined and situated in the context of entrepreneurship theory and practice addressing how this extreme divergence is possible. Second, the paper addresses the ways in which ETA challenges the accepted premises of traditional LBOs through the lens of agency theory. Third, search funds are examined as an exemplar of ETA to demonstrate *ex ante* entrepreneurial intent in the acquisition of existing businesses as well as showing how entrepreneurs create value for the acquired business through growth. Applying the search fund data as empirical grounding, propositions are developed to establish an agenda for follow-on empirical studies of ETA. Finally, key contributions, research opportunities and potential limitations are summarized, including potential refinements, extensions and implications for the entrepreneurial finance literature.

II. Situating ETA in Theory and Practice

Conservatively estimated, ETA accounts for at least $25 billion of new entrepreneurial activity each year in the U.S. alone, most of which is directed towards the transformation of under-performing businesses. Despite the obvious scale of ETA and its direct role in fueling entrepreneurial revitalization of dormant business assets, little empirical research has followed largely as a consequence of three unsurprising realities: (a) the paucity of readily available data; (b) the definitional and theoretical biases towards viewing new venture creation as the primary entry mode for entrepreneurial activity; and, (c) the long legacy of viewing leveraged acquisitions primarily as vehicles for financial engineering, rather than business rejuvenation.[1]

[1] There are no published data for annual ETA transactions in the U.S. However, by combining public and private sources, estimates can be formulated for total deals and dollars. InfoUSA reports that there were, on average, 700,000 annual business ownership transfers in the U.S. from 2000 – 2010. Approximately 10% of these transfers involved actual acquisitions of companies with $500,000 to $50MM in annual revenue and up to 500 employees. Of these 70,000 acquisitions in the ETA range, we estimate that 10,000 (14%) involved businesses acquiring other businesses, based on a random sample of ownership among 2,000 firms with revenues between $500,000 and $50MM in the Dun & Bradstreet database. Of the remaining 60,000 firms, 30,000 (50%) are estimated to be acquisitions with entrepreneurial intent, based on interviews with 15 mid-market business brokers and 3 mid-market investment banks specializing in transactions up to $50 MM. In the opinion of this panel, approximately half of acquirers undertook acquisitions for non-entrepreneurial reasons, such as lifestyle considerations, investment diversification or the implementation of a milking strategy. Most of these acquirers did not plan to personally manage the acquired business full-time. This leaves 30,000 instances of "true" ETA, where there exists an *ex ante* entrepreneurial intention of implementing growth-oriented transformational strategies. As an added source of conservatism given the vagaries of small business management, we estimate that some number of entrepreneurs may be forced to abandon their growth plans after completing the purchase, suggesting that a conservative range of 20,000 to 30,000 ETAs come to fruition each year. Shifting to dollars from this transaction volume, we have estimated that ETA-sourced firms constitute between $25 - 40 billion in total

We acknowledge the lack of appropriate data that is publicly available which would greatly enhance the study of ETA and therefore make suggestions on how scholars might overcome this later in the manuscript. The other two realities we address in the following paragraphs and illustrate the divergence of ETA from the LBO literature in the process.

ETA is a notoriously elusive subject. For many scholars, there is no disputing the "acquisition-ness" of ETA, but there is tremendous ambivalence regarding the "entrepreneur-ness" of it. According to our definition above, a key condition that must be satisfied is that the acquisition is entrepreneurially motivated. In the absence of an entrepreneurially motivated acquisition, it is difficult to differentiate between an LBO and a one-off transaction in terms of the overall expectations for the deal. By developing a more thorough understanding of what entrepreneurial motivation involves, we lay the foundation for differentiating between the various types of acquisition activity that occurs in the SME realm.

1. Underscoring the "E" in ETA

Wright, Hoskisson, Busenitz and Dial (2001a; 2001b) proposed that entrepreneurial acquisitions (which they termed "management buy-ins") constitute "an efficient means of succession when the founding entrepreneur lacks good management and adaptation skills and when incumbent management lacks entrepreneurial capabilities" (2001a: 253). In this sense, ETA often involves the revitalization of under-managed, under-performing businesses. As Tables I and II emphasized, this constitutes a radical departure from conventional agency theory-driven conceptions of LBOs. The presence of *ex ante* entrepreneurial intent signals a growth-based strategy in ETA, rather than a harvesting strategy built on tight management control and efficiency improvements (Jensen & Meckling, 1976; Jensen, 1989b).

How is entrepreneurial intent identified? First off, a great deal of time can be saved and intellectual distress can be quelled by acknowledging from the outset that not all acquisitions of businesses between $500,000 and $50 million constitute entrepreneurship (See Figure 1). It is patently incorrect to lump all small business purchases together with entrepreneurship because most small business acquisitions are intended to do nothing more than perpetuate a proven cash stream, capture the annuity value of the firm and secure a stable source of employment for the new owners (Carland, Hoy, Boulton & Carland, 1984). It is widely agreed that simply buying a small business or operating a small business does not constitute entrepreneurial activity (Carland et al., 1984; Thurik & Wennekers, 2004). Neither is it specifically the presence of growth that makes a business entrepreneurial (Davidsson, Delmar and Wiklund, 2008). Although firm growth is often an excellent indicator of entrepreneurial mindset (Gartner, 1988), the presence or intention of growth is a necessary but insufficient basis for entrepreneurship (Davidsson, 2004).

With respect to the entrepreneurial motivation condition of ETA, the defining consideration is that risk capital is placed in support of an acquisition for which transformational strategies will be implemented that expand and enhance the acquired business-system. In this vein, Covin and Miles maintained that entrepreneurship involves risk and innovative behavior by individuals who attempt to champion their ideas by exploiting new opportunities (1999). Similarly applicable is Baumol's conception of the entrepreneur as "innovator," regardless of whether or not the transformation occurs through the creation of a new venture (1993). This is precisely the intent of ETA: acquisition of an existing business-system with a vital spark of innovation. For instance, George Earl purchased a minimally profitable $2.5 million Colorado

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acquisition consideration based on a median transaction size of $1.25MM as well as the R.W. Baird/Dealogic estimate that the upper small firm ($1MM – $5MM) and lower mid-market ($5MM - $50MM) transactions are a $125 billion annual segment.

Springs-based plastic injection molding company in 2010, sensing that increasing labor costs in developing countries like China will re-open the door to U.S.-based manufacturers. Financed with a combination of personal assets, a bank loan and a seller-carried note, Earl has invested in new equipment to make products that will allow it to expand beyond its base of local customers.

As Earl's acquisition demonstrates, although there are important differences between ETA and new venture creation, the common threads are more important and more numerous, particularly pertaining to opportunity identification and exploitation. According to Shane and Venkataraman, "Entrepreneurship involves the study of sources of opportunities; the processes of discovery, evaluation, and exploitation of opportunities; and the set of individuals who discover, evaluate, and exploit them" (2000, p. 218). In this sense, entrepreneurship via either ETA or new venture creation represents an approach grounded in many of the same processes and desired outcomes. Davidsson sets one of the highest bars among current scholars for defining entrepreneurship by further asserting that entrepreneurial activity must involve a significant impact to the market processes (2004). As we shall see in examining the case of search funds, ETA fulfills all these important criteria.

2. The Issue of Size: ETA Means Small, But Not Too Small

Obviously, not all acquisitions involve small companies, and most acquisitions of small companies do not involve entrepreneurship. So, how is ETA situated in this slurry of transactions? The answer is to define a sensible range, the boundaries of which capture the great preponderance of owner-managers who acquire a business for entrepreneurial intentions and who possess the abilities and resources to engage in transformative strategic activity. Given this, ETA does not pertain to the smallest acquisitions, which predominate in sheer number of completed transactions, or the largest acquisitions, which predominate in sheer dollar amounts. The range propounded here extends from $500,000 to $50 million in annual revenues. It is projected that there are at least 20,000 to 30,000 ETAs within this range (see Footnote 1 above). To provide some context for the significance of this pool, one should consider that at the peak of venture capital investment in 2000, only 2,200 U.S.-based start-ups received initial capital from VC firms (Gompers & Lerner, 2001). In 2009, 728 firms received first-time funding (NVCA, 2010).

Below this $500,000 to $50MM range, the businesses are very small and the transaction flow is very high. 78% of all American businesses gross less than $100,000 per year (SBA Office of Advocacy). This category comprises more than 80% of all the businesses sold each year, but this category cannot be considered ETA. While it is certainly true that entrepreneurship can be manifested in a countless array of sizes and innovative pursuits, businesses below $100,000 in revenue rarely allow the acquirer to generate a living wage, much less allowing him or her to engage in strategic transformation of the business. Even acquired businesses grossing less than $500,000 per year rarely possess the financial capacity to simultaneously compensate the entrepreneur, cover the debt maintenance associated with the business acquisition, and still allow for substantive investment in a market-transforming strategic reorientation of the business.

Of the acquired businesses with revenues exceeding $50MM, several hundred annually involve large firms with transactions extending up to billions of dollars. These high-profile acquisitions are financially and strategically material, but we would not consider them ETA. Large buyouts can certainly have entrepreneurial motivations, but these transactions involve a complex array of financial and organizational considerations that make it far more difficult to identify and isolate entrepreneurial activity subsequent to the acquisition, much less

entrepreneurial intent prior to the acquisition. Another reason to exclude buyouts larger than $50MM from ETA is due to the fact that this threshold approaches the upper limit for which entrepreneurship can generally be pursued by owner-operators. Above this threshold, private equity (PE) firms begin to have competing interests since profitable firms over $50 million have the capacity to support a large professional management team at top salaries and still have free cash flow sufficient enough to make the financial reengineering worth incurring the associated transaction costs (Metrick & Yasuda, 2010). To be sure, there exists a large population of small private equity firms that buy businesses under $50 million (Fenn, Liang & Prowse, 1995); however, most PE firms are interested in keeping the pre-acquisition management in place long-term. In sharp contrast, ETA involves the acquisition of businesses by owner-investors who actively manage the acquired business.

III. Challenging the Legacy of Mega-LBOs

With the exception of a small cadre of scholars such as Wright and colleagues (1991, 2001a, 2001b), Malone (1989) and Kelly (Kelly, Pitts & Shin, 1986), ETA has been simply lumped in with the broad swath of transactions known collectively as leveraged buyouts (LBO). While this would technically be true – ETA usually involves the purchase of a business with borrowed funds – the LBO heritage and its scholarly literature have little of substance to contribute to a discussion of ETA. This is especially important when seeking to understand why ETA is driven by the pursuit of innovation and growth rather than the value capture and operational efficiency focus of traditional LBOs. Efforts to address this mismatch extend as far back as the 1980s (Kelly, et al. 1986; Malone, 1989), when the term "entrepreneurial leveraged buyout" (E-LBO) was coined to distance small company LBOs from the dominant scholarly and popular conceptions of multi-billion-dollar LBOs that were fueled principally by the goals of financial manipulation (Malone, 1989).

The attempt to differentiate LBOs from E-LBOs is understandable, but Malone's conceptual pathway is strained and somewhat incomplete because the most important facet of an E-LBO is not its leveraged structure, but its entrepreneurial intent. By constructing a limited sample from existing small firms (n = 56), the Malone study suffers from a sample selection bias (Cameron & Trivedi 2005) that cannot capture intent. As a one-time, cross-sectional survey, the study can only retrospectively presume the presence of *ex ante* entrepreneurial intent. In some cases, the acquisitions in Malone's study occurred more than six years prior to the survey. Because of these factors, Malone's categorization of the 56 firms as E-LBOs involves a tautology since the firms were classified as E-LBOs on the basis that they each displayed certain characteristics that Malone judged to be consistent with his definition of E-LBO (Malone, 1989). Malone's findings and his conception of E-LBOs thus fail to differentiate entrepreneurial buyouts from traditional LBOs on the basis of *ex ante* entrepreneurial intent. More broadly, since most LBOs, including small company LBOs, are not undertaken for entrepreneurial purposes (Wright, et al., 2001a; 2001b), the inability to identify clear, *ex ante* entrepreneurial intent leaves Malone's E-LBOs chained to the convoluted heritage of the classic LBO model.

The differentiating substance of an *entrepreneurially motivated* LBO is that "the purchaser expects that he can substantially improve the firm's prospects" (Malone, 1989) and therefore acquires the business with the intention of implementing innovative means to expand and enhance the acquired business. The difference between LBO and ETA is not one of mere semantics. There are a number of important reasons for the differentiation. The first reason is a matter of effective set-building: not all LBOs are entrepreneurial. As Wright et al. noted, there

are different categories of buyouts (2001a), most of which are not entrepreneurial. Second, the popular and scholarly conception of LBOs is utterly unrepresentative of the intentions and outcomes associated with entrepreneurially motivated small business acquisitions (Meuleman et al., 2009; Wright et al., 2001a). Every facet of the famed mega-LBOs runs contrary to ETA: the sheer size, the hyper-leveraged financing vehicles, and the oft-resultant carnage. Third, the long-standing bias against including small firm LBOs in discussions of entrepreneurship has marginalized even those acquisitions that are patently entrepreneurial. The bias is not without foundation since there was a period in which small business management and entrepreneurship suffered from a troubling level of conflation, as noted by Carland et al. (1984). However, the bias makes little sense now that the definitions for entrepreneurship have matured in the ensuing decades, making differentiation straight-forward (Thurik & Wennekers, 2004). The most famous example of ETA, underscores this differentiation. In 1995, Jim Ellis and Kevin Taweel purchased Road Rescue, a dilapidated $6 million roadside assistance company. Fifteen years later, the company has become Asurion, a $2.5 billion provider of cell phone insurance. Rather than approaching Road Rescue as an annuity-driven, small business management opportunity, Ellis and Taweel leveraged the company into an innovative growth engine (NYT, 2009).

The Wright et al. buyout model (2001a; 2001b) advances a perspective that does much to support these sources of differentiation between traditional LBOs and growth-oriented buyouts. Unfortunately, the framework suffers from two notable shortcomings. First, is the recurrent confound of sample selection bias. The Wright et al. study suffers from the same deficiency as the Malone (1989) study in that their retrospective analysis of management buyouts cannot demonstrate the presence *ex ante* entrepreneurial intent. A second deficiency is that the model only offers limited explanatory power and practical applicability, specifically to the ETA phenomenon. For example, the focus on larger company management buyouts leads Wright et al. to model relationships and circumstances that draw distinctions between the "entrepreneurial mindset" and the "managerial mindset" (2001b). This distinction has decidedly less application in the context of ETA, where the acquirers fully intend to be active owner-managers from the outset, long before even consummating the acquisition. Therefore, the types of agency issues (Jensen and Meckling, 1976; Jensen, 1986) and managerial intention issues (Carland et. al., 1984) that might arise in management buy-outs are rarely, if ever, evidenced in the case of ETA. Indeed, principal-agent and manager-entrepreneur roles are intentionally conflated through ETA in order to maximize the entrepreneurial effects of the acquisition. For instance, Paul Vardley and Trevor Buschlein acquired a $5 million hard copy printing company in Los Angeles, that had loyal customers but declining revenues due to technological changes in the printing industry. It took four years to convert the business to a fully electronic platform, but by aggressively reinvesting profits rather than distributing gains, Vardley and Buschlein retained their customer base and have positioned the business to become a $10 million company by the end of 2011. Examples like this underscore the importance of clearly distinguishing ETAs from LBOs, management buy-outs and even management buy-ins and E-LBOs. ETA must be conceptualized as a separate value-generation vehicle in and of itself, as we shall see in examining an illustration of ETA: *Search Funds*.

IV. Search Funds: A Window to Entrepreneurially Motivated Acquisitions

Without the existence of a population of ETA-sourced companies that constitute a defined pool of entrepreneurially motivated acquisitions, it would be impossible to properly frame the defining characteristics of ETA. Fortunately, there is just such a population of firms

that can serve as an effective exemplar of ETA: *Search Funds*. Started in 1984 by Stanford Business School Professor Irv Grousbeck, search funds constitute a small, but rapidly growing niche of ETA whereby entrepreneur-searchers raise capital for the sole intent of identifying and acquiring undermanaged businesses that grow in value through an infusion of entrepreneurial strategic intent (Grousbeck, 2010). Analysis of search funds provides a meaningful basis to confirm empirically that buyouts occur for the purpose of implementing entrepreneurially motivated strategies, allowing us to develop an understanding of how ETA meaningfully contributes to small business growth and entrepreneurial capacity.

The relative neglect of search funds is somewhat at odds with the extent to which ETA generally has attracted interest among business school students (evidenced by the increasing number of classes and student organizations devoted to the subject) and investors (evidenced by press references and vehicle-specific funds). Although more a manifestation of systemic search processes (Fiet & Patel, 2007, 2009) than entrepreneurial alertness (Kirzner, 1997), search funds elude simplistic categorization, except this: search funds are a pure example of entrepreneurship through acquisition. And for that, they are of great value. The search fund model involves four stages (see Figure 2). In stage one, entrepreneur-searchers raise a relatively small pool of capital (averaging $450,000) from ten to twenty investors to cover the expenses during their search for an attractive business to buy. If a promising opportunity is identified, then stage two financing is invoked, involving an additional round of funding to purchase the identified company, which is subsequently operated by the entrepreneur-searcher (Stage 3), who maintains an ownership stake in the acquired company. Stage four involves exit from the acquired business.

Aggregate pre-tax IRR for the known universe of search funds is 37% (Grousbeck, 2010 – See Table III), exceeding the long-term range experienced by upper-tier angel and VC investors (Table IV), and with somewhat less variance. Aside from the similar returns, sharp differences separate search funds from other entrepreneurial investments. Far from competing for nascent-stage opportunities, search funds actually fill a notable gap between angel investors, venture capital and private equity because they offer the prospect of initiating entrepreneurial activity within the parameters of a pre-existing business platform. In this sense, search funds provide an interesting model of entrepreneurship financing because the survival risk that typically accompanies early-stage investment is significantly mitigated when an entrepreneur assumes control of an existing business. This mitigation of survival risk, however, comes with the price tag of heightened liquidity risk. Since search funds primarily seek to acquire under-managed business assets in reliable, well-worn, highly fragmented industries (Table V), it is rare for novel, innovative assets to transfer with the acquisition, thereby impacting the downstream marketability of the business.

Five specific areas of inquiry will be examined through the lens of the search fund model in order to provide develop empirically verifiable propositions regarding ETA:

1. Entrepreneurially motivated acquisitions can be empirically demonstrated.
2. ETA constitutes a dynamic, large-scale entrepreneurial pathway.
3. ETA exhibits less survival risk than new venture creation, but with at least comparable returns and substantially less variance.
4. ETA exhibits key investment trade-offs involving liquidity risk versus capital structure flexibility.
5. ETA's system wealth generation equals or exceeds that of VC-backed ventures.

1. Comparative Data

This review of search funds compares a variety of publicly accessible data sources for search funds, angel-backed firms and start-up-stage venture capital-backed firms. Except for data pertaining to IPOs and M&A, all of the data is self-reported by individual firms to third-party data-aggregation entities. The search fund data analyzed here was gathered largely from the 129-firm database collected by the Center for Entrepreneurial Studies (CES) at Stanford University's Graduate School of Business. The CES database represents the only comprehensive and systematic collection of data pertaining to search funds. The data includes all the U.S.-based search funds known to exist as of December 31, 2009. Search funds in Canada and Europe, which are still few in number, are not included in the CES data. Since much of the search fund data is gathered through self-report surveys, there are material gaps in some of the data. Therefore, the CES report was supplemented by 52 telephone interviews: 17 investors, 12 current owners, 8 current searchers, and 15 search fund alumni to confirm major trends and better understand the underlying data. Also, since the CES data only includes search fund foundings through 2009, the data for 30 known funds initiated in 2010 was gathered independently and added to the CES data.

Angel data was gathered from a combination of sources: The Kauffmann Foundation Annual Angel Report and the SBA Office of Advocacy (Shane, 2008) and Thomson Reuters (SDC). All the data sources that are used in this study have been used previously in analyses of angel investment returns and descriptive demographics. Venture capital data is also gathered from a combination of sources comprised of databases maintained by Thomson Reuters (SDC), Cambridge Associates, and the National Venture Capital Association (NVCA). All the data sources that are used in this study have been used previously in analyses of venture capital investment returns and descriptive demographics.

2. Search Funds as Evidence of *Ex Ante* Entrepreneurial Intent

By definition, search fund owners possess entrepreneurial intent. Initiating a search fund definitionally entails *ex ante* signaling of entrepreneurial intent in a fashion that no other form of buyout can readily replicate. For this reason, search funds provide empirical confirmation that LBOs occur for reasons other than financial engineering, thereby demonstrating explicitly that Wright et al. (1991; 2001a; 2001b) were correct in contending that *ex ante* conditions often exist regarding entrepreneurial intentions in buyouts, but did not go far enough in demonstrating how ETA constitutes its own class of entrepreneurially motivated activity.

Searchers have entrepreneurial ambition equal to that of new venture creators, but the entrepreneurship is grounded in an existing business-system (Lumpkin & Dess, 1996), utilizing an approach that is more focused on implementing the benefits of evidence-based management (EBM), which "seeks to apply the best currently available data and theory to management decision making" (Pfeffer, 2010: 7). In this sense, "ETA is the creation of value through applied business innovation" (Chaflin, 2010:1). Search fund-sourced companies are traditionally selected from fragmented industries with few dominant players (Table V). Entrepreneur-owners of these businesses necessarily seek to implement EBM because it is indispensible to business-system expansion and enhancement. This receptivity to more effective decision-making processes underlies the significantly lower survival risk in search fund-sourced businesses (Table IV).

The post-acquisition entrepreneurial commitment of search fund owners is similarly evidenced. Findings from the Stanford Report (Grousbeck, 2010) reveal that 97% of search funds successfully consummating an acquisition identified increased revenue as a primary value

creation lever in the newly acquired business. Differentiating themselves from private equity–led small company buyouts, search fund owner-managers serve in key operating roles in the acquired companies, and remain with the company for a median period of nine years after forming the search fund (Grousbeck, 2010). Although owner-managers earn salaries, the primary motivators are the opportunity to run a business and to share in its equity ownership.

3. Search Funds as Evidence of ETA Sector Vitality

Consistent with its roots, most search funds continue to be initiated by recent graduates of top MBA programs. There is evidence, however, that search funds are being created by a widening circle of MBA graduates (Grousbeck, 2010). Previously the primary domain of Stanford and Harvard graduates, recent fund launches have come from graduates of Wharton, Chicago, Babson, Duke, and others. This trend has had interesting collateral impact. Classes in ETA are now offered by several business schools, including: Wharton (MGMT811: Entrepreneurship Through Acquisition), Stanford (STRAMGT543: Entrepreneurship Through Acquisition). Ross (ES516 Entrepreneurship via Acquisitions), and Kenan-Flagler (MBA843: Entrepreneurship Through Acquisitions: Structuring Your Buyout). Several dozen student organizations devoted to ETA have been initiated, reflecting the growing interest in pursuing entrepreneurship by applying alternatives to new venture creation. The most surprising and impactful development of all may be that there is evidence of the model extending outside MBA networks to include mid-career professionals (Grousbeck, 2009).

As with most business sectors reliant upon leverage, search funds felt the pinch of tightened credit during the 2008– 2010 period. It is all the more impressive then that the number of new search funds grew dramatically over that time period (Tables VI). Only ten years ago new search funds appeared at the rate of 2 or 3 per year (Grousbeck, 2010). Significantly, 2010 saw the commencement of at least thirty new funds. Near-term, the competition for good companies is unlikely to be a factor. The target pool of U.S. companies with revenues between $5MM to $15MM and EBITDA greater than $1 million is approximately 300,000, providing searchers with a plethora of targets, especially as aging baby boomer-owners seek to exit their businesses.

Mirroring this heightened interest among entrepreneurs, and partially fueling it, there is an increasing number of investment funds devoted to financing search funds. Primarily initiated by search fund "alumni," they are set up to fund increasingly large portfolios of search funds (Grousbeck, 2010). From a handful only five years ago, there are now several dozen funds devoted partially or exclusively to investment in search funds. Though small when compared to typical venture capital or private equity funds, search fund-focused investors have raised well over $150 million for new investments, including $35 million raised by fund manager and search fund alum, Jim Southern of Pacific Lake Partners (NYT, 2009).

4. Propositions

The special case of search funds provides a window to entrepreneurship through acquisition that is instrumental to the formulation of several propositions that chart a course for future empirical inquiry and put to the test the prevailing conceptions of entrepreneurial risk-return, firm failure rates, and value generation.

4a. Entrepreneurship with Less Survival Risk than New Venture Creation

As we have seen, search funds involve the purchase of existing businesses, typically in highly fragmented industries marked by relative stability and slow growth. (Table III) As Jim Southern, a search fund investor and the founder of PacificLake Partners, noted: For aspiring entrepreneurs who embrace the search fund model, the likelihood of a quality return is much greater for a search fund than "the gamble of trying to do a start-up" (NYT, 2009). In sharp contrast, angel-financed and early-stage venture capital investments are geared towards new business creation. Survival risk for seed-stage and early-stage firms is legendary (Mason & Harrison, 2002; Cochrane, 2005; Kaplan & Schoar, 2005; Shane, 2008). And, for the most part, the portfolio investment approach to early stage investment by angel and venture capital firms underscores the extent to which the presence of this risk is well understood (Van Osnabrugge 1998). However, while the presence of risk may be well understood in the case of new ventures, there is evidence that start-up and survival risks are notoriously mispriced (Kaplan & Schoar, 2005). ETA meanwhile, certainly entails some degree of survival risk, but it side-steps start-up risk entirely while largely mitigating the mispricing of survival risk. This is driven by the fact that many of the firms acquired by search funds have operated for nearly a generation, well past the time frame for which company survival hangs in the balance. In this regard, it is therefore proposed that the ETA will generally display the survival advantages found among search fund-sourced firms.

> *Proposition 1: On average, ETA-sourced companies will display less survival risk than seed/early stage companies when comparing ETA-sourced companies from inception with angel and VC-backed firms from inception.*

Table IV reveals the enormous difference between the survival rates for search fund-sourced firms (90%) versus angel and VC-backed firms (35% each). Without question, most of this difference arises simply due to the fact that starting a business as a new venture is inherently more risky than acquiring and operating a business with a pre-existing cash flow. It could be reasonably argued that comparing search fund survival rates to angel and VC-backed start-ups is comparing apples to oranges. But this is only a compelling assertion if the long-term angel and VC investment returns are meaningfully better than ETA, thereby indicating that angel and VC investors are compensated for the higher risk of business failure. Table IV shows, however, that angel and VC funds hold no performance edge over search funds.

4b. Liquidity Risk Versus Capital Structure Flexibility

Although search fund-sourced businesses display less survival risk than angel and VC-backed firms, it is possible that the mitigation of operational variability comes at the cost of increased barriers to liquidity opportunities. Since the great preponderance of companies acquired by search funds are in service-related industries or light manufacturing (Table III), there is relatively little intellectual capital transferred in the acquisition. Innovations developed by the new management team will often transform the company-specific prospects, but these transformations are less likely to involve novel technologies. Alternatively, new ventures are likely to face a steep climb to achieve ongoing viability, but those that do survive will have built their valuations through novel processes or technologies, potentially providing them a wider array of exit alternatives. However, this is only expected to be true for those companies that have survived to the point of achieving a "steady state" of operations. When measured from firm

inception, it would be expected that search funds would have no worse, and potentially somewhat better liquidity event prospects than the average angel and VC-funded firm. This is true for two reasons: (a) the effects of higher attrition for angel/VC-backed firms; and, (b) search funds typically will be more heavily debt-financed than angel/VC firms, which will be primarily equity-financed. Accordingly:

> *Proposition 2a: On average, ETA-sourced companies will display less exit/liquidity risk than angel or venture-backed companies when comparing ETA-sourced companies from inception with Angel and VC-backed firms from inception.*

Measured from inception, the low start-up risk and survival risk will, by extension, create a liquidity event advantage for search funds over VC-sourced ventures. However, when VC-sourced ventures are measured from the point of adolescence rather than infancy, it is not expected that search funds will maintain the liquidity advantage. After allowing for the culling out effects of early attrition, liquidity events for the pool of surviving VC-backed ventures are expected to be more frequent than liquidity events for search fund-sourced firms (Table IV). On this basis, it is asserted that:

> *Proposition 2b: On average, ETA-sourced companies will display more exit/liquidity risk than angel or venture-backed companies that have achieved profitability or have survived at least five years."*

Since the principal preoccupation of ETA is the growth of a business-system, the looming specter of liquidity that plays a substantial role in the venture capital arena has a markedly different character in ETA. The ability to finance a ETA-sourced business through debt rather than equity inherently de-emphasizes the focus that is often associated with the drive towards a liquidity event in those entrepreneurial ventures that are principally structured with equity financing. Given the relative abundance of debt-issuance alternatives available to ETAs, it would be expected that owner-manager tenures at ETA-sourced firms would be significantly longer than tenures at angel and venture-backed firms. Since entrepreneurs acquiring existing businesses often intend to run the businesses for many years, even decades, it is highly apropos that the ETA structure afford owners the financial flexibility to consummate a recapitalization enabling investors to exit while still allowing the entrepreneur to retain ownership control of the company.

The ETA owner-operator rarely faces investor-driven expectations that a well-defined exit plan be in place from the outset, as is the VC-sourced milieu of limited partner agreements and investor pools (Kaplan & Stromberg, 2003). For VC-backed companies, the absence of a liquidity event is often tantamount to a failure to attain any investment returns on that portfolio component. Not so, in the case of ETA. The operations-intensive orientation of the ETA entrepreneur-owner frames the issue of investor liquidity as just one part of a wealth-generation context rather than a precondition of the wealth-generation context. Since ETA owner-managers acquire businesses as both long-term investments and the principal source of their occupational livelihood, it is expected that ETA owners will capitalize on their ability to issue debt when cashing out equity investors. In this fashion, the entrepreneurs can continue to operate the company while allowing their investors to exit.

Proposition 3a: Debt restructurings will be more prevalent in ETA-sourced companies than in angel or venture-backed companies.

Proposition 3b: On average, owner-managers of ETA-sourced companies will display longer tenures and will exit less frequently than angel or venture-backed companies.

Proposition 3c: On average, exit proceeds will constitute a smaller proportion of financial returns to owner-managers of ETA-sourced companies than for angel or venture-backed companies.

On the whole, liquidity exits are far more prevalent for angel and venture-backed companies than for ETA companies, as is evident in the search fund data (see Table IV). Search funds specifically, and ETA-sourced companies generally, have experienced less frequent and less lucrative exits than have companies comprising the universe of angel and VC-backed firms. This phenomenon is partially due to the debt issuance power of ETA discussed above, but also the more limited market for ETA company assets. The annuity value of ETAs provides owner-operators access to a wider array of strategic financing options, including the option to cash out financial investors while retaining ownership of a privately held company. However, the price tag for this lower risk is manifested in lower exit potential and a concomitantly higher exit-related liquidity risk.

While IPOs and even strategic sales are clearly less common among ETAs, the relative de-emphasis of exit strategies and liquidity events for ETA-sourced companies, versus angel and VC-backed firms, is far from absolute. There are instances of ETAs having highly lucrative liquidity events (primarily through strategic sales) and there are instances of VC-backed firms maturing into independent, well-capitalized, closely held corporations. Clearly though, neither of these scenarios represent the norm. There are numerous reasons for this. First, venture capital investments are managed as a portfolio of firms. Overall portfolio returns require extraordinarily high gains on a handful of “stars” to offset the numerous failures, thereby necessitating lucrative exits wherever they can be attained (Pfeffer, 2010). Second, ETAs can be financed with a smaller percentage of equity than start-ups and nascent-stage industries. Without having to cash out investors’ equity holdings, there exists a wider range of financial options, including debt-driven recapitalization to allow original investors to see a return on their investment. Third, ETA-sourced companies are often in low-tech, low-growth industries. IPOs are a more difficult route for these kinds of businesses, though strategic sales to larger aggregators could be very attractive. Finally, the relationship that the ETA manager-owners have with their investors and their businesses is different from angel and venture-backed firms. Unlike nascent-stage firms, entrepreneurial acquisitions immediately place the entrepreneur in the position of managing customers and delivering products or services. The daily preoccupation of an owner-manager (of an ETA-sourced firm) is in servicing the system that has been purchased, expanding and enhancing it through innovation and dynamism. In this context, the issue of investor liquidity is less prominent because a lucrative exit is not a precondition to a successful investment.

Of course, the paucity of IPOs among ETA-sourced firms cannot be solely attributed to long owner-manager tenures and higher debt carrying capacities. While it is certainly true that many ETA-sourced firms are never intended for resale (Malone 1989), it is also true that

potentially attractive liquidity event options, such as IPOs, are not realistically viable for the vast majority of ETA-sourced companies. Therefore:

> *Proposition 4: ETA-sourced companies will have IPOs at a lower rate than angel or venture-sourced companies.*

4c. A System Wealth Approach to ETA Value Creation

By its very nature, ETA involves acquiring an existing business-system and making it larger and more vibrant. In this sense, the only way to substantively capture the relevant wealth creation (and preservation) is to formulate the conception of ETA as a system. Otherwise, the tendency is to focus primarily on the liquidity exit, which is only one facet of wealth creation, and one which is heavily ensconced within the new venture portfolio approach to risk identification and exploitation. As we have seen, ETA often possesses elements that are analogous to VC/Angel-backed firms: outside investors/stakeholders, growth orientation, entrepreneurial purpose and intent. But, ETA also possesses elements that are analogous to family firms: value creation and promulgation of an existing system of wealth, for which the primacy of liquidity/exit outcomes is rendered to subordinate to the preservation and growth of the wealth system. These hybrid characteristics are the key to understanding the wider circumference of ETA value creation.

Notably, even Jensen and Meckling (1994) argue, "there does not have to be a loss of economic efficiency when owner–managers pursue the maximization of a utility function that includes non-economic goals." Chrisman and Carroll (1984) went even farther by demonstrating that firm pursuits of noneconomic goals can actually "enhance their economic performance and produce a systemic, synergistic effect upon wealth creation" (Chrisman et al., 2003: 468). System value creation captures multiple goals and a purpose that transcends profitability. Therefore, it is proposed that:

> *Proposition 5: On average, ETA-sourced companies will display overall system wealth creation at least comparable to angel and venture-backed investments, and with less variance.*

V. Conclusion

In a sense, this treatment of entrepreneurship through acquisition signals the end of a Ulyssesian voyage back home. And so it is fitting that the rebranded ETA concept be launched under the auspices of entrepreneurial finance. Among all the various entrepreneurial finance vehicles, ETA stands the most resolutely as equal parts entrepreneurship and finance.

We have asserted from the outset that traditional conceptions of large-scale LBOs are ill-equipped to address the antecedents and outcomes of entrepreneurial acquisitions. Agency theory, which is well-suited to the description and prescription of mega-LBOs, is of limited use in the context of the "owner as agent" governance found in ETA. Though traditional LBOs and ETA share a common starting point in identifying underperforming businesses, they swiftly embark upon radically different paths, ultimately bearing little material resemblance to one another. Though ETA literally involves the financial machinations of an LBO, there is little in the LBO literature that forcefully addresses the antecedents and outcomes of ETA.

Prior efforts to identify and explicate the phenomenon of entrepreneurial buyouts (Kelly et al. 1986; Malone 1989; Wright et al. 2001) have succeeded in demonstrating the presence of

entrepreneurial buyouts, but not their importance. Even the terminology they have employed misses the point. Wright et al.'s management buy-ins and buy-outs (2001a, 2001b) fail to apprehend the entrepreneurial component, while Malone's E-LBO (1989) identifies entrepreneurship, but mistakenly links ETA to the heritage of classic large-scale leveraged buyouts. Only "entrepreneurship through acquisition" conveys the fact that entrepreneurial intent results in the engagement of entrepreneurial finance towards the instigation of entrepreneurial action. In ETA, the acquisition of an existing business system is the vehicle through which entrepreneurial intent is operationalized. This is the dynamic that differentiates ETA from all other forms of entrepreneurial finance because the owners are creating new value from existing value, and new innovations from dormant assets.

In addition to proffering a coherent conceptualization of ETA, this paper has also brought important closure to long-standing inadequacies in the LBO literature. For the first time, an empirical case has been presented to definitively conclude that buyouts are not solely confined to realm of financial engineering and milking strategies. Rather, we find compelling evidence that in the form of ETA, buyouts are motivated by *ex ante* entrepreneurial intent.

Limitations. A current limitation related to the study of ETA is finding appropriate data. While it is certainly true that data collection challenges accompany analyses involving virtually any facet of entrepreneurial finance, the effort required to access ETA data is particularly burdensome. Efforts to formalize the reporting of venture capital data has opened frontiers in that sphere, now spanning 25-years worth of generally reliable data. Even the collection of angel investment data from highly diffuse sources has improved dramatically in last decade. While organizational networks comprised of mutually interested parties have helped to formalize the collection and dissemination of angel and venture data, the process of building a similar data collection mechanism for ETA from the tens of thousands of business brokers, commercial real estate brokers, merchant bankers and mid-market investment bankers is comparatively daunting. Of course, our stipulation that ETA necessarily involves *ex ante* entrepreneurial intent only exacerbates the data acquisition challenge.

Recognizing that there is little value in simple identifying the data availability challenges, we have sought to build our propositions on a relatively small but highly reliable source of ETA data in the form of search funds, supplemented by extensive interviews with scores of prospective acquirers and owner-managers from ETA-sourced firms. Although the search fund data is a starting point not an ending point in the process of researching ETA, it constitutes a significant advance over retrospective data that failed to capture *ex ante* entrepreneurial intent.

Generalizability. Given the heavy reliance on the search fund model in this discussion of ETF, the generalizability of search fund results requires careful consideration. First and foremost, it was our aim in this article to contribute a coherent description of what ETA is and how it operates. We are fascinated by ETA's scale, its importance, its distinctive characteristics and, ironically, its virtual anonymity. Without equivocation, each of these key facets is readily generalizable from the search fund data. In fact, search funds are uniquely helpful in illuminating the distinctive nature of ETA because of the inherent process of signaling *ex ante* intent through the birth of each new search fund.

There are, however, reasons to expect that there is a difference between search funds and the general pool of ETAs. For instance, it is prudent to expect that most ETA-sourced firms will not look exactly like search funds because most ETAs are likely to involve smaller targets than

the $5 million to $15 million range favored by search funds. While search funds gravitate towards companies with sufficient EBITDA to support a larger management team – typically $1 million or more – most ETA-sourced firms are expected to originate from the pool of 25,000 U.S. businesses that are sold annually with 20 to 50 full-time employees and with revenues ranging from $2 million to $5 million.

Smaller ETAs should not be mistaken for less-successful ETAs. While the average ETA transaction size is expected to be smaller than the average search fund acquisition, the similarities between search funds and the general pool of ETAs are likely to be more numerous and more consequential than the differences because all ETAs – including all search funds – embody the same central assumptions about firm governance and strategic intent. Unlike traditional LBOs, ETAs are governed by "owner-agents" and unlike angel and venture-backed firms, ETAs acquire underperforming assets in out-of-favor industries. These distinctive characteristics define the operational focus, risk profile and financial potential of all ETAs. By supplanting the prior owners, the acquiring entrepreneurs have maximum latitude to embark new growth through market-transforming strategies. For these reasons, the success rate for search funds should be indifferentiable from the complete population of ETAs even while size may vary considerably as a function of acquisition mode.

Perhaps most importantly, search funds are a categorical exemplar representing the *ex ante* entrepreneurial impetus that distinguishes ETA from traditional LBOs and even the buyout modes included in the Malone (1989) and Wright et al. (2001a) studies. Search funds demonstrate the entrepreneurial dynamic in a fashion that ultimately eludes earlier efforts to study buyouts. This shared dynamic simultaneously differentiates ETA from other buyouts and binds them as a subject of interest to entrepreneurial finance. LBOs are rooted in the discovery and exploitation of existing value. Angel and venture-backed firms are rooted in value creation. Meanwhile, ETA is rooted in existing value *and* value creation.

Future Opportunities. The agenda for ongoing studies of ETA is broad and deep, and it directly engages entrepreneurial finance scholars and practitioners. First and foremost, there is a need to build more and better data sources. In the absence of existing data, researchers will find it fruitful to conduct detailed case studies to further refine the portrait of ETA. Armed with an improved understanding of the antecedent conditions of ETA from these detailed studies, it is likely that the targeted use of retrospective data sets will bear more and better fruit. Specifically, the private sector data in Securities Data Company (SDC) and the new business longitudinal panel data comprising the Kauffman Firm Study (KFS) are typical of sources that may become more applicable to the study of ETA when used in conjunction with qualitative research data.

Access to new and better data will open avenues to a broader analysis of the conditions impacting variation in ETA's risk-adjusted returns and its ability to contribute to socio-economic rejuvenation. The dual effects of value-creation and value-preservation situate ETA as a phenomenon of interest to numerous fields. Cross-disciplinary research will find in ETA an intriguing playground for testing notions of innovation, development and emergent finance.

Figure I
ETA within the U.S. Acquisition Landscape

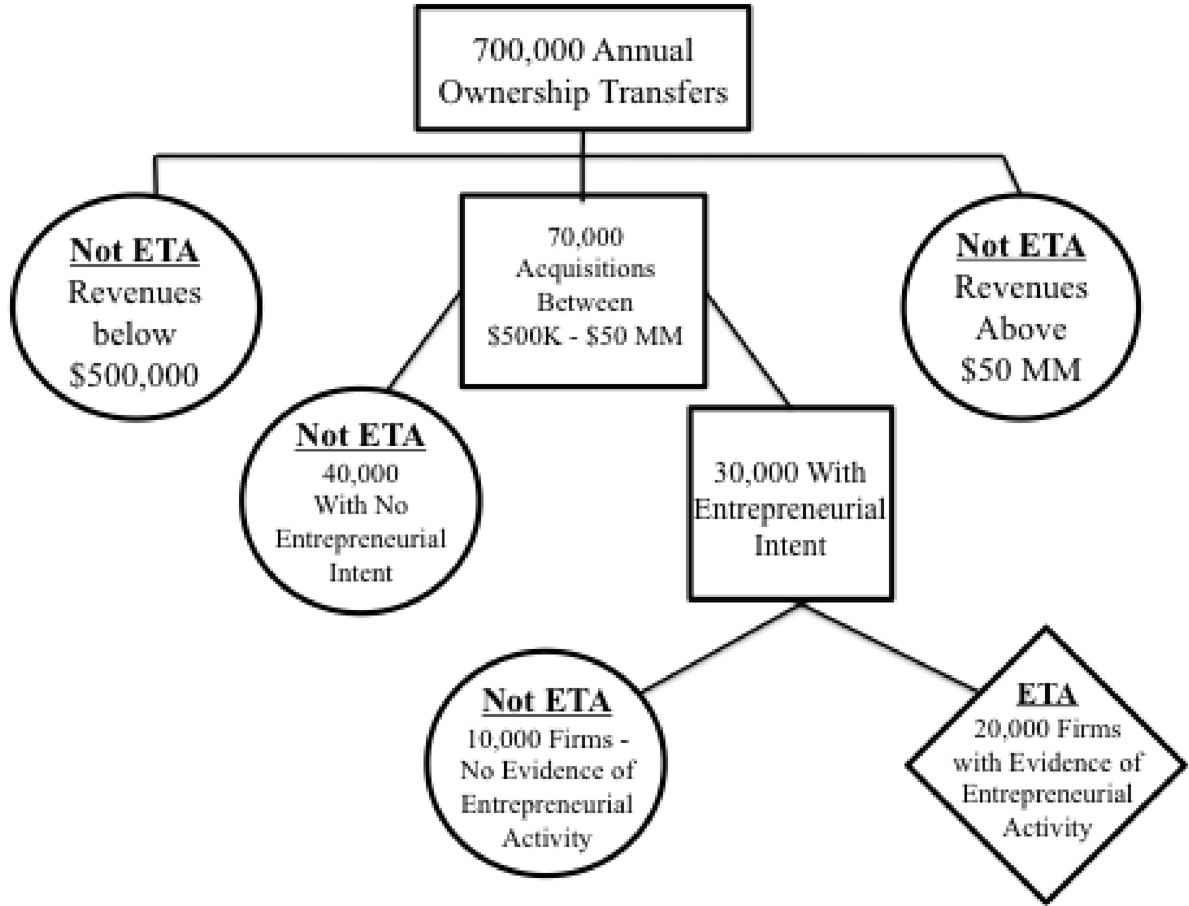

Figure II
Four Stages of the Search Fund Process

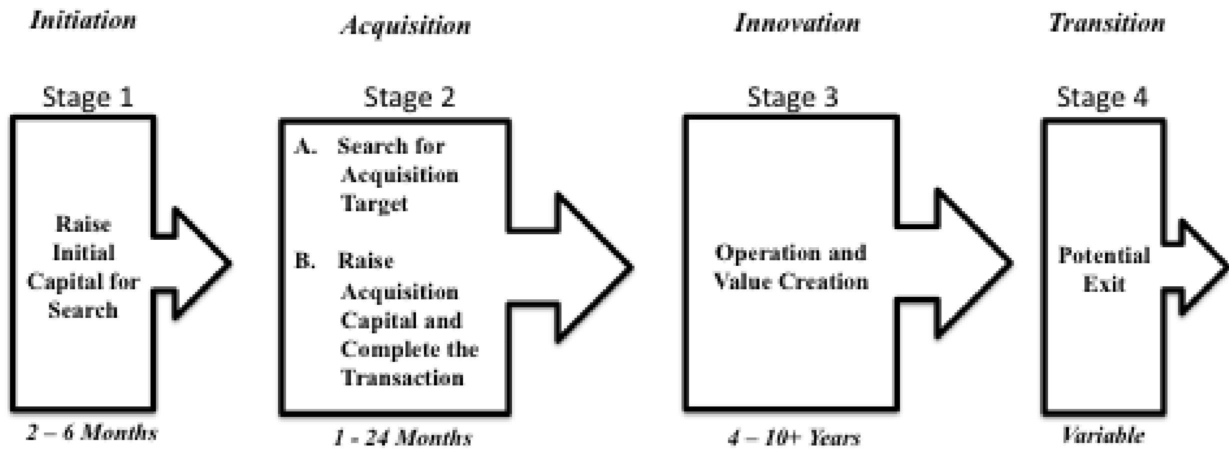

TABLE I
LBO and ETA - Key Similarities and Differences

Dimension	**Defining Characteristics**	
	LBO	**ETA**
Over-Arching Purpose	Identification and capitalization of undervalued assets	Identification and capitalization of undervalued assets
Theoretical Heritage	Agency Theory (Jensen & Meckling 1976; Eisenhardt 1989)	Entrepreneurship Theory (Knight 1921; Schumpeter 1942; Kirzner 1978, 1999; Shane & Venkataraman 2000)
Ownership Trajectory	Public firm taken private and then taken public again	Private firm remains private.
Typical Owner-Investors	Financial sponsor – usually private equity firms or LBO associations.	One or more individual entrepreneurs.
Governance	Classical Owner-Agent structure	"Owner as Agent"
Defining Strategy	Short-term financial engineering	Long-term growth/expansion into new products, services and markets
Approach to Free Cash Flow	Cash flow to service debt.	Cash flow deployed to growth initiatives
Holding Period	Up to several years	Up to several decades or generations
Exit Strategy	Key element of purchase decision. Typically taken public 3 to 5 years after the LBO.	Rarely instrumental to purchase decision.
Ideal Candidate	Underperformance. Financially undermanaged	Underperformance. Operationally or strategically undermanaged
Size	Up to $100 Billion and 10,000s of employees	Up to $50 Million or 500 employees
Expense Rationalization	Expense reduction for profit enhancement	Expense reduction for strategic redeployment
Leverage	Leverage is the key to producing high returns. Focus on the "discipline of debt" to influence management behaviors	Leverage holds no special importance because of long-term horizon and "owner as agent" governance.
Management Approach to Risk	Short-term focus due to expectations of return. Potential danger of incoherent long-term commitment.	Long-term focus. "Owner as Agent" governance creates potential for insufficient short-term risk-taking.

Management Continuity	Strong existing management to implement new owner goals	Existing management entrepreneurially limited. Displaced by the acquirers.
Impact on Capital Structure	Replacing equity with debt. Cash deployed to dividends.	Replacing equity with debt. But, cash is used for growth.

TABLE II
LBO and ETA – Candidate Selection Criteria

Target-Firm Features	**Selection Criteria**	
	LBO	**ETA**
Prior Results	Historical underperformance	Historical underperformance
Assets / Holdings	Large asset base	Often small. Sometimes virtually non-existent in service companies.
Investment Requirements	Low future capital requirements	Expectation of investment for growth.
Cost Structure	Potential for process improvements towards cost reductions.	Same, but cost reductions involve strategic realignment and emphasis on growth.
Market Position	Strong, even leading, market position.	Emphasis placed on untapped potential of marginalized performers.
Company Management	Strong team in place to implement profit goals.	Management team largely, if not wholly, replaced.
Value Multiples	Relatively low enterprise value.	Looking for value, but redirected growth strategy and long-term investment horizon can justify higher multiples.

TABLE III
Search Fund Returns (Through 2009)

	2001	2003	2005	2007	2009
Distribution of Search Fund IRR					
Total Loss of Capital – No Acquisition	N/A	N/A	11%	12%	17%
Total Loss of Capital - Acquisition	N/A	N/A	9%	10%	15%
Partial Loss of Capital	N/A	N/A	33%	27%	28%
0% to 25%	N/A	N/A	22%	25%	19%
26% to 50%	N/A	N/A	14%	18%	14%
50% to 75%	N/A	N/A	4%	2%	3%
76% to 100%	N/A	N/A	2%	2%	2%
Greater than 100%	N/A	N/A	4%	5%	2%
	2001	**2003**	**2005**	**2007**	**2009**
Aggregate Blended IRR	38%	32%	37%	52%	37%

Source: Center for Entrepreneurial Studies (CES) at Stanford University and phone surveys.

TABLE IV
Comparison of Investment Returns

	Search Funds	Angel Investments	VC – Start-Up Stage Investments
Aggregate Blended IRR	37%	27%	24%
Companies Exiting with Negative Returns	44%	52%	65%
IRR of 50% or more	7%	23%	22%
Median Multiple of Returns for Exits	1x	Negative Returns at Median	Negative Returns at Median
% of Firms Surviving as Going Concerns	90%	35%	35%
M&A Strategic Exits 2005 - 2010	20 (12% of Search Fund Universe)	1,427 (3% of Angel-Backed Universe)	2,132 (8% of Venture-Backed Universe)
Initial Public Offerings 2005 - 2010	0	177	293

Sources: Search Fund Data from CES and phone surveys. Angel Data from Kauffmann Foundation Report. Venture data from National Venture Capital Association.

TABLE V
Favored Industries – Recent Trends by Funding Source

Search Funds	**Angel Investments**	**Seed and Startup VC**
Misc. Services (60%)	Software/Internet (19%)	Software (24%)
Manufacturing (20%)	Health/Biotech (18%)	Biotech (15%)
Distribution (5%)	Bus. Products & Services (16%)	Med Devices & Equip (10%)
Manufacturing/Service (5%)	Consumer Prods & Srvcs (15%)	Media & Entertainment (9%)
All Other (10%)	Hardware (12%)	Industrial & Energy (8%)

Sources: Search Fund Data from CES. Angel Data from Kauffmann Foundation Report. Venture data from National Venture Capital Association.

TABLE VI
Search Fund Pipeline – Through 2010

Stage	Number of Search Funds
Funds Launched in 2010	30
Funded Searches In Process (Prior to 2010)	41
Operating Acquired Company	33
Closed Fund without Acquiring Company	19
Exited Acquired Company with a Loss	16
Exited Acquired Company with a Gain	20
TOTAL Search Fund Universe	**159**

Source: CES. 2010 data gathered through phone interviews.

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