

Search Funds Are Changing the Small Business M&A Landscape

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In recent years, search funds have seen increased usage in small business acquisitions, offering a structured yet flexible approach to acquiring and growing companies. The "origin story" is often credited as arising out of Stanford Business School in the 1980s, and has gained traction among entrepreneurs, investors, and family offices since then. It provides a new path to ownership and long-term value creation.

So, why are search funds transforming the small business M&A landscape? The answer starts first with the structure of these search funds, how they differ from traditional private equity, and the legal and financial considerations investors and entrepreneurs need to understand. They share many similarities with independent sponsor deals but also have a number of stark differences.

What Is a Search Fund?

A search fund is a structured investment vehicle designed to help an entrepreneur find, acquire, and operate a small business. It typically follows a two-stage process:

Search Phase

Investors provide initial capital to support a qualified entrepreneur as they search for a business to acquire. The timeline for this search can typically take 12–24 months and is often dictated by the terms of the investment documents. This initial capital is used to cover due diligence expenses, professional fees, and provide some form of compensation to the searcher (although this last point can turn off some investors).

Searchers typically target businesses that fit a particular investment thesis, such as those with strong recurring revenue, low customer concentration, and proven stability. The process requires extensive outreach, negotiation, and due diligence, making it both intensive and time-consuming.

Acquisition & Operation Phase

Once a suitable business is identified during the search phase, the entrepreneur leads the acquisition, often bringing in additional investor capital and financing for the purchase. SBA loans are often utilized as a financing option unless it is an asset-heavy target, in which case a traditional lender may be willing to finance the deal.

Post-acquisition, the entrepreneur operates and scales the business, creating value for investors over a 5- to 10-year horizon. This differs from independent sponsor deals where the independent sponsor may prefer a "hands-off" approach rather than taking on the "operating partner" role.

The target size for these acquisitions is typically small businesses with \$1M–\$5M in EBITDA, focusing on stable, profitable companies where an operational leader can add significant value.

Some might be willing to acquire a business with less stable footing if there are clear deficiencies that can be quickly remedied. An example of these remedies can include digital transformation, improved sales or operational processes, faster accounts receivable cycles, or vendor/supplier issues that can be addressed with fresh capital.

Why Are Search Funds Growing in Popularity?

Aging Business Owners & Succession Gaps

- Many Baby Boomer-owned businesses are coming up for sale, but they lack internal succession plans. We've all heard about the upcoming "transfer of wealth." This is largely what is being discussed. There are huge amounts of capital locked up in small business ownership.
- Search funds provide a structured solution, offering business owners an exit while ensuring continuity under capable leadership.

Alternative to Private Equity & Traditional M&A

- Private equity (PE) firms often seek larger, high-growth businesses or require substantial restructuring post-acquisition.
- Search funds focus on stable, cash-flow-positive businesses, often without excessive debt financing. These search funds also offer emerging managers a platform to showcase their skills and set up future (larger) deals.

Strong Investor Interest in Small Business Buyouts

- Many family offices, high-net-worth individuals, and independent investors are attracted to the long-term, hands-on nature of search fund investments, and the chance to mentor emerging entrepreneurs.
- Unlike traditional PE, investors partner directly with an operator, aligning interests toward sustainable growth rather than quick flips.

Proven Success & Institutional Recognition

- Studies show that successful search funds yield attractive returns. Stanford's research indicates an average IRR of 30–35% for successful search fund investments.
- Business schools and institutional investors are increasingly supporting search funds as a legitimate investment class, with many schools creating "entrepreneurship through acquisition" workshops or curriculums.

Key Legal & Financial Considerations

While search funds present compelling opportunities, structuring the deal properly is critical to long-term success. Here are key legal and financial considerations investors and entrepreneurs should keep in mind:

Legal Considerations:

Fund Formation & Investor Agreements:

- Search fund structures vary—some use traditional LP/GP models, while others form LLCs with pro-rata investor rights.
- Well-drafted legal agreements define profit splits, investor rights, and operational control.

Due Diligence & M&A Structuring:

- Business acquisitions involve legal, tax, and regulatory complexities.
- Asset vs. stock purchases have different tax implications and liability considerations.

Governance & Founder-Investor Alignment:

- Search funds operate with investor oversight, often with board seats or advisory committees.
- Proper corporate governance structures protect both investors and the entrepreneur.

Financial Considerations:

Equity vs. Debt Financing:

- Search funds typically rely on equity-heavy funding rather than high levels of debt.
- However, some deals incorporate SBA 7(a) loans or seller financing to optimize capital efficiency.

Profitability & Valuation Metrics:

- Investors focus on stable EBITDA margins, typically in the 15–25% range.
- Many search-acquired companies operate in low-tech, recession-resistant industries (e.g., B2B services, healthcare, niche manufacturing).

Exit Strategies:

- Search fund exits typically occur via private equity acquisition, strategic buyer sale, or investor buyout.
- Holding periods range from 5–10 years, aligning with long-term wealth creation.

Should You Invest in or Launch a Search Fund?

For **investors**, search funds offer a compelling alternative to traditional private equity, allowing for:

- Higher potential returns in undercapitalized small business sectors.
- More direct involvement and operational influence in acquired businesses.
- Alignment with long-term value creation, rather than short-term financial engineering.

For **entrepreneurs**, search funds provide:

- A structured pathway to business ownership with investor-backed support.
- Access to capital and advisory networks without needing personal funds upfront.
- A leadership role with strong financial upside.

Final Thoughts: The Search Fund Model Is Likely to Continue Trending Upwards

As small business ownership transitions accelerate, search funds will continue to play a growing role in the M&A ecosystem. For investors, they provide an opportunity to back talented entrepreneurs in acquiring and scaling high-quality businesses. For "searchers" or buyers, search funds offer a viable and structured alternative to a startup.