Yale SCHOOL OF MANAGEMENT

YALE CASE DECEMBER 10, 2021

On the Nature of Seller Selection in a Search Fund Project

How to identify genuine sellers and desirable sellers

Mark Anderegg[1]
Lucas Braun[2]
Jürgen Rilling[3]
Ryan Robinson[4]
A. J. Wasserstein[5]

Aspiring entrepreneurs pursuing a search fund journey face many challenges in the early stages of identifying a business to acquire. One significant challenge is identifying sellers of businesses who are actually ready to release their business and engage in a transaction. A fantastic company in a wonderful industry can be enticing, but if the potential seller is not truly a seller, the opportunity is a mirage and is not actionable.

Another challenge, in addition to identifying viable sellers, is finding good or forthright sellers. A practicable deal opportunity might be attached to a seller who is a bad actor or a potentially great partner. A bad actor seller could be setting up the search fund entrepreneur for a tortuous deal process and post-closing headaches. In contrast, an angelic seller puts the aspiring entrepreneur on the path to a smooth closing and a collaborative post-closing partnership.

This invites the following questions:

- What are the telltale signs of a potential seller being ready to sell?
- What type of seller should an entrepreneur do a deal with?

In this note, we will examine ways to identify if a seller is ready to sell and how to categorize potential sellers in a deal opportunity. See **Figure 1** for telltale signs a seller is prepared to sell. See **Figure 2** for the three buckets into which a seller might fall. Finally, we close the note with some brief comments about working with potential sellers.

Figure 1: Telltale signs a seller is ready to sell

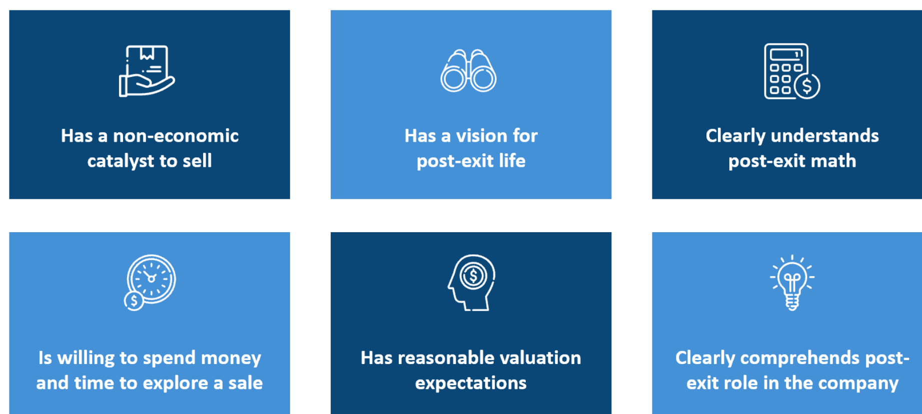

Figure 2: Three buckets into which a seller might fall

As former and current entrepreneurs and CEOs of successful businesses and as investors who have invested in more than 100 search fund projects, we have personally experienced the emotional rollercoaster of attempting to acquire a business to operate and have watched endless entrepreneurs do the same. In a search fund journey, time is the most precious resource, and squandering it on opportunities that are not functional is the searcher's biggest mistake. Finding applicable opportunities is as much about picking a seller as selecting a business.

How to tell if a potential seller is an actual seller

When a search fund entrepreneur is prospecting businesses and sellers, there are many reasons why a potential seller might choose to engage with the searcher with no bona fide intention of ever selling the business.

It is flattering to be called on by a smart, young, energetic MBA graduate who wants to buy the business. Being solicited inflates the potential seller's ego and gives them a sense of importance and accomplishment – it is pleasing to be pursued. Talking to a talented searcher is more fun and interesting than attending to the mundane tasks of running a business. It is more enjoyable to talk about the company than to address issues involving angry customers or thorny employees. This conversation gives the potential seller a chance to brag about the business and reflect on their accomplishments with an eager and attentive listener – something the potential seller's spouse probably does not tolerate well.

Hypothetical sellers might be interested in free consultative advice from an objective outsider's perspective. They may see it as an opportunity to obtain intellectual input on the business. Finally, the potential seller might view the searcher conversation as a way to get a complimentary business valuation – everybody enjoys being told how much they are worth.

So, the search fund entrepreneur needs to be wary of frittering away precious time on fictitious sellers. We assert that certain telltale signs indicate that the potential seller is indeed ready and intends to sell their business. Our list is non-exhaustive but will help business buyers distinguish genuine sellers from illusory ones. We suggest that search fund entrepreneurs channel their inner detective and look for clues that their prospective seller is actually a seller. If the indications are not there, searchers should resist the temptation to try to convert a non-seller into a seller – it is an extraordinarily challenging task. Instead, we recommend that searchers wait until enough clues are present in a desirable opportunity and then laser in and try to move the deal forward.

Our telltale signs that a seller is genuine are the following:

- **Has a non-economic catalyst for selling.** This is the fundamental feature of an authentic seller who is ready to sell a business. Ideally, a lifecycle event prompts the decision to exit rather than the desire to capture a specific inflated price or time an auction. Non-economic catalysts might include reaching a predefined retirement age, the need to care for an ill spouse, relocating to a new geography to be closer to grandchildren, burnout and malaise from running a business for an extended time, seeking more leisure time and a slower life pace, recognizing the business has outgrown the seller's managerial skills, a family death, a divorce, or a mental or physical disability. When events such as these drive a seller's thinking regarding a business sale, the seller is emotionally and psychologically ready for the business ownership chapter to end. If a seller is just trying to time a frothy market or fishing for a magical number, the probability of a transaction getting to the proverbial finish line dramatically decreases. We encourage searchers to seek out sellers who are engaging for emotional and personal reasons – not purely financial ones.

- **Has a vision for post-exit life.** Selling a business is a giant transition for a CEO – we have experienced it at the end of our entrepreneurial arcs and can attest to this. Even when filled with newfound wealth, it can be a very emotional and even traumatic experience. Sellers who are ready have a vision for their post-exit life. They know where they are going professionally and personally. This post-exit game plan might be articulated by moving to sunny Florida, planning to play 100 rounds of golf per year, pursuing volunteer work at a favorite not-for-profit organization, increasing time spent with grandchildren, lounging about on an extended around-the-world cruise, or pursuing an encore career that is not competitive to the business (like teaching!). The essence of this point is that the seller has deeply contemplated what is next in life and is comfortable letting go of the business and moving on to the next chapter.

- **Clearly understands post-exit math.** While selling a business can come with a pecuniary windfall, it is rare that the post-exit, after-tax proceeds will replace the cash-generating capability of the business itself. For every dollar of purchase price, the seller will likely net 80 cents after tax. Furthermore, the investable proceeds (in public equities and fixed income securities) will likely not generate the same returns as a small, private business – at least in theory. Additionally, the seller will now have to bear expenses like personal vehicles, health insurance, cell phones, and perhaps travel and dining that the business might have previously covered with certain tax advantages. To be ready to move forward with a transaction, the seller needs to fully digest the monetary reality of post-exit life.

- **Is willing to spend time and money to explore a sale and has communicated the sale process to key parties.** Sellers who invest human and financial capital are signaling they are ready to transact and committed to doing what is necessary to consummate a deal. For example, when a search fund entrepreneur asks for certain information (like company financials, customer data, and sales growth data), if the seller is willing to take the time to produce the data, that should be taken as a positive sign that they are earnest in their interest to explore a transaction. Conversely, if the seller is hesitant or unwilling to share detailed information, this might be a sign that a more direct conversation is required about the seller's goals and objectives. Of course, if the seller engages an intermediary (a sell-side agent like a broker or investment banker) who has been paid a retainer, the seller has crossed the emotional chasm and is actively seeking to close a deal. Other actions the seller might take indicating they are on a deal track include hiring a competent transaction lawyer and engaging their accountant to develop a financial package, no matter how rudimentary or inchoate.

An additional signal that a seller is fully engaged and ready is that they have told key employees in the company that the business is being sold. This implies that the seller is emotionally committed and has employees aligned and on board with the potential transaction. Furthermore, a seller who has shared their intentions with a spouse or children and received buy-in has completed a significant step. A surreptitious seller can have family members or employees ambush a potential sale process and disrupt a buyer. A seller who does not spend time and money early in the sale process or communicate their intentions to employees and family members might be a phantom actor.

- **Has reasonable valuation expectations.** Inevitably in the sale courting dance, valuation and price expectations come up in the conversation. This is healthy, and the search fund entrepreneur should use this as an opportunity to test the seller on authentic commitment. If a seller articulates valuation expectations in line with normal industry parameters, the seller is more likely to be engaged. For example, if the seller has a $2 million EBITDA[*] business and thinks the business is worth $25 million, the search fund entrepreneur might be misspending their time on a very low probability situation. The seller may express valuation as a nominal number as compared to a multiple of EBITDA or cash flow. This is perfectly fine as long as the number links to industry comparables. Actually, a seller who articulates a 'hit my number' ask is quite desirable – they know what they need, and there is a stake firmly in the ground. This is far better than a nebulous moving target. Closely connected with reasonable valuation are realistic terms and structure. An all-cash ask with no seller paper, escrow, or earnout might be a futile expedition.

- **Clearly comprehends their post-exit role in the company.** Some sellers want to completely exit the business when a sale is consummated, and other sellers remain in the business, at least temporarily. This can be at the seller's request to earn more money or the searcher's request to provide a smooth transition to a new owner and leader. If a seller entirely departs the company, they should appreciate that there is no longer any formal role or link to the business. They can certainly be a friend of the business, but any explicit part for them to play is nonexistent. If a seller is to remain in the business, they need to fully grasp what their role in the company will and will not be. Specifically, the seller should recognize that the search entrepreneur will now be the CEO and will be entirely in control with all decision-making authority. They will need to be part of a functioning team and abide by the rules and procedures established in the business. If the seller is a board member, they will be one voice of several and certainly not in control.

When search entrepreneurs are curious detectives and can objectively assess seller signals and behaviors, they can relatively easily discern true sellers from posers. By carefully probing and testing the seller, the searcher can quickly conclude whether to keep investing time and energy or jettison the prospect for another that is more tenable. Searchers must be dispassionate about this evaluation process. All too frequently, searchers invest months into an opportunity with no result and then retrace their steps to clearly see that the seller never exhibited any of the telltale signs of actually being a bona fide seller. One wonderful way to assess a seller's orientation is to present a term sheet (a non-binding offer for purchase with business terms and conditions) at some point in the series of conversations. Asking a seller to sign something – even if it is non-binding – is an excellent way to evaluate intentions and commitment. Of course, every potential seller will likely not check all of the telltale signs enumerated above. Searchers should seek at least a few to conclude a seller is authentic.

[*] Earnings before interest, taxes, depreciation, and amortization

Elise Polezel (Harvard Business School 2020) acquired HigherMe, a hiring software solution for restaurants, in June 2021 from Rob Hunter, who founded the company in 2014. Polezel saw several signs that Hunter was a genuine seller: 1) he had turned down an offer from a strategic buyer because he wanted to keep his team intact, 2) he provided Polezel with the materials he put together for the other buyer, 3) he considered himself a great "zero-to-one" founder and already had another startup he was working on, and 4) he had reasonable valuation expectations. With all of these telltale signs in place, Polezel and Hunter signed a letter of intent just four days after their first call. Six months after the acquisition, the business had grown more than 40 percent.

> Looking back on the first six months of running the company, I'm most proud of the relationship I've built with the seller and executive team. I walked away from a previous deal because the seller was very transactional and difficult to deal with. I only planned to buy one business, so I wanted to put myself in the best position to be successful. I knew a positive relationship with the seller would be an important part of my future success.
>
> The relationship with Rob felt right from our first conversation. We got along great, and he was transparent at every step. In order to optimize the relationship with Rob, I focused on quickly building trust through commonalities (we had both been through Y Combinator), reciprocating his transparency, and following through on all the things I said I would do. I treated him the way I would want to be treated because I knew the way I treat the seller is a big indication to the team of how I will treat them.
>
> The relationship we built was incredibly valuable to me during diligence. Rob gave me access to company systems and people to get primary information. I was invited to a Slack channel called "Welcome Elise", where I could communicate with the executive team and ask questions. Even after the transaction, Rob continues to be a great advisor to me. Our relationship laid the foundation for the team to trust and respect me as the new CEO.
>
> Being collaborative and open with Rob worked really well for me. I would definitely take that approach again.

The three types of potential sellers

Once a search fund entrepreneur concludes a seller is truly a seller, there is another level of detective work and analysis for the searcher to pursue. Not all sellers are created equal and pursuing a deal with a corrosive seller will lead to a transaction process that is fraught with emotion, hard to conclude, and difficult even after the sale is closed. We believe that sellers can fall into one of three buckets: partners, transactors, and no-tolerance sellers. Search fund entrepreneurs should only consider moving forward with the first two categories and should unconditionally eschew the last.

- **The Partner.** The ideal seller is highly ethical, trustworthy, easy enough to interact with (not confrontational), and able to add future incremental economic value to the project. This category of seller is reasonable and fair, has a positive attitude towards getting a deal done collaboratively, and cares about and believes in the business's future. They want to be part of the business going forward as a board member, employee, or investor – and they clearly understand their position in those various roles. Most significantly, the searcher genuinely believes the seller will add value that

will benefit the searcher and the searcher investor group. This potential seller has a unique set of needs and circumstances that a search fund entrepreneur can distinctively solve. Perhaps the seller is unenthusiastic about seeing the business being acquired by a large industry consolidator, or the seller wants to play a minor role in the company's go-forward trajectory, or the seller sees the searcher as an idealized version of themselves at a younger age. This seller is a partner and someone the searcher is thrilled to be economically entwined with post-deal.

- **The Transactor.** This seller is very similar to the partner described above. They, too, are ethical, of high integrity, honest, and pleasant to work with. They are easy enough to deal with and are committed to getting a transaction done in a mutually beneficial way without unnecessary drama. The big difference here is this seller cannot add future value to the business. The searcher should be delighted to transact with this seller but resist the temptation to have this seller on their board or team or as an investor. We view this seller as a one-and-done situation – there is no future relationship that connects the parties together (we do encourage searchers to still keep in touch with this seller and treat them with respect, deference, and appreciation – but not to include them in the ongoing business). Sagacious investor Bill Egan articulates that cash is a one-time expense and equity is a forever expense. Searchers should not create a forever expense with transactors.

- **The No-tolerance Seller.** The final bucket of seller we identify is not ethical, honest, or easy to deal with. They have checkered pasts with lots of broken relationships and businesses. Everything is difficult with this seller. There is a confrontational tone, and that has manifested itself in the past through litigation. This seller cares a great deal about the non-compete agreement and is signaling storms ahead. With this seller, everything is emotional and filled with drama. Each conversation feels like a game of brinkmanship and is on edge, with the tone at level ten. We think of this seller as the no-tolerance person. As soon as the searcher detects the slightest whiffs of this behavior, they should move on. Not only will trying to get a deal done be laborious and emotionally exhausting, but it is also likely the no-tolerance character will make the searcher's post-deal life arduous. The only thing worse than doing a deal with this player is having them involved in the business in some capacity. Searchers should be warned that no amount of legal documentation and contracting can make this odious seller tolerable. Legal papers cannot make a bad person a good person (we have tried and failed at this). The only way to interact with a no-tolerance seller is not to interact at all. As desirable as a business target might be, it is not an actionable opportunity if a no-tolerance character owns it.

Searchers need to play detective and ascertain whether a seller is a partner, transactor, or no-tolerance seller. Searchers should not brook no-tolerance sellers at all. We are optimists (we are entrepreneurs and investors, after all). We think most potential sellers are good people who are fair, honest, and capable of getting a deal done in an agreeable way. But searchers need to be on the lookout for imposters who are no-tolerance sellers in disguise and avoid these sellers at all costs. Finally, searchers should trust their instincts. If a seller seems fishy for some reason, just move on. This is too big a decision to stretch and reach for a deplorable seller.

In 2016, Kevin Brady (Carroll School of Management at Boston College 2006) joined Little Sprouts (acquired via a search fund in 2012) as head of business development after eight years as a private equity investor. The primary focus of his new role was to source and execute inorganic growth initiatives, namely, the opening of new schools and acquisitions. With nearly a decade of dealmaking experience, Brady was no stranger to the different dynamics and personalities that one encounters when canvassing the landscape of acquisition candidates. Moreover, he was familiar with the pressure that can be felt to close deals even when there is 'hair' on them. Brady encountered just such a situation when he was about a year into his tenure with Little Sprouts, at a time when the company was behind in its plan and starting to encroach on debt covenants.

> I had seen this situation previously during my private equity career – the company really needed to shuffle the deck to reset covenants, and an acquisition was an obvious way to do so. I had been courting a business owner for several months, and, from the beginning, it just didn't feel right. He was a younger guy in his early 40s, and I never really understood why he would sell. While he was charming, I always got the sense that we did not share similar values. As an example, the seller struggled to answer due diligence questions easefully or with a sense of openness, causing me to question whether he was being fully honest. In spite of this concern, we bought the business in a manner that sought to mitigate post-closing risk through a buyer-friendly purchase agreement, which proved helpful but still fell short of being a complete solution.
>
> Fast forward a couple of years. We were being acquired by a large global strategic buyer. Late in their legal diligence, it became known that the seller may have conveyed the business to us fraudulently. This, by extension, had serious effects on the sale of our business. It not only prolonged the process but also introduced profound anxiety because it became highly uncertain whether the buyer would close. Many tens of millions of dollars were at risk.
>
> To this day, it remains unclear whether or not the business was conveyed fraudulently by the seller, but I learned to trust my instincts to not buy companies from sellers I don't understand or with whom I do not share base-level values.

A no-tolerance seller can wreak havoc not just during the deal process or the immediate aftermath but also at unpredictable and inopportune times throughout an entrepreneur's journey.

Some thoughts on how to treat sellers in an acquisition process

Although this case note is not about the specific process of managing sellers during the acquisition process, we thought we should share some very brief thoughts since it is tangentially related to seller selection.

When a search fund entrepreneur is pursuing an acquisition target, regardless of the type of seller, the searcher should reframe the process at hand. Rather than thinking about *buying* a business, we encourage searchers to think about *selling* a business owner on the concept of trading their precious business for the searcher's funds. The process is not about being a buyer; it is about being a seller and ingratiating yourself with the business owner. Furthermore, searchers should metaphorically step into the seller's shoes and understand what they want to achieve from a transaction. Searchers would do well to let that understanding guide the content and tone of interactions, especially the earlier ones. It is too easy for searchers to think the

deal is all about them. The focus should be on the seller's needs, not the searcher's. This way of thinking – and behaving – will serve searchers positively.

Periodically, we witness search fund entrepreneurs approaching potential sellers with a superior tone and a condescending manner. Searchers often have gold-plated resumes with names like JP Morgan Chase and McKinsey and hail from private equity and investment banking. Additionally, searchers have likely attended elite business schools like IESE, Stanford, and Yale. Searchers tend to be extremely book smart. This can potentially be off-putting to business owners, and searchers would be well served to be humble. Business owners may often lack the pedigreed background of many searchers, but what business owners *have* done is start a business, nurture that business into a profit-generating machine, and lead a complex company – something most searchers have *not* accomplished. Business owners also tend to be very savvy and street smart.

We encourage searchers to approach the selling process with genuine respect and appreciation for what business owners have accomplished. Flatter owners with admiration and compliments, but not in a smarmy manner. Give business owners the ego boost they deserve for building a desirable company.

Searchers who understand that they are actually sellers and not buyers and have an approach of politely nurturing the business owner relationship with sincere appreciation for the owner's skills and accomplishments will increase the probability of getting a deal done – and of the deal having more appealing pricing, terms, and conditions.

Be genuinely nice; it is the right thing to do and pays worthwhile dividends.

Conclusion

Although identifying an attractive business to acquire, operate, and grow is a search fund entrepreneur's primary objective, the searcher must also focus on finding an actual seller who is also appealing. Searchers should don their detective caps and pick up their magnifying glasses to look for telltale clues that a seller is authentic and prepared to let go of their company. Sellers inevitably provide hints about their psychological state and their post-exit vision. It is the searcher's job to pick up on these. When a seller is shopping for furniture for their new beachside home in Florida, they are inarguably a seller and worth investing time to pursue.

Additionally, sellers fall into three buckets – partners, transactors, and no-tolerance sellers. Partners and transactors can be terrific people from whom to acquire a business, and searchers should actively screen for and identify these sellers. No-tolerance sellers are nothing but friction and headaches and are not worth the effort. No legal documents can mitigate the risk and pain of dealing with unethical and unsavory sellers. The only way to address a no-tolerance seller is to move on.

Good luck on your search fund journey, and we hope you find sellers who are ready to engage and are potential partners!

This case has been developed for pedagogical purposes. The case is not intended to furnish primary data, serve as an endorsement of the organization in question, or illustrate either effective or ineffective management techniques or strategies.

Copyright 2021 © Yale University. All rights reserved. To order copies of this material or to receive permission to reprint part or all of this document, please contact the Yale SOM Case Study Research Team: email case.access@yale.edu.

Endnotes

[1] Mark Anderegg is a senior advisor at the Center for Private Equity and Venture Capital at the Tuck School of Business at Dartmouth College. He is Co-Founder & Managing Partner of Newbury Franklin and the former CEO of search fund company Little Sprouts.

[2] Lucas Braun is a managing partner of Brown Robin Partners. He is the former co-CEO of the search fund company OnRamp.

[3] Jürgen Rilling is the founder and managing director of Mirablau GmbH. He is a former searcher and co-CEO of Grundig Business Systems and is currently a board member of the Search Fund Center at IESE Business School in Barcelona.

[4] Ryan Robinson is a managing partner of Brown Robin Partners and a steering committee member of the Women's Search Network. He is the former co-CEO of the search fund company OnRamp.

[5] A. J. Wasserstein is the Eugene F. Williams, Jr. Lecturer in the Practice of Management at the Yale School of Management.