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Search funds attract young Brazilian entrepreneurs

By **Maria Luiza Filgueiras** | São Paulo

In the last two months, Minas Gerais native Tulio Gomes, founder of TBG Investimentos, has already analyzed 130 small and medium-sized companies. He can spend another year just screening, financed by investors, until finding a specific company: with stable revenue, EBITDA margin above 15%, annual cash generation between R$5 million and R$20 million and growth potential. If everything goes as planned, in 2019 he will be the CEO of a Brazilian company.

Tulio Gomes

The history of Mr. Gomes and his TBG Investimentos is part of a small but growing financial segment in Brazil. It is of search funds, vehicles nonexistent here five years ago but which now count at least seven management firms in the country. “The fund is for those with entrepreneurial spirit, to run a company, but eliminating the risk of a startup, which grows basically from one idea,” Mr. Gomes says.

Search funds originated at Stanford University’s Graduate School of Business. With a series of students with starry academic records, good professional experiences and interested in running businesses, the university’s teachers began investing in funds that financed them in the 1980s — more than 20 years later, search funds became a specific program at business schools, propagated especially at Stanford and Harvard (where Mr. Gomes studied). In the US 258 funds of the type have already been raised. Its entrepreneurs on average are 32 years old.

A potential entrepreneur raises funds from investors to pay for daily expenses with accommodation, traveling, audits, until finding the ideal company. In the American experience, this takes on average two years. After the target company is identified, the entrepreneur raises a second fund for the acquisition of the company — the first fund’s investors have preference, but if they don’t like the choice they don’t put new money. The goal is to make the company grow, enter new markets or services and, usually, sell it to a private-equity fund, to competitors or to other entrepreneurs.

Peter Kelly, a lecturer at Stanford, created the world’s third search fund and teaches the subject since the first class in the US, in 2009, and at the first international program, at the IESE Business School in Barcelona. Mr. Kelly has already invested in 15 funds of students — currently he invests in two search funds in Brazil, in addition to funds in eight other countries, including Mexico, Switzerland and Kenya. “Today there are more people making and understanding search funds. Success histories help promote the model,” Mr. Kelly says.

Of the seven Brazilian search funds, three have already found and acquired a company. Rio de Janeiro-based Meissa Capital, one firm in which Mr. Kelly has invested, bought Sullab Diagnósticos in February — after a search of a little over two years. The Rio Grande do Sul company develops techniques, equipment and automation for laboratories. Healthcare, education and logistic services are among the main targets of global funds now. The other two funds are Colibri, which acquired Fleming, a cram school to prepare students willing to study medicine in college, and Taqia Capital, which bought IS Logística — both deals were last year.

One curiosity of these funds is that they have several investors in common. “It is part of the search fund concept to repay what you have accomplished,” says José Stella, co-founder of QMC Telecom. Mr. Stella and his partner Rafael Somoza worked together in Puerto Rico, when they attended graduate school in the US and decided to raise a search fund. “Rafael was the one who heard about this and convinced me. Basically the idea was not to wait being over 40 years to be businessmen,” Mr. Stella says.

Since then, the partners had one fund — which invested in a billboard company and had a 55% return — and have already invested in more than 40. Of the seven Brazilian funds, they invested in six. “The entrepreneur must have a reason other than just making money. We identify who are the youths committed, with positive work and academic records, and like to see the old bosses investing in them,” Mr. Stella explains. The experience as entrepreneur also served for both to found their own company, QMC Telecom, today with operation in four countries. “QMC was not born in a search fund, but the experience we’ve had as entrepreneurs was determining,” he says.

According to the entrepreneurs, the search and investment process is interactive. “We discuss the business model, the price evaluation, there is a lot of exchange, since the investors have experience,” says Oswaldo Garcia, founder of Garos Capital. Garos raised a search fund nine months ago and already approached or was approached by more than 400 companies, advancing to proposals with three companies.

The main challenge is to manage the company, but finding it is the first obstacle. In the US, 18% of the funds had no success in the search phase. “So far, this has not happened in Brazil, but it will happen. And it’s OK,” says Ashley Giesler, partner of Anacapa, an American private-equity firm that invests in search funds. “If they do serious work, these people continue having a great career, meeting investors, they will work with them or create a company. It’s better than buying the wrong company,” she says.

Anacapa has already invested in 141 search funds in the world, including five in Brazil. “The more we learn about Brazil, the more we believe in the expansion of this model. The percentage of family businesses, of small and medium size, and without succession plan is very large and this is a natural target for these search funds,” Ms. Giesler says. According to a Deloitte study, of the 200 small and medium-sized fastest-growing companies in Brazil, 75% are family owned, 78% have no succession plan and 54% have no business plan.
