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Exploring Risk Mitigation Concepts in a Search Fund Company

A structured framework to think about risk management

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Search fund CEOs face a cornucopia of challenges, opportunities, and responsibilities in their leadership role. Finance, sales, and culture often float to the top of the CEO's agenda. After all, these are high-impact, glamorous, and offensive moves that are fun to tackle and potentially drive equity value. Risk mitigation usually hovers near the bottom of the search fund CEO's agenda because it is not urgent or sexy and feels like playing defense. Risk analysis is about protecting the downside and is not centered on upside gains. Despite this pedestrian posture, risk analysis is a crucial function in a small business. It might even be more pertinent than in a large firm because a small speed bump can easily dislocate an entrepreneurship through acquisition (ETA) business. Think of a rowboat and an aircraft carrier out at sea. Which craft is more susceptible to waves or a tsunami? The skiff or the battleship? Tiny might be agile and nimble, but a diminutive company is vulnerable in the context of risk. Additionally, the cliché of entrepreneurs being gunslinging, risk-loving actors is categorically false. Savvy entrepreneurs think about and calculate risk constantly – and do everything possible to diminish it.

In an ETA firm, the CEO is the chief risk officer, among many other chief roles. A search fund business usually does not have the talent depth for someone else to own risk management issues, especially at its inception. Therefore, the CEO needs to allocate time and mindshare to this prosaic function. Famed investing sage and guru Warren Buffett has written, "Our CEO will always be the Chief Risk Officer – a task it is irresponsible to delegate."[3] That lens is especially true in a small firm. We are certain board members and investors will not applaud a risk mitigation presentation, but the CEO will look like a hero when something goes sideways and there is a plan in place to blunt the impact.

Risk can manifest itself in different ways and at various moments in the ETA journey. For example, at the initial acquisition, most buyers are worried about deal risks, such as purchase price, debt ratios, and pro forma add-backs, that are tied to the target company purchase. As a business grows, matures, and creates equity value, however, risks can change as there is more at stake and more to lose. This note will center on risks associated with the general operation of a firm and not the incipient issues present at the acquisition.

It is worth noting that most ETA CEOs hold an interesting position on the risk spectrum in that they are initially optionees in the company's capital structure. Only when the firm has built up wealth and equity value does the CEO have something to lose. Until then, the CEO has reputational risk and opportunity risk, but little financial downside risk. CEOs certainly do not want to fail, and they are extremely emotionally invested in their project, but the financial skin in the game is low. Optionees are often risk seeking until the option is in the money. ETA CEOs must be aware of this posture and channel it in their risk manager role. Investors address this known CEO behavior pattern by building large, diversified portfolios of entrepreneurs, mitigating the concentrated perverse bad conduct of any single CEO.

A robust risk mitigation program can prevent many headaches and much financial pain and operational disruption. The right adjective to use when contemplating risk is contingent. None of the risks we will shortly discuss is guaranteed to happen (and we hope they do not for any of our readers), but they might. The occurrence of any of these risk events depends on something happening and catalyzing a disagreeable outcome at an undesirable time.

We generally think about a risk management program using the analogy of rain. Depending on geography, it might rain or not rain on a given day. A risk manager can choose never to go outside to be certain to avoid the rain. Another choice could be purchasing an appropriate umbrella while the sun is still shining. Perhaps a different tactic is to try to buy an umbrella when there is a downpour and everybody else is scrambling for an umbrella, too. Finally, someone can just accept getting soaked. Each approach reflects a different but viable way to manage and take risks.

Although there is no single right way to address risk, we do not want to avoid all rain risks and never venture outside, and we would prefer not to get drenched either. With modest forethought and expense, we can reasonably scrub out a bunch of rain risk. Similarly, ETA CEOs must ascertain if they want to invest in umbrellas and when.

Incurring risk abatement costs frustrates some executives because they feel they are not getting anything for the expense. Although accounting protocols mandate that we expense on the profit and loss statement any cash that is consumed in risk reduction initiatives, we think a better treatment could be intellectually thinking about the cash used as a balance sheet item. A future contingent asset is created when risk is proactively addressed. If something terrible happens, a resource is available to deal with it (or the probability of something bad happening has been compressed). Some CEOs feel that risk capital is wasted because the likelihood of a loss is low and their counterparty wins. When we invest money in risk alleviation activities, we hope we lose on the bet. The only way someone wins with fire insurance is when their house burns down. Who wants to win that trade?

This note will explore a quartet of risk topics (**Figure 1**). We believe these themes will help ETA CEOs better understand risk in general and how to think like a risk manager in a small business in particular. This note is introductory in nature, and we do not claim it is a comprehensive opus on all things risk management. Furthermore, our target audience includes nanocap companies with millions of dollars in earnings and scarce resources, not the Fortune 1000 behemoths with tricked-out risk management departments. We are aiming to create a useful primer for the uninitiated search fund CEO.

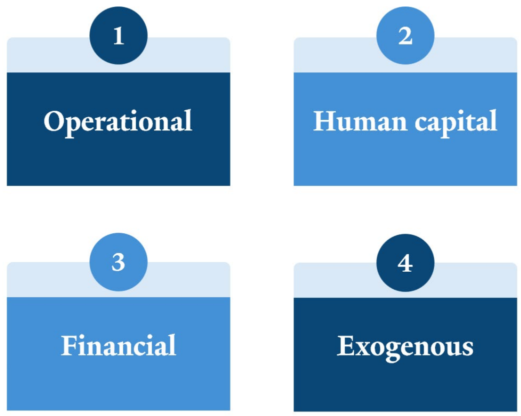
Figure 1: A foursome of risk topics this note will probe

- **01** **The four risk buckets**
- **02** **Three ways to address risk**
- **03** **Approaching risk with a probabilistic and mathematical viewpoint**
- **04** **Some thoughts on building a risk management program**

The four risk buckets

Risk lurks in every corner of an ETA business. We believe search fund CEOs should approach risk in a deliberate and structured manner. This activity must be preemptive in nature. In this section, we will not consider how to address the risks; instead, this section is focused on risk identification – the opening move in any robust risk mitigation program. The first step is developing an organized way to find and bucket risk (**Figure 2**). We think there are four silos in which risk lives, and this lens can help expand how CEOs identify and think about risk.

Figure 2: Four risk buckets in an ETA business



We will now more deeply examine the four risk buckets we identified in **Figure 2**: operational, human capital, financial, and exogenous. Our aim is to provide illustrative examples of each type of risk. It is impossible for us to detail every risk that might be present in each of the categories. Furthermore, large swaths of risk are idiosyncratic to each individual business. Certain people risks might be common, but operational risks are likely unique. Because of this, we do not discuss examples of risk to give CEOs a punch list of topics to explore; instead, we aspire to introduce a framework and way of thinking about risk that is appropriate for each entrepreneur.

01 *Operational*

Operations lie at the core of any ETA company, and they can be prickly and complex – and present scores of risk-taking opportunities. Operational failures or breaks can result in wasted time or financial setbacks. We strongly encourage ETA CEOs to ponder what operational risks skulk about in their business waiting for a surprise ambush. We will now discuss a handful of illustrative operational risks.

There is a host of risk embedded in technology infrastructure and assets. If an ETA business uses a primary ERP system that serves as the backbone of the company's operations, several things can go wrong with the software. First, the software provider (the vendor company) can sunset the software, experience financial problems, or sell the company to another company. Second, to run the software, the company might rely on internet service that, if down, would debilitate the firm's operations – literally bringing the business to a standstill and angering customers. Third, all companies are subject to nefarious cyber-attacks that could compromise or expose data, including customer financial data like credit cards, requiring embarrassing disclosures. We apologize for channeling our inner doom and gloom, but we have just pulled on a single thread. There are many more shadows in which risk can hide.

Another example of an operational risk is losing a proprietary asset like real estate or intellectual property. If a company leases operational space and it would be complicated to relocate, there is a risk that the landlord will not renew the lease if the tenant does not have the contractual right to do so. Relocating might be operationally disruptive or extraordinarily expensive with no economic return. Similarly, if the company has intellectual property (IP), it needs to ensure that its rights and claims to the IP are valid, protected, and in force.

We are safety hawks. Not only does safety matter as it relates to workers' compensation costs (and who wants to get entangled with OSHA?), but we cannot imagine a more painful and devastating scenario for a CEO than to have a severe industrial accident occur. Yet forklift, vehicle, and machine accidents (and deaths) happen all the time. This event can shatter an individual's life and be expensive, time intensive, and costly, with the risk of legal claims. Any industrial environment exhibits safety risks.

Many ETA CEOs are acquisitive and embrace the notion of programmatic acquisitions. We will ignore the financial risk of doing so for now and focus on the operational risks of this strategy. Integrations can be thorny and may involve the inability to merge systems, resulting in the failure to present invoices, process payroll, or fulfill basic customer service. Employees often choose to quit when a new owner arrives, hampering operations. Customers can view a transition as a catalyst to reexamine their relationship with the company. Acquisitions, even when priced brilliantly, offer plenty of operational risk.

We will close out the operational risk section by highlighting that most businesses bear product and service liability risk. Customers might rely on the performance of the company's products and services, and trouble can ensue if they do not comply with prescribed service level agreements. Additionally, product-centric firms can be subject to all sorts of claims if a customer is injured using their product. Recall the incident when McDonald's was sued by a customer who burned themselves with hot coffee. We never said the world was rational or fair.

CEOs should complete the exercise of identifying all the operational snafus that could waylay them. Identification is the first step in a healthy risk mitigation system.

02 *Human capital*

It is hard to overstate a key team member's impact on a small, emerging ETA business. They truly do amazing things, and any CEO who thinks they alone can drive a company forward is deeply mistaken. However, employees are a hornet's nest of risk. Employees can impair a business in many ways, and CEOs need to think deliberately about all of the future risks team members represent. Human capital risk is less of an if question and more of a when question – it will happen. CEOs should understand and embrace labor laws in their markets and build best practices for compliance. We will now highlight a few human capital risks.

Losing a key person – perhaps the head of sales or operations, someone who is vital to the company's daily flow and growth – is one of the biggest threats for a small business. Loss of an essential person poses many risks. It can be expensive and take time to recruit a replacement, and it can be distractive to the CEO. The departing person might poach more team members if they are headed to a new shop, and in the case of a sales professional, their absence can impair anticipated growth. People come and go in a search fund–like enterprise all the time, but some departures can cause great pain and dislocation.

If an ETA business grows to a certain size, the risk of bad people behaviors goes up. We think of this group of offenses as including harassment, discrimination, and intimidation. Employee-to-employee, employee-to-customer, or employee-to-vendor bad behavior can each create a huge mess. These risks usually involve lawyers and a series of he-said-she-said arguments. Furthermore, no CEO wants to be at the helm when a team member acts in an unethical and abhorrent way. When a situation like this breaks, it can harm culture, negatively impact customers and vendors, and even show up in the news, if ugly enough. It is truly unpleasant. However, at some point, most organizations wrestle with these hideous issues.

We ardently believe that ETA CEOs and companies should treat team members well and provide appropriate wages and benefit packages. Not only is it the right thing to do, but it also makes business sense. Furthermore, CEOs should understand that people are a salient part of any company's success. While we hope these enlightened views carry the day with team members, a risk in certain search fund firms is for employees to organize and seek union representation. We believe unions play an important role when a company is mistreating employees, and we are neither inherently for nor against them. However, with all things being equal, we imagine leading a business without unions is easier than with them. Employee organization and unions can be a human capital risk to consider.

In tight labor markets, companies are susceptible to wage pressure. When an employee can easily switch jobs and earn more money, a CEO should consider and contemplate this risk. All employees think they are worth more and deserve a raise (we do, too). When employees can act on that, CEOs harbor a contingent liability that can materially alter a firm's cost structure. This can be especially potent in labor-intensive firms where people are a significant part of the expense base. Wage pressure is akin to a vendor having pricing power with a crucial good that the company needs – it poses a material risk.

There are many latent human capital risks in an ETA business. We have provided just a few examples of problematic potential risk areas. We encourage CEOs to iterate on the many, many ways human capital issues can pose risk.

03 *Financial*

All risks can have financial consequences, but there are some risks that are uniquely financial in nature that are worthy of examination. CEOs, perhaps in collaboration with their CFOs, can scrutinize the firm and dream up a laundry list of things that can pose a hazard. We will now provide a few typical examples.

An easy financial risk to identify is interest rate risk. Whether a company uses fixed- or variable-rate debt, rising interest rates can negatively impact a firm's weighted average cost of capital. This can result in anticipated equity returns contracting. If the business is highly leveraged, rising interest rates can be particularly tricky. Although fluctuating debt costs will not attenuate EBITDA,[*] they will absolutely compress cash flow. A sharp change in rates can catch a CEO off guard and cause heartache. Furthermore, if attractive fixed-rate debt is maturing, an increase in debt costs might make rolling over the loan difficult and even untenable if covenants are challenged.

Companies with less-predictable revenue and earnings streams might be susceptible to EBITDA compression. This will result in angry board members and investors and inquisitive creditors reviewing loan documents and covenants. An EBITDA setback can be due to inferior leadership, suboptimal operations, or just bad luck; regardless, it is an omnipresent risk for a small business where earnings streams

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

are often far more tenuous than many CEOs appreciate. A contracting EBITDA number implies melting equity value.

Unfortunately, evaporating EBITDA is not the only way to diminish equity value. If EBITDA multiples contract, a CEO can be punished by the market while doing an excellent job in growing earnings. The math gets pretty ugly rather quickly when multiples constrict a few turns. Although CEOs have no control over prevailing trading multiples, that does not mean it is not a risk that can damage the business. A frequent catalyst for contracting EBITDA multiples is rising interest rates, which poses a double whammy for CEOs – capital gets more expensive and the equity value of the business flags. Another reason for compressing multiples is a fundamental change in the attractiveness of the company or the sector in which it operates.

If a U.S. company conducts business in currencies other than U.S. dollars, there is currency risk at play. If a non-U.S.-based search fund raises funds in U.S. dollars from U.S.-based investors, there is also currency risk. Once again, even the most proficient CEO cannot control currency markets, but it is still a risk worth exploring.

We include fraud and embezzlement in the financial section, but these can also be considered human capital risks since it will be an individual who perpetrates the fraud. We do not believe it to be fraud when an employee swipes a box of pens from the office supply cabinet for their high school child’s use. It might be dishonest and petty theft (and disappointing), but it is not a high-level crime. Instead, we are discussing falsifying expense reports, creating ghost employees in the payroll process, adding a personal utility account to the corporation’s master invoice, and establishing non-existent vendors. The embezzlement that terrifies us the most is if an employee can wire a large sum of funds in a fraudulent scheme. The money can evaporate in minutes. Sadly, these are all common occurrences and risks that need to be confronted.

Inflation can be biting to firms that are unable to fully pass along inflation-related cost increases through amplified prices to customers. It can be an insidious cost that does not explicitly appear on the profit and loss statement but is a serious risk. When inflation strikes, if a firm cannot raise prices successfully, it will quickly find itself sliding backward. CEOs cannot predict inflation patterns; if they could, they would not be running Lilliputian companies; they would be running the Federal Reserve. Unfortunately, their inability to prognosticate does not relieve CEOs of the risk.

There are many financial risks embedded in a small business. Risks in this category tend to pose big swings in earnings or equity values and must be approached humbly. Many are out of the CEO’s control, but identification is the first step in a comprehensive plan to address the unpredictable.

04 *Exogenous*

Our final bucket of risk is exogenous or outside of the company. These risks tend to be unrelated to the business itself and might correlate with geography or the specific industry in which a firm operates. We could consider some previously identified exposures (like inflation or interest rates) as exogenous risks, but in this context, we are thinking more about regulatory or weather-centric events. We will now provide a few examples of exogenous risks.

Natural disasters are prime examples of exogenous jeopardy. Hurricanes, hailstorms, tornados, extreme snowfall, windstorms, and floods are all excellent instances of exogenous risk. These events can cause extreme physical damage, disrupt a company’s operations, and even cause death in an industrial setting. These weather catastrophes can be prone to occur in specific geographic regions and pose more exposure depending on where a company operates.

Another form of exogenous risk is regulatory in nature. Sometimes, this is colloquially referred to as stroke of the pen risk, meaning an industry can change overnight because of a law modification by some legislator signing their name to a new policy. This might be regulation or deregulation of an industry. Or, if a company relies on a government-mandated reimbursement rate (think healthcare Medicare or Medicaid) and the rate is suddenly promulgated to be lower, that is regulatory risk in action. This can quickly change the revenue quality of a company or the competitive nature of an industry in the case of deregulation.

Five years ago, we would not have articulated widescale health risks as a form of exogenous hazard, but thanks to COVID-19, we are now well aware that pandemics, community diseases, and public health crises are disasters that can adversely affect ETA businesses. These perils can close down businesses temporarily or permanently, injure and waylay employees, and disrupt customers. These black swan–like events are threatening risks CEOs need to at least ponder in a fulsome risk management platform.

Three ways to address risk

Risk exists in every operating business. Some hazards might be common and cut across industries and firms, while others might be unique to a given organization and its distinctive characteristics. Regardless, risk is ubiquitous. The real question search fund entrepreneurs face is not how to find a business without risk (an impossible folly) but how an ETA CEO can manipulate the perils faced in the company.

In **Figure 3**, we propose three ways ETA entrepreneurs can process identified risk. The first is to shift risk to another party. The most common way to do this is through a contract with another party who is compensated for accepting the risk. The second way is to attempt to blunt the risk through the company's procedures, policies, and culture. The final way to deal with risk is to accept it. These approaches are often a function of whether risk-shifting markets exist for the designated risk or not.

Figure 3: A trio of ways to address risk

01 *Shift*

There are robust risk-transferring opportunities for certain types of risk in a business, allowing the original risk holder to shift risk to a counterpart willing to bear the contingent risk for a fee. These contractual arrangements are the bedrock of the commercial insurance industry. Simply put, when a company has a risk that they are unwilling to tolerate because of the exposure and potential consequences, they shift the risk to an insurance company for an insurance premium with prescribed rules governing the contractual relationship. An insurance contract is an aleatory one in that the premium paid is a small percentage of the limits the insurance company promises to pay out in a claim (i.e., $10,000 of annual premium for $5 million of insurance protection). We love transferring risk through these financial arrangements. With a certain fee arrangement, a CEO no longer holds risk in a given category; it is an excellent way to defy undesirable jeopardy.

Typically, for a risk to be insurable the policy holder cannot gain from a loss; they can only be made whole. Also, for insurance to work, the risk needs to be convertible into a price (the insurance premium), so exposures tend to be measurable and predictable over a long period of time. Insurance underwriters are mathematicians wagering on a basket of probabilities and actuarial occurrences.

When engaging in a risk-transferring contract, CEOs must completely understand the nature of the contract. This includes pesky details like caps, exclusions, deductibles, and exact coverage terms. Contracts govern claims, and if the contract does not perform in the manner in which the CEO expects, they will be disappointed. Many insurance policies are manuscript contracts, where there is bespoke language and coverage tailored to the insured's specific needs. Coverages and contracts can vary widely between underwriters; entering into these contracts is a caveat emptor proposition.

CEOs can also transfer risk through hedging strategies. For example, if a U.S. business has operations or customers in non-U.S. locations, they can hedge currency exposure through a foreign exchange hedge. Additionally, that same firm can write contracts in U.S. dollars instead of a local currency. This explicit and implicit hedge is a way to transfer risk.

Let's study one more example in the mitigate bucket. Most CEOs are apprehensive about interest rates tied to their debt. They should be because adverse interest rate fluctuations can result in higher interest expense. It is very challenging to manage rates since they tend to be set by markets far out of the CEO's control. One way to protect against variable interest rates moving in the wrong direction is to enter into a swap covering part or all of the debt. This strategy synthetically changes variable-rate debt into fixed-rate debt. Conversely, participating in fixed-rate debt is a type of hedge that eliminates rate oscillation exposure.

We will now explore some foundational and more exotic categories where a CEO can relocate exposure to an insurance underwriter. First, we will examine the essential building blocks CEOs frequently use in insurance and risk management programs.

- *General liability*. General liability transfers the risk of a third-party lawsuit or claim to an insurance carrier. The claim must be the result of bodily injury or property damage occurring because of a business's products or operations.

  - ✓ *ETA claim example:* Significant inventory damage occurs when an HVAC company fails to properly install a commercial refrigeration unit at its customer's facility. The insurance carrier replaces the customer's lost inventory.

- *Property*. Property insurance protects a business against losses to its physical assets. It covers a business's buildings, contents, fixtures and fittings, tenant improvements, equipment, and inventory. Property insurance can also include replacement income to a business in the event of a loss of an insured physical asset. This feature of property insurance is referred to as "business income" coverage.

  - ✓ *ETA claim example*: A manufacturer experiences a fire at one of its facilities. In addition to damage to the building, equipment, and inventory, the business experiences a loss of income due to the inability to sell its product. Property insurance provides funds to restore the business property and equipment to a predisaster and functional state. Business income insurance replaces lost gross profit until the facility is operational.

- *Auto*. Commercial auto insurance covers vehicles used for business purposes. It is designed to protect against third-party liability claims as well as physical damage to owned vehicles. Coverage features can include rental reimbursement, roadside assistance, trailer coverage, and insurance on custom equipment installed in a vehicle. It also can pick up losses a business owner might suffer from an accident with an uninsured motorist.

  - ✓ *ETA claim example:* Overnight, the catalytic converters on all the vehicles in the operations yard are stolen. The insurance carrier pays for the replacement parts and labor. Additionally, insurance covers temporary rental vehicles to use until the necessary repairs on the owned vehicles are finished.

- *Workers' compensation*. This coverage provides wage replacement and medical benefits to employees injured in the course of employment. In exchange for these benefits, employees relinquish their right to sue their employer for negligence. This system aims to ensure that injured workers receive timely and fair compensation while protecting employers from costly litigation.

  - ✓ *ETA claim example:* An employee is seriously injured while repairing a roof at a customer's home. The workers' compensation insurance carrier steps in to pay lost wages to the employee and current and future medical expenses.

- *Umbrella.* This insurance provides extra liability coverage beyond the limits of the general liability, auto, and workers' compensation policies. It is designed to protect a business when extra insurance limits are needed to resolve a large claim. This is also referred to as catastrophic coverage.

  - ✓ *ETA claim example:* An insured vehicle, en route to a job site, suffers an at-fault accident with a motorcyclist. The total expected injuries of the claimant are $4 million, including legal fees. The first $1 million of the claim is paid by the auto insurance, which usually caps out at $1 million, and the remaining $3 million is paid out of the umbrella policy.

- *Employee practices liability (EPLI).* This protects employers from lawsuits brought by employees alleging various employment-related wrongful acts. These can include claims of discrimination, harassment, wrongful termination, retaliation, and other violations of employment laws.

  - ✓ *ETA claim example:* A new CEO eliminates several positions upon acquiring a company. A terminated employee files an age discrimination claim against the business. The insurance company defends the insured as long as the claim is not bona fide.

- *Directors and officers (D&O).* This is liability insurance that provides financial protection for the company's directors and officers in the event they are sued in conjunction with the performance of their duties. The claim is triggered by an alleged wrongful act, which can include breach of fiduciary duty, mismanagement of company assets or finances, and failure to comply with regulations, among other items.

  - ✓ *ETA claim example:* During an exit process, the insured is sued by the potential buyer for alleged misleading statements and wrongful acts leading up to the sale. The significant legal expenses and ultimate settlement amount are paid by the insurance company.

- *Professional liability*. Also known as errors and omissions (E&O) insurance, professional liability is a type of coverage designed to protect professionals from claims alleging negligence, errors, or omissions in the performance of their professional services. This insurance is crucial for professionals who provide specialized services or advice to clients.

  - ✓ *ETA claim example*: A physician at a medical spa faces a medical malpractice claim. The damages and legal expenses are paid by the insurance carrier.

- *Cyber*. Cyber insurance, or data breach insurance, is a specialized insurance policy designed to protect businesses and individuals from the risks and liabilities associated with cyber-attacks and data breaches. In today's digital age, where cyber threats are increasingly common and sophisticated, cyber insurance provides essential financial protection and support.

  - ✓ *ETA claim example:* A successful phishing attempt leads to a ransomware incident. The cyber insurance carrier steps in to eliminate all malware and negotiate unlocking the computer network.

We will now highlight some more exotic insurance upgrades a CEO can consider. Note that if a U.S.-based ETA company is operating outside of U.S. jurisdictions, they will need a host of coverages to address their precise geographic needs.

- *Key person*. The purpose of this insurance is to financially protect the business from the potential loss of income or impact on operations that could result from the death or incapacitation of a key individual.

  - ✓ *ETA claim example*: The CEO or an essential salesperson dies. Policy limits are paid to the business to recruit a replacement and reimburse for lost revenue suffered from the death of that critical employee.

- *Personal guarantee*. This is a newer insurance coverage that is not yet available in the U.S. but is available in Europe. It provides insurance coverage to individuals who have provided personal guarantees to secure business loans or lines of credit. When a business owner or director provides a personal guarantee, they are essentially pledging their personal assets (such as savings, investments, or property) as collateral in case the business is unable to repay the borrowed funds.

  - ✓ *ETA claim example:* The CEO provides a personal guarantee to a creditor when taking on debt. Unfortunately, there is a default, and the lender seeks to make a claim under the personal guarantee. Subject to policy restrictions and certain exclusions, the borrower receives financial protections in the event of this default.

- *Representations and warranties*. Representations and warranty (R&W) insurance is a type of insurance policy used in mergers and acquisitions transactions to protect the buyer against financial losses resulting from breaches of representations and warranties made by the seller in the purchase agreement. It is often used as substitute for an escrow or "holdback." This enables the seller to maximize the guaranteed cash at close and ensures the buyer that they have protection if there is a representation and warranty breach.

- ✓ *ETA claim example:* The seller of a business misrepresents the current client list to the buyer. The buyer learns of the inaccuracy within the first few months following closing. The buyer files a R&W claim and receives reimbursement, less the deductible, for the loss of value as a result of the inaccurate client list.

Risk can also be transferred through non-insurance contractual arrangements. For example, a customer contract can have provisions for hold harmlessness clauses, predetermined liability limitations, and indemnification rights. These concepts can help limit exposure and effectively shift risk to the other contract party – without incurring a premium fee.

02 *Mitigate*

Unfortunately, not all risks can be transferred to another party for a fee. Mainline insurance underwriters often only make markets where they can make lots of bets and have some visibility on how a large portfolio of wagers will perform over time. Additionally, underwriters shun categories where there might be a moral hazard for the insured – the entity purchasing the policy is interested in catalyzing a claim. Finally, an underwriter typically does not make a one-off bet – will the sales manager at ABC Company quit in the next twelve months?

If a CEO cannot transfer risk through a contractual arrangement, the next best choice is to explore how to mitigate risk. The best first step in a mitigation strategy is for the CEO to be paranoid and a risk hawk. By contemplating all of the furtive perils, the CEO is on the right path to contain and mitigate exposure. Mitigation might mean an elimination or reduction in the frequency of peril or the scale of the impact. Avoidance is another possible mitigation choice: if a certain service presents a meaningful exposure, the CEO can consciously choose not to participate in the market. Alleviating risk without a transfer often comes down to operational practices within a firm. Recall that risks cannot be fully eliminated; there is always some probability of an event. However, CEOs can attenuate exposure and shock through best practices, training, culture, systems, and processes. Let's look at a handful of examples where a CEO can attempt to mitigate risk without using market-based financial instruments.

No CEO wants to face the results and consequences of an industrial accident, especially one that involves a death. To mitigate the risk of an accident, a CEO can invest heavily in training and safety equipment. For example, before an employee can operate dangerous industrial machinery, there could be a rigorous and comprehensive training program involving reading, discussion, and trial operations prior to ultimate independent operations. To further mitigate risk, mandatory training could take place at regular intervals. Culturally, the CEO and other executives could regularly talk about operational accident risks, why they are so awful, what steps the company has taken to minimize the events, and how employees can best apply and align with these measures. This regular communication heightens awareness and drives desired behaviors. A company can reward employees who perform accident-free for extended periods of time with bonuses. Finally, the company can purchase the necessary and best protective gear to prevent accidents and injury. Keep in mind that none of these practices will entirely eliminate risk and its consequences. However, the protocols can blunt the frequency and impact of the threats.

Let's consider another non-operational example. As previously mentioned, we are terrified of embezzlement involving fraudulent outbound wires. Depending on how many outbound wires a company processes monthly, the CEO can set up protocols with the bank to prevent anybody else from initiating and authorizing a wire. Yes, this creates work for the CEO, but if they are the sole person capable of setting up and sending a wire, they drastically reduce the odds of a problem.

Customers are the lifeblood of any small business, and losing one stings. Losing a bunch of customers can be catastrophic. Customer defection is a risk anywise, and the concerned CEO should fret over it. However, although it is impossible to fully eliminate the risk of customer shrinkage, a CEO can take action to attenuate this threat. The best way to prevent customers from bolting is to provide best-in-market products and services at fair prices. This is easier said than done, but CEOs can choose to orient their entire set of business operations around providing a superior customer service experience – even though this might contravene the ETA CEO's goal of short-term profit maximization. Training employees on customer service, hiring people with a bent toward service, measuring attrition, and speaking about and rewarding customer retention are all ways to shore up customer service. Celebrating customer service heroes who excel creates a culture that accentuates what matters most. Paying employees fair wages and treating them the way a CEO would like them to treat customers can help, too. Even the most excellent companies periodically shed customers, but this risk can be managed with intention. Retaining customers is a huge morale and financial bolster – and an unpleasant pitfall avoided.

Additionally, CEOs can use less debt to mitigate the impact of an interest rate swing. Remember, the CEO is thinking about the downside and catastrophic outcomes, and if the CEO uses less debt or enters into a swap to enjoy some benefit, they might look like a dunce if rates drop. That is life. If rates surge, they will look like a genius. The point is there are mechanical steps (with consequences) a CEO can take to think about rate exposure.

03 *Accept*

Some risks can be neither transferred nor mitigated, and the CEO and company must resign themselves to accepting the risk fully. Whether they think in these terms or not, this is implicitly self-insuring the exposure. This means that if the risk manifests and causes harm somehow, the company will bear the loss's complete financial burden and impact. We are not implying this is an unacceptable strategy, but we hope ETA CEOs pursue this track consciously and not by default. Ideally, if a hazard can be laid off at a reasonable cost or mitigated through some operational approach, it should be. Accepting risk is the last-resort choice in a risk management program.

Most CEOs fret about equity value in their companies because changes to both EBITDA multiples and interest rates can quickly and negatively impact equity value. It is very challenging to manage rates and multiples since they tend to be set by markets that are out of the CEO's control. Unless a CEO is willing to protect equity value against a reversal by selling equity in the firm when things are going swimmingly, the default choice is to hold the risk. CEOs and investors typically want to ride the anticipated equity appreciation wave and tend to accept the risks associated with that decision.

Similarly, some exogenous legislative risk is hard to mitigate. If, for example, a company provides a service that is subject to regulation and effectively protected due to this regulation, an adverse change could very quickly upset market pricing or stability. It would be difficult to mitigate against this risk or find an insurance company to hold this risk unless the CEO were willing to pour lots of dollars into a proactive lobbying program. This being the case, CEOs in this position might default into accepting the risk and hoping for the best.

Finally, if an ETA CEO is operating in a franchise system, they are implicitly making a bet on the franchisor's logo and brand equity value. If something horrible were to happen at an unrelated franchisee location and that event were to become national news, it could adversely impact the CEO's operations. For example, salmonella in one Taco Bell location could spell trouble for everybody with the wrong media attention. Insurance companies do not make markets for this risk, and it would be hard to mitigate in any way. CEOs are pushed into the accept corner.

Approaching risk with a probabilistic and mathematical viewpoint

Risk is not an absolute concept. CEOs need to think about probabilities, costs, and expected values. For example, let's identify a relatively common risk – an automobile accident. Although this is a risk market that insurance companies participate in, let's break it down and develop a quantitative approach to thinking about risk.

If a business has no commercial vehicles, the probability of a company auto accident is zero, and the business need not worry about that risk. If a company has a fleet of 100 trucks, the probability of an accident is greater than zero, but how much? There is probably actuarial data on this risk, but let's pretend the CEO cannot access it. Maybe the CEO believes there is a 2% chance of any vehicle having an accident in a given year. That sounds pretty low and innocuous. However, there are 100 exposures in the portfolio, and the probability of an accident occurring at least once in the entire portfolio is 86.7%.[†] All of a sudden, that seems like a reasonably likely risk. The next question is, what is the anticipated cost of an accident? We will randomly assume $25,000. The CEO can then calculate the expected value of $21,675. Now that the CEO has some information, they can constructively think about how to process the risk by shifting, mitigating, or accepting.

We can create a two-by-two matrix to help us think about probability and cost (**Figure 4**). If the probability and the cost are both low, the risk is possibly irrelevant and not a concern. If the probability and the cost are both high, that is a big problem and must be attacked; it is a known monster. If the probability is high and the cost is low, that might not be an issue and is likely merely a nuisance. When the probability is low and the cost is high, it can be a very tricky circumstance. These tend to be unforeseen events that happen rarely with devastating consequences. These are sometimes referred to as black swan events. They happen once in 100 or 1,000 years but with significant impact (think COVID-19). Within the black swan quadrant, we think there are actually two vectors to explore. Although they are close cousins, they are not identical twins. The first vector is a *true* black swan in that the peril is an exceptionally low probability with an unfathomably high cost. This is likely an uninsurable risk that must be accepted and self-financed. The second path is a *near*-black swan in that it is still a very low probability with a punitive cost, but it is not at the same level as a true black swan. Depending on the specific peril, a near-black swan hazard might be transferable through an insurance contract and does not have to be accepted.

[†] 1 – probability of no accident = 1 – ((1 – 0.02)^100) = 86.7%.

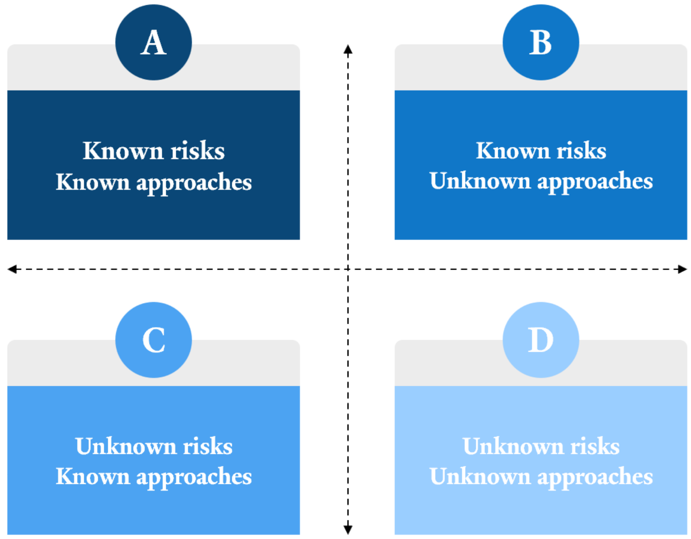
Figure 4: The probability–cost matrix for risk assessment

When the CEO starts to think about risk using probability of occurrence, cost of occurrence, and expected value, they are on the road to constructing an integrated and coherent risk management program. Risk needs to be assessed in context and with as much math as possible. In our case considering automobile accidents, if it costs more than $21,675 to transfer the risk or mitigate the risk, a CEO might consider self-insuring and accepting the risk. We are ignoring legal and ethical obligations in this simple example. If it costs less than $21,675 to insure, a sensible CEO would gladly participate in that trade. Similarly, the CEO would choose that course if the expense to mitigate the risk were less than the bogey. Here is a quick thought to consider: if CEOs think they can beat the insurance company croupiers at bookmaking, they should be very careful or very confident. The underwriters are playing with vastly more data and observations and are, in effect, setting the market. That is usually not a bet we want to be on the other side of. Using our framework in **Figure 4**, we see that the aforementioned automobile accident is a high probability and low cost event and is a nuisance. It is not low probability or high cost. To be clear, whether a CEO chooses to self-insure, transfer risk, or mitigate the exposure is dependent on the cost of transferring and mitigating. Furthermore, those costs must be compared to an expected value calculation.

When CEOs contemplate the dollar exposure, they must do so in context. One area that is currently experiencing substantial inflation is jury litigation. Juries are prone to reward plaintiffs with mega-sized payouts. Additionally, private equity and venture capital firms are now engaging in litigation finance where they bear the legal costs of quixotic litigation pursuits for a share of the winnings. This increases the frequency of litigation and the desire to play the game as long as necessary for a lottery-jackpot-sized outcome. CEOs need to contextualize this as they quantify exposure, top-end risk, and whether they perceive something as a black swan when it is really a known monster.

Risk is not always apparent, and the most guileful risks are those we do not see coming. Former Secretary of Defense Donald Rumsfeld articulated this concept as related to information, but we could easily substitute risk for information. In **Figure 5,** we depict Rumsfeld's Known-Unknown matrix.

Figure 5: The Rumsfeld Known-Unknown matrix



When a risk is known and we know what to do about the risk, it is relatively easy to feel confident in quantifying and tackling the exposure. This might be considered the first rung in a risk complexity ladder. Automobile accidents are known hazards, and we know what to do about them. This is a pretty simple quadrant in the matrix.

Things get a bit more complicated when there are known risks but we do not know what to do about them. This is akin to facing the risk of EBITDA multiple compression. We can identify and articulate the risk but are unsure what to do about the peril. This is a second rung issue on the risk ladder.

We now venture into unknown risks. As hard as a CEO might try, it is likely impossible to call out all the risks facing a company. There are scores of unknown and unforeseeable risks. Sometimes, a risk like this pops up, and the CEO is fortunate enough to have the tools and knowledge to encounter the risk successfully. This bucket sits on the third rung of our ladder.

Finally, the most vexing situation is an unknown risk with unknown abilities to respond to the risk. This is the apex of our ladder and the situation CEOs should fear the most. This is getting sideswiped and being defenseless concurrently. As hard as it is to conceive of the unknown, CEOs should game out as many scenarios as possible and attempt to conjure up the unexpected. They can then develop tools and tactics to mitigate the risk or resign themselves to accept it.

Some thoughts on building a risk management program

So far, we have examined some risk mitigation principles in theory. We think this is important because it underpins a vibrant risk management program in action. However, we do not aim to create risk theorists; we aspire to arm ETA CEOs with ideas and tools to successfully implement and operationalize a winning risk management program.

We will now discuss a hexad of action steps to be a fantastic CEO-cum-risk manager (**Figure 6**). These are all common sense but worth emphasis.

Figure 6: A half dozen thoughts for a CEO to consider when constructing a risk management program

- **01 Own risk management as the CEO**
- **02 Have monthly or quarterly executive risk management sessions**
- **03 Think about broker selection**
- **04 Think about underwriter selection**
- **05 Conduct an annual top-to-bottom risk assessment audit and analysis**
- **06 Think with a risk-oriented and defensive lens**

01 *Own risk management as the CEO*

We are realists. We know that search fund entrepreneurs are not agog for risk management topics. We get it. However, this function must reside in the CEO's domain. If this is not the boss's project, it will get short shrift from the team members. If the CEO throws their full weight, resources, and attention into an active and vibrant risk management program, it will likely have a high probability of gaining traction and making a positive impact by better boxing and controlling loitering dangers. Of course, the CEO can and should engage additional executives and team members to manage the function, but they alone should retain ultimate responsibility and control. Perhaps when a firm reaches double-digit EBITDA numbers there can be a non-CEO risk leader, but when the company is embryonic, the CEO is the right person.

02 *Have monthly or quarterly executive risk management sessions*

As part of the CEO's leadership, monthly or quarterly risk management meetings should be held. This will likely include the executive team or key team members. By establishing a regular meeting cadence focused exclusively on risk issues, the CEO will prioritize and illuminate the topic. It should not be the last agenda item in a three-hour marathon meeting when everybody is exhausted and thinking about lunch. It should be a standalone event that captures participants' fresh attention and focus.

Furthermore, regular risk management conversations will give team members time and space to think proactively and evaluate results and occurrences. This is a perfect opportunity to assess what novel risks have popped up and what is working or not. It is common for companies to have periodic sales summits; risk management must get the same showcasing to build a thriving practice.

03 *Think about broker selection*

Customarily, companies partner with an insurance agent or broker to help them operationalize their risk transfer program when they purchase various insurance policies. These brokers conventionally are compensated by the insurance carrier via a commission percentage of the total premium. A superb insurance broker can add value to the insured (the company purchasing the insurance policy). Brokers help determine exposures and appropriate dollar limits. They often deliver quotes from various insurance companies as part of the program scaffolding process. Even though the insured does not directly pay the broker, it frequently feels like the broker works for the insured.

Selecting a top-flight broker is an important task and should not be underestimated. A CEO should put the insurance brokerage relationship on par with law and accounting firm partnerships. CEOs should seek brokers who consider risk comprehensively and view the association as a genuine alliance, not a transactional dynamic. Some high-end brokers have consultative services offerings that focus on risk management. This can be a very worthwhile feature in the engagement. Insurance brokers matter, and finding the right one can assist in bolstering the risk management and mitigation tasks.

04 *Think about underwriter selection*

Equally crucial to brokers are the insurance companies (also known as insurance carriers). It is the insurance company that holds the risk and pays claims if a loss is incurred. Selecting a carrier that pays promptly and is collaborative when an insured suffers a loss is important. Additionally, a carrier who can write the appropriate policies that specifically meet the needs and coverages a company seeks is crucial. Furthermore, not all insurance companies are created equal. Despite being regulated entities, some are more financially secure than others. Entering into an insurance contract with an economically impaired underwriter does not attenuate risk; it amplifies it.

Great carriers have the resources to help businesses identify and compress risk. After all, carriers make the most money when a loss does not happen, so they are incentivized to help insureds prevent losses. Carriers have an abundance of resources that can help CEOs assess, train, follow best practices, and mitigate risk. CEOs should think about selecting carriers with strong financial capabilities, generous payment policies, and the ability to help manage risk proactively.

05 *Conduct an annual top-to-bottom risk assessment audit and analysis*

In addition to the monthly or quarterly meetings we mentioned above, we endorse an annual risk audit. CEOs can think of this as being akin to a financial audit where, once a year, an outside party opines on the veracity of the presented financial statements and the systems and controls relied upon to produce the financial results. Similarly, a perennial risk audit is excellent hygiene to revisit the risk assessment status in the business. This is not a superficial check-in; this is a comprehensive top-to-bottom critique. A third party conducts the review of a financial audit. In the risk audit, the underwriter and broker can likely help with at least parts of the examination; the balance will probably be led by team members. The goal is to approach the risk function with a critical mind and fresh eyes yearly. This minimizes the risk of the program growing stale or being shunted to the sidelines.

06 Think with a risk-oriented and defensive lens

We will close the thoughts section of this note with our most potent point: CEOs must embrace a risk-oriented and defensive lens in their executive roles. Most CEOs have a natural inclination and disposition to play offense. They aspire to grow the business, make incremental acquisitions, and introduce new products and services. Their default orientation is to win the game by scoring more runs, to use a baseball analogy. Unfortunately, business, like baseball, is as much about defense as offense. In a company, minimizing unforced and unforeseen errors (risk and the associated losses) is as essential as growing. If CEOs fail to alleviate the deleterious risk impacts, they can find themselves in a Sisyphean pattern of two steps forward and three steps backward. By adopting a risk-oriented and defensive lens, CEOs can strike an appropriate balance of offense and defense. Sometimes, the best way to win the game is to seek appropriate upside while simultaneously vigorously focusing on ameliorating the downside.

A mini-profile: an ETA CEO's risk mitigation program in action

Jackie Kopcho (Columbia Business School 2019) is the CEO of Tortorella Group, an award-winning swimming pool designer and builder operating in the Hamptons, New York. Before purchasing Tortorella through a search fund in 2021, Kopcho held leadership positions in the consumer products, financial services, healthcare, and technology sectors in business strategy, operations, marketing, and finance roles. Tortorella is the largest pool services company operating in the luxury segment in its marketplace. For over 40 years, Tortorella has serviced commercial and residential customers in eastern Long Island.

> I think a lot about risk in our business. We have two main product lines: we build pools, and we service pools. These revenue streams pose significant risks to our employees and the company. For example, the services we provide are labor intensive, involving heavy equipment and employee injury exposure, and we are doing this work at multi-million-dollar customer homes. We mitigate many risk prongs by investing in extensive employee training. We have something called pool school, where employees receive technical training with a considerable emphasis on safety and best practices protocols. We also make sure we treat our employees well and offer many opportunities for them to grow in the company. We promote internally and treat everybody with respect and appreciation. As a result, our A-player attrition is pretty low. In addition, we try to eliminate key person exposure by having a team that is willing and prepared to step up and by creating processes that revolve around data and not people. I worry about human capital risk daily and work hard to eliminate that as much as possible.
>
> I own risk in our small business. It is not something I can delegate yet. That does not mean I do not have input from my executive team; I do. I also work closely with our insurance broker, Oberle. They have been a wonderful partner and have helped me understand what risks can be shifted through a well-thought-out insurance program. The folks at Oberle are intelligent and insightful. They are on-site at least once a year and have coached and trained us on mitigation strategies and techniques. I have upped our coverages since the acquisition – especially the umbrella. That is cheap money for the incremental coverage when something goes very wrong. Oberle helps craft the risk transfer program, but I read every contract and understand exclusions, limits, and the ins and outs of how my coverage gets operationalized.
>
> We have another excellent partner in The Hartford, our primary insurance carrier. They visit us three or four times yearly and lean in on training and risk identification. They have enormous resources and depth of knowledge. It's easy math for them. They do not want us to incur a loss that triggers a claim, so they invest time and dollars in our relationship to help reduce that probability. No claims is a very profitable account for the underwriter.

> Since I stepped in, we have backed away from some tangential business lines that were leaving us too open to exposure. Additionally, overly complex pool projects pose more risks, like flood damage or construction complications. We price those jobs more to reflect that exposure, and we have tighter warranties in those contracts.
>
> Risk management starts at the top, with the CEO. It also entails a meaningful partnership with the broker and the carrier. They are your friends, not your adversaries. Saving money on insurance is very shortsighted and not a place to be frugal. As a final piece of advice, if a person, even a high performer, poses excessive human capital risk, they must be dropped. It is just not worth it.

Conclusion

Whether ETA CEOs actively want to be risk managers or not – they are. Search fund entrepreneurs can gracefully and competently wear their risk manager hat by identifying risks in their company by thinking about four primary buckets: operational, human capital, financial, and exogenous risk. Once they detect risk, CEOs can choose to address the liability by transferring it through a financial arrangement; mitigating it through systems, processes, and culture; or accepting the risk.

Risk needs to be viewed probabilistically, mathematically, and in context. Low-frequency risks that have low costs are easy to bear. Intermittent perils with high costs can be scary, and they are black swans. High-frequency risks with low costs might be annoying but are tolerable. High-frequency risks with high costs are burdensome and need to be addressed.

CEOs can architect a vibrant risk management and mitigation strategy by fully taking on the chief risk officer role, selecting terrific brokers and underwriters, and hosting regular risk management meetings, including a once-a-year risk audit.

It is impossible to escape risk entirely in a small company, but we hope you dull its potency and prevalence by harnessing a risk mitigation paradigm. By lasering in on risk management principles and playing some defense, you will mitigate the inevitable vicissitudes in a search fund company. We wish you good luck and good fortune in your odyssey and hope that you dodge as many perils as possible!

Exhibit 1: Additional resources

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Endnotes

[1] August Felker is the CEO of Oberle Risk Strategies, a St. Louis–based insurance brokerage firm specializing in ETA companies.

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

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