

## Including Employees in a Search Fund Waterfall

Search fund company employees deserve to be included in the waterfall when the company has a desirable outcome

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Search funds have proven to be a dynamic means of wealth creation for entrepreneurs and investors alike. According to the 2022 Stanford Graduate School of Business Search Fund Study, the average equity earned for an entrepreneur who has exited a business is \$7.57 million. In aggregate, investors enjoyed \$9.8 billion in equity value from \$2.3 billion of invested equity from 1986 through 2021. Entrepreneurs received \$2.4 billion in equity in the same period.<sup>4</sup> Clearly, this cottage form of entrepreneurship has been good for investors and entrepreneurs.

When we think about primary constituents in a search fund odyssey, we obviously start with the entrepreneur, the protagonist driving the project, and the critical component for its success. We also consider investors who provide investment capital, wisdom, guidance, and emotional support. We believe that investors' unique role – being more than just money – is part of the secret sauce that has made search funds special and successful. The final group of constituents that is an essential piece of the search fund puzzle is employees (we refer to employees as team members). Team members are crucial to executing the CEO's strategy and transforming the awkward ducklings that search fund companies start as into the graceful swans they become.

We encourage our students and entrepreneurs to think about themselves, their investors, and their team members as three distinct but connected elements contributing to a search fund project's accomplishments. All are important and necessary for a search fund acquisition to thrive, grow, and create value. We like to embrace an image of a three-legged stool in which each leg is represented by one of the constituent parts. The stool is stable and upright when all three legs are in balance. When any one leg is disregarded, the stool inevitably collapses. Team members are essential to keeping the company (the stool in our analogy) upright and functioning.

Unfortunately, non-executive team members typically do not share in the economic rewards like entrepreneurs and investors. We believe that non-executive team members\* should be included in the exit waterfall when a search fund company has a desirable outcome. We think of non-executive team members as being everybody below the C-suite or executive team. They include line workers, hourly-wage workers, and middle managers. In a histogram of team members, they would represent the largest number of people in an organization.

Regrettably, team members do not have a voice at the negotiation table when a search acquisition is made. They are often perceived as fungible inputs into the investors' and CEO's financial

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\* Executive team members often participate in a 5% option (or profits interests) pool, but non-executive team members typically do not participate in any equity, or proxy equity, economic programs.

outcome. Without a voice, team members are at the mercy of the CEO's generosity when it comes to any type of equity or exit bonus compensation.

In this brief case note, we will explore the following:

- 01 Why team members should be included in the exit waterfall
- 02 When team members should be included in the exit waterfall
- 03 Suggested steps for operationalizing a non-executive team member exit bonus
- 04 Illustrative mathematical analysis detailing the impact of including team members in the waterfall

## Why team members should be included in the waterfall

Being a search fund entrepreneur is not an individual endeavor. They are many people who support the search fund CEO and facilitate their success. For example, the executive team, investors, board members, peers, river guides, personal coaches, and team members. We think team members are the unheralded players in the search fund project and do not get the attention, celebration, and rewards they deserve. Team members are the backbone of any company and dutifully execute on the company's vision and strategy. They buy into the CEO's vision and culture. They embrace the products and services the company offers and are the customer-facing heroes who deliver on its service proposition daily. It is impossible for a company to move forward and create value without team members playing their role.

In the search fund context, team members do what CEOs ask to help grow and create a better business. They invest their time and make an emotional investment in the company. They facilitate the value creation and have invested their human capital. Then, after approximately five years, the company is sold, and team members are often surprised at best and shell-shocked at worst. The entrepreneur and investors enjoy their economic rewards and typically move on to new projects. Team members remain to confront new leaders and new owners; in a good outcome, they keep their job; in a bad outcome, they lose their livelihoods. Rarely do they enjoy sharing in the economic rewards, and they are often left feeling that claims about culture, being a family, and customer service were disingenuous and hollow.

Be assured, we are unabashed capitalists and understand that companies get sold and that capital can be disproportionately rewarded compared to labor. We are simply advocating for labor to modestly enjoy some of the rewards too. We will now detail several reasons why team members should be included in a search fund exit waterfall.

*Team members have facilitated the business's success.* As important as CEOs and investors are to creating equity value and propelling growth in a company, it is insincere – and incorrect – to discount the importance of non-executive team members. These are typically the very people who grind it out on a daily basis for customers, their co-workers, and the CEO. Persuasive CEOs engage team members and convince and motivate them to deeply connect with the company, perform Herculean tasks, and embrace the mundane daily. Without team members' commitment, energy, and performance, the business would not grow and thrive.

*A share in the waterfall is material for team members and significantly less material for investors and entrepreneurs.* We are proposing that CEOs and investors share a small part of the economic profit with non-executive team members in circumstances where the overall returns warrant such an additional sharing component.

While these funds are likely not material to investors and entrepreneurs, they are very important and meaningful to team members. If \$1 million is carved out for a non-executive team member bonus, internal rates of return are negligibly compressed, and due to a diversified cap table, no one investor is overly funding the bonus. If a company has 50 team members and the \$1 million is shared ratably, a \$20,000 bonus at the exit can be life-changing for line workers, who are often hourly employees or mid-five-figure salaried earners. This sum can extinguish credit card debt, serve as a down payment for a modest home, or help pay for a child's college education – life-altering opportunities for people who typically do not have access to a cash windfall.

*Lawyers and investment bankers are richly compensated for their role in an exit, and team members should be as well.* When a company is sold, investment bankers commonly receive seven-figure paydays for engineering the transaction. We believe talented bankers are a meaningful part of a successful exit and deserve all of their compensation. Similarly, lawyers and quality-of-earnings firms receive six-figure sums to help prepare for and guide an exit. These professionals also deserve their remuneration. Bankers swoop into a company at the tail end of the journey and reap large rewards for their efforts. Many times, lawyers and accountants have been with the company for the duration of the ownership period, but they also receive a significant one-time exit payment in connection with the sale transaction. CEOs and investors do not bemoan the fees paid to these valuable service providers because of the value that they create and protect. Team members, in contrast, have supported the company for years and will receive far less than these professionals.

*It is the right thing to do.* Search fund companies and CEOs ask a great deal of their team members. There are typically accelerated growth plans, lots of system and process changes, the implementation of a revitalized culture, and fresh reporting protocols. This certainly can be invigorating and dynamic for team members, but it can also be stressful – especially for people whose lives might already be burdened with childcare challenges, economic headwinds, and the general woes of an hourly-wage existence. Periodically, CEOs need to use the Golden Rule standard (Do unto others as you would have them do unto you). If CEOs did not benefit from elite MBA educational opportunities, access to capital, and the opportunity to acquire a company and were themselves the laborers, they would likely appreciate being part of the exit waterfall.

*It feels good for the CEO.* Selling a business can be an emotionally confusing event for entrepreneurs (see our case note, [What's Next: The Entrepreneur's Epilogue and the Paradox of Success](#)). CEOs can be filled with mixed sentiments, part of which might stem from the impact on employees. One way to assuage these feelings is to share some of the financial rewards with team members. Furthermore, it might just make the CEO feel great to do something for employees who helped build and grow the enterprise. Giving often correlates with happiness and feeling good, especially when you know the recipients.

### When team members should be included in the exit waterfall

Although we are proponents of being generous with team members in all circumstances, the nature of the concept here is to provide rewards when a particularly attractive exit has been achieved. Our objective is not to prescribe exact protocols for when a non-executive team member bonus should be deployed. We encourage entrepreneurs to craft their own bespoke scheme when they originate their equityholders' agreement. Therefore, the simplistic themes below are merely directional guidelines for consideration.

*Investor equity has grown by no less than four times.* We propose including non-executive team members in the exit waterfall when investor equity has multiplied at least fourfold. If a typical business is held for five years, this implies a gross internal rate of return equal to 32%. While search fund entrepreneurs can deliver tenfold

returns, we assert that anything in the fourfold and up range is a delightful outcome for investors and entrepreneurs alike and warrants including non-executive team members.

*Team members are working at the business at the time of exit.* To participate in the exit bonus, we envision team members being employed at the time of the sale. We are not supportive of including any team members who departed the business for voluntary or involuntary reasons. It is a binary test. Employment implies inclusion, and separation mandates exclusion. No compensation or bonus program is perfect, and this one is certainly no exception. We would suggest including team members who joined the business a week before the exit in the same fashion as those who were at the company for the duration of the search fund ownership. We propose that team members receive identical bonus amounts regardless of tenure, a simple and elegant solution. Of course, a CEO can design a program to reward team members more heavily with longer employment histories.

*Team members have no other equity proxy incentive plans.* Our program is explicitly for employees who do not participate in any other equity or change-of-control compensation plans. The CEO, who has the opportunity to earn equity through closing a transaction, time vesting, and performance vesting, should not be included. Team members participating in any option program should also not be eligible. This program is intended exclusively for those team members who do not have other equity exposure opportunities.

*Entrepreneurs and investors care about this issue.* We do not anticipate our concept being widely adopted in the search fund ecosystem. There are plenty of entrepreneurs and investors with whom our proposal will not resonate – and that is totally fine. Our aim is not to judge but rather to nudge some people toward recognizing and supporting team members in a desirable outcome. Therefore, the establishment of our program requires CEO and investor support. In an ultra-competitive environment for investors to win entry into search fund projects, this compensation bonus for team members could be a screen for entrepreneurs to evaluate potential investors. Furthermore, many MBA students (the typical background of search fund entrepreneurs) care deeply about social impact, workplace culture, and societal issues. When entrepreneurs are concerned about and embrace these notions, our program is one way to create action. An employee exit bonus program is nothing like charity – it rewards hard work, loyalty, and value creation.

## Suggested steps for operationalizing a non-executive team member exit bonus

Although we are not proposing a singular approach for establishing an exit bonus program, we will offer some guidelines to operationalize such a bonus.

*Establish the bonus in the shareholder operating agreement at the time of acquisition.* Emotions often run high as a company approaches an exit. It is the culmination of years of hard work. Investors and entrepreneurs alike can feel parsimonious despite large potential earnings. We think it is easiest to establish an exit bonus program at the front end of the search fund journey. Emotions might be more placid when the concept of an exit is years away. A commitment to include team members in the closing waterfall under certain prescribed circumstances should be established upfront in the company's operating agreement when the initial acquisition is consummated. Setting forth objective standards upfront will also obviate the need to add the exit bonus program to the to-do list during the sale process while a CEO is already juggling enough workstreams. Keeping the program simple and straightforward should not add in any meaningful way to the upfront legal costs associated with receiving the investors' equity capital and closing the initial acquisition transaction.

*Do not share the plan existence with team members.* We do not consider the non-executive team member bonus plan an incentive tool for motivation. Accordingly, we would not suggest communicating the plan with any potentially eligible team members. We assume this posture for a few reasons. First, discussing an exit with employees typically does not send a productive message. Most team members crave predictability and stability in their jobs. Second, if the program were shared, it would be a letdown and disappointing if the bonus did not materialize at the time of exit. Finally, we envision this program as a way to thank team members for hard work and participation when the CEO and investors are reaping economic rewards, and there is a disruptive change-of-control event, not as a prospective motivational tool. We do encourage CEOs to establish other monetary programs to motivate and reward team members during the operation of the business. While there are significant benefits to having the plan in place from the outset, whether or not it remains confidential could be an ongoing decision point for the CEO and the Board.

*Cap the bonus pool at \$1 million.* To encourage the adoption of our proposal, we suggest that it have an upper limit of \$1 million. This might assuage investor concerns since there is a hard cap, and the contingent bonus amount is known and defined. We recognize that this might result in a comparatively small bucket. Additionally, we are not proposing a sliding or growing bonus pool. We are attempting to suggest something that is simple, can win investor support, and can be easily operationalized. A straightforward, imperfect program trumps a perfect, complex scheme that cannot win support and adoption. That being said, if the simple program finds success in the ecosystem, then it would be easier to begin to build out a more sophisticated structure to, for example, reward longevity for team members and increase in size as returns hit various thresholds.

*Note that the exit bonus would not be tax-advantaged.* We envision the exit bonus being funded at the exit as normal payroll, subject to all taxes. Although this is tax inefficient, it is uncomplicated and easy and does not require a need to establish an IRS-sanctioned tax-sheltering vehicle with attendant legal and accounting complication and costs. We suggest encouraging team members to maximize their contributions to tax-sheltered vehicles like 401K or Simple IRA programs to alleviate the tax bite, but there would never be a situation where an employee would be required to pay taxes without actually receiving compensation in cash. This structure has the advantage of allowing the company to be more generous at exit in the event of a superior outcome without having to change any pre-existing compensation plan.

## Illustrative mathematical analysis detailing the impact of including team members in the waterfall

We will now walk through an illustrative example (**Figure 1**) to see the proposed program in action. Let us assume an entrepreneur purchases a business with \$2.5 million in EBITDA for 6x EBITDA for a total acquisition valuation of \$15 million. Let's also assume that \$7 million of equity and \$8 million of debt are used to finance the acquisition. This is a proxy of a reasonably typical search fund transaction.

If the business operates for five years and the \$7 million of equity grows fourfold to \$28 million, the gross internal rate of return is 32%. This would be a delightful outcome that all investors should be happy with, and the entrepreneur should be thrilled. To understand the impact of the non-executive employee bonus, let's first explore the waterfall without the bonus. We will disregard any preferred return and catchup mechanisms to keep things simple. We are assuming two co-CEOs will share 30% of the equity.

*No team member bonus.* The \$28 million in equity first needs to satisfy the investors' initial equity contribution of \$7 million, leaving \$21 million to be shared by the investors and CEOs. If the investors



enjoy 70% of the equity, they claim \$14.7 million, and the co-CEOs reap \$6.3 million. The investor yields a net 25.4% internal rate of return (IRR).

*Including a team member bonus.* The math changes slightly if we include the proposed \$1 million team member bonus. The same \$28 million in equity first needs to satisfy the investors' initial equity contribution of \$7 million, leaving \$21 million to be shared by the investors, the CEOs – and the team members. If we subtract \$1 million for the team member bonus, there is now \$20 million to be distributed to investors and the CEOs. At 70%, the investors receive \$14 million (compared to \$14.7 million above), and the co-CEOs garner \$6 million (contrasted with \$6.3 million above). The investor net IRR shrinks to 24.6% (an 80 basis-point contraction).

**Figure 1: An illustrative example**

|                     | No exit bonus | With exit bonus |
|---------------------|---------------|-----------------|
| Equity invested     | \$7,000,000   | \$7,000,000     |
| MOIC                | 4.00x         | 4.00x           |
| Equity at exit      | \$28,000,000  | \$28,000,000    |
| Duration in years   | 5             | 5               |
| Gross IRR           | 32%           | 32%             |
| Profit              | \$21,000,000  | \$21,000,000    |
| Team members' bonus | \$0           | \$1,000,000     |
| Co-CEOs             | \$6,300,000   | \$6,000,000     |
| Investors           | \$14,700,000  | \$14,000,000    |
| Investors total     | \$21,700,000  | \$21,000,000    |
| Net IRR             | 25.4%         | 24.6%           |

We certainly do not want to make light of a million dollars – it is a lot of money. But the cash proceeds and IRRs change only slightly because the \$1 million is borne by a diffuse and distributed shareholder group. Let's look at a hypothetical distribution in the cap table to observe the nominal dollar impact on various constituents.

In most search fund ownership structures, a large investor might own 20% of the equity with successively smaller investors who have attenuating ownership percentages. The CEOs likely are the largest shareholders when they are fully vested and earn the complete potential performance shares. With this diffuse ownership dynamic, no one party bears the full \$1 million exit bonus. Rather, each shareholder proportionally contributes a small amount to fund the proposed bonus pool. See **Figure 2** for the individual shareholder impact. In our hypothetical example, at 20%, the largest investor will contribute \$140,000 to the pool, and the most minor 5% owners will give \$35,000. The co-CEOs will each provide \$150,000. Are these sums material? Perhaps, but they are justified to thank and recognize one of the company's key constituent groups and backbone.

This illustrative example shows the impact on the various constituents in a solid exit profile. Of course, these effects are even more muted as transaction exit values increase while keeping the \$1 million bonus pool fixed. Investors will have many more opportunities for exits, and CEOs might as well. For team members, this could be the only real opportunity throughout their career to receive a meaningful sale bonus, and the search fund ecosystem should be proud to provide it.

Figure 2: The waterfall impact by individual shareholder

|      |                              | No exit bonus | With exit bonus | Difference  |
|------|------------------------------|---------------|-----------------|-------------|
|      | CEO A                        | \$3,150,000   | \$3,000,000     | (\$150,000) |
|      | CEO B                        | \$3,150,000   | \$3,000,000     | (\$150,000) |
| 20%  | Investor 1                   | \$2,940,000   | \$2,800,000     | (\$140,000) |
| 15%  | Investor 2                   | \$2,205,000   | \$2,100,000     | (\$105,000) |
| 15%  | Investor 3                   | \$2,205,000   | \$2,100,000     | (\$105,000) |
| 10%  | Investor 4                   | \$1,470,000   | \$1,400,000     | (\$70,000)  |
| 10%  | Investor 5                   | \$1,470,000   | \$1,400,000     | (\$70,000)  |
| 10%  | Investor 6                   | \$1,470,000   | \$1,400,000     | (\$70,000)  |
| 5%   | Investor 7                   | \$735,000     | \$700,000       | (\$35,000)  |
| 5%   | Investor 8                   | \$735,000     | \$700,000       | (\$35,000)  |
| 5%   | Investor 9                   | \$735,000     | \$700,000       | (\$35,000)  |
| 5%   | Investor 10                  | \$735,000     | \$700,000       | (\$35,000)  |
| 100% | Total for CEOs and investors | \$21,000,000  | \$20,000,000    | \$1,000,000 |
|      | Team members                 | \$0           | \$1,000,000     |             |

## Conclusion

Non-executive team members are an integral part of the search fund success story. They are the company's backbone, they buy into the culture, and they operationalize the CEO's strategy. They are essential in the three-legged stool of CEO, shareholders, and team members. Unfortunately, team members do not have a voice at the negotiation table and are typically excluded from the exit waterfall. In addition, a successful exit for the CEO and investors can mean stress, confusion, and job dislocation for team members.

Our exit bonus concept is a way to sincerely and meaningfully thank the team members who helped create a successful outcome and assuage some exit disruptions. It is not a prospective motivational tool, just a simple and elegant way to include the people who helped operationalize the winnings.

Good luck on your search fund journey, and we hope you consider including your team members in your exit waterfall when you celebrate your entrepreneurial victory! Good luck.

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.

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## Endnotes

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<sup>4</sup> Kelly, Peter, and Sara Heston. 2022 Search Fund Study Selected Observations. Stanford University Graduate School of Business. Case E-807.