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BEING NIMBLE AS A SELF-FUNDED SEARCHER

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SEARCHFUNDER INTERVIEW OF JAN RIEHLE

We spoke with Jan Riehle about opportunistic tech purchases in Brazil and merging business cultures.

Tell us about how you came to the search fund path?

I first heard about the search-fund model when I did my MBA at INSEAD and I liked the idea a lot. I thought of a search fund as bringing private equity and entrepreneurship together. I previously worked at a private equity mid-market fund in Switzerland and from there jumped into tech- entrepreneurship. I've been an entrepreneur in Brazil for the last 7 years now. I was more of a traditional entrepreneur, starting businesses from zero and then developing them to a certain point. However, I'm doing this in an emerging market, which is not an easy environment for entrepreneurial activities. The advantage of having less competition comes at the considerable cost of increased uncertainty, lack of infrastructure and access to resources.

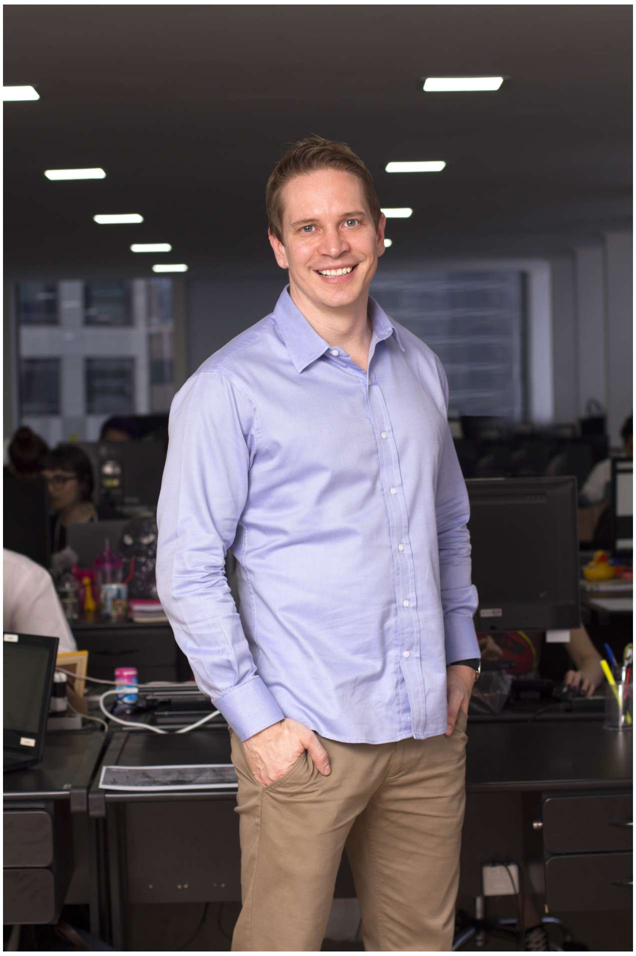
Nonetheless, I managed to build a track-record in Brazil, having started several companies in the tech space and looking back at 2 relevant exits in the last 7 years.

I'm not Brazilian, by the way; I'm of German descent (as you can tell by my German accent) and came to Brazil in 2011. The Brazilian economy has been in a difficult economic situation recently. In 2011, Brazil was in an economic boom phase. Now, it is coming out of a very deep recession. There are many troubled companies available for sale.

In 2017, I decided that a search fund was an interesting way to pursue my next entrepreneurial endeavour. Right now, Brazil is an interesting environment to acquire assets at attractive prices and to develop them, rather than starting a company from zero again.

How did you get started?

I exited my last venture at the end of 2016, selling Itaro, an ecommerce company in the automotive aftermarket, to a local acquirer. In 2017, after the sale- and transition-phase of Itaro, I looked at the search fund model again. During my research I found the Stanford research papers about Search Funds as well as the platform searchfunder.com. I started talking to US investors mainly using Searchfunder.com. I created a PPM and the standard literature for a traditional search fund and started raising money for the search phase.



In parallel, I already started looking for opportunities through my network in Sao Paulo, Brazil, connecting with business brokers, investors and other entrepreneurs. Potential deals were quickly coming in – just that most of them were on the tech side. Those deals mostly did not fit the standard search fund profile, which is about cash flow, stability and very slow changes to an acquired company. Deal-flow as well as my profile were more about tech, growth and agility in getting things done, which translates into quicker changes. Also, the traditional search fund model did not combine well with the local market scenario at that moment. The scenario was about opportunities, as there were a lot of companies suffering from the economic crisis.

Although it was not the market that traditional search fund investors in the US were looking for, they found my prospects interesting anyway. I probably could have raised a traditional search fund and could have gotten investors to adapt to a deal that was more opportunistic or not so perfectly aligned with the search fund ideals. However, I had deals coming in quickly and was eager to make the best from the current economic situation and move quickly.

Thus, I ended up closing a more opportunistic deal, leveraging a deal-structure typical for a self-funded search-fund, financing the deal with a small number of investors, including myself, and without any financing for the short search phase.

I found two companies in the digital beauty space, pursuing activities close to Ipsy and Glossier in the USA: A subscription model for female beauty products and an ecommerce for male products that already possessed a proprietary direct--to-consumer brand. My intention was to continue developing these two digital distribution channels and leverage them not only for the sale of third-party but also the of additional direct-to-consumer brands.

The huge Brazilian beauty market, which is the fourth biggest in the world and will be the third biggest until 2020-, is today mainly dominated by direct-selling and retail-based distribution approaches. As such it offers huge opportunities in online-distribution, especially for new direct-to-consumer brands, which specifically cater to millennials.

It was an opportunistic deal as both companies were struggling with results and certain levels of debt and that in an environment in which it was very difficult to raise new money, even if there were great perspectives on future growth.

I had already before developed network of investors through my prior fundraising over the last 7 years for several ventures I was involved in. Together with one of the investor who already had invested together with me in a prior deal, we consolidated more than 90% of the shares in the 2 companies and merged them into one.

How long did your process take?

I started my preparation in January 2017, with setting up my fund's website www.risingventure.com.br, talking to search fund investors, etc. I started looking at opportunities in March of 2017. By July, I had the terms closed, entered into the legal-execution phase and started managing the operations. Being in Brazil, the closing of the legal documents overall took us until December 2017. The pre-closing allowed me to already manage the business and begin a restructuring effort before all legal registers were completed. I had to take a company that was losing money every month to a point at which it is at least breaks even. That was quite challenging.

Today, I am running B4A as the CEO. B4A is the name of the new company which is the result from merging the 2 original ones. These companies have gone through a lot of change during this period, especially with regards to their culture. It was a huge change exercise, which is little different than the traditional search fund endeavor in which you typically don't change so many things, especially within the first 6 months of operation.

Because of the distressed situation, the price we paid for equity was reasonably low. The majority of the capital that I required for the deal was used in order to remove debt from the balance sheet and to enable operational restructuring efforts.

Was there something in your past experience that made you feel comfortable doing a distressed business?

Distressed is a relative term. Technology startups are by definition rarely profitable during their first couple of years of existence. In the US, you probably wouldn't call it distressed because it is a technology company, which usually is by definition focused on growth and not on profitability. In Brazil, such a company becomes distressed because if you are in an economy in which you are unable to close a successful funding-round and you are not profitable, you are kind of running out of options to continue.

The companies I acquired were not mature companies that got into a distressed situation. They were growth companies that had never been profitable before and now were running out of capital. However, they were already at a considerable size, at a point at which I felt that I could turn it around into a profitable whole, especially when I would leverage the synergies between them.

On the deal-side, I was confident that I could get it done through my past experience in the private equity and venture space. On the operations side, I was accustomed to running companies that was not yet earning cash and getting them as lean as possible.

What is doing the due diligence like in Brazil?

A due diligence is a pretty difficult endeavor in Brazil. You should be prepared to still discover a lot of issues afterwards. Therefore, it is important to have certain covenants in place in order to avoid problems that appear later on.

You have a hard time to find good professionals to do the diligence. If you find them, they tend to be very expensive. Because the deal was very opportunistic, I did not conduct due diligence in the traditional sense. This was more of a quick screening, but this was justified by the deal terms. I expected to find additional liabilities afterwards and, indeed, I did find them.

What was merging the companies like? Did they have different cultures?

Not only did the two companies have very different cultures, but I also had a very different leadership style than they were used to. Effectively, we had 3 cultures clashing. The first 4 months that was an extremely tough exercise for everyone. It was emotionally stressful as we were also going through a turnaround situation in which we basically forced a break-even. The goal was to break-even within 4 months. At the same time, I needed to bring 3 cultures together and form one common culture everyone could align with. Almost half of the team changed within the first 8 months since inception of B4A as many realized on the way that they did not combine anymore with the new core-values. Today, we're really starting to become one company. 8 months ago, it was 2 different companies with one CEO who usually had a different take on many things.

How would you describe the current culture?

We redefined vision, mission and core-values for B4A after inception and are taking actively care to live our values in the day-to-day. We are striving to be an organisation at which people like to work at, emphasizing on innovation, getting things done, teamwork and meritocracy.

We are currently doing a 52-week exercise in which every employee can earn a prize every week for actively living our core-values. Who won the prize, determines the winner of the next week and sends an email to the entire organisation describing an example of how this person was actively living B4A's core values. The prize needs to exchange between departments and cannot go to the same person twice. This is one of the ways our corporate development team makes sure we are actively living our core values.

Why was combining the companies emotionally difficult?

If you buy a company that is distressed, you are going to have distressed employees as well… If you possess no capital reserves, you need to turn the business profitable, which usually means: Either you grow your revenue or you cut your costs. It's hard to almost impossible to grow revenue very aggressively on the short run, especially in a recessive economy. So, I mainly focused on the cost side in the beginning. There are fixed costs, primarily people's salaries in a service-oriented business, and variable costs connected to the services the company provides. On the variable cost side, we worked very efficiently to increase the contribution of our product offerings, which was not so difficult as it mainly means to renegotiate deals with suppliers.

On the fixed cost side, things are more tricky because you might need to let people go or negotiate for some to stay, but maybe earn less for a while, which is not an easy sell I can tell you. You have to explain very well to the remaining team why these actions are necessary; basically because otherwise the company closes down and everyone loses their jobs. But you only get to a certain point of acceptance in explaining these kind of casualties to employees.

At the same time, you need somehow to realize synergies and maintain happy clients, in order to, ideally not lose your revenue streams.

All that together makes for a rather stressful mix.

As you look back on that process, do you have lessons learned or anything you would do differently?

There are a lot of learnings, most of the them are around people. Many times, in the beginning, you make wrong judgments and then later you need to correct yourself. But, it's difficult to say I would have done it differently. Some things you only get to understand with time. You have to get to know people before you can make tough calls. When you come in and have very little time, you sometimes need to make tough calls based on insufficient information. It's certainly something I had to do a lot in the beginning. Some I would do differently considering the information I received at a later point in time. But again, this is part of the game.

I unfortunately did not have the luxury of time. Overall, we achieved an excellent outcome and I am pretty satisfied with it.

You're looking at growth?

Absolutely!

B4A is now profitable since October 2017. We have managed to get EBITDA and margins up considerably. I wouldn't say that we achieved a comfortable profitability, but it is sustainable. However, we are a tech company in the beauty space, and Brazil is the 4th biggest beauty market in the world. Due to the recent recession in the country, we are almost without serious competition in our niches.

So, I used the last months to design a growth plan with a one-year, 3-year and 10-year perspective. I am talking to venture capital and private equity investors at the same time, as we have a bit to offer to both worlds.

What would you be your advice to searchers in Brazil or more broadly Latin America?

Brazil is very different to the US or to other mature markets for example in western Europe. When it comes to financing a deal, it is very different because we have high interest rates here in Brazil so you aren't going to want to finance an acquisition with debt. The due diligence is different because many liabilities can't be determined very well or the amount of effort to determine liabilities might not be justified by the expense the determination takes. On the flip side, when you start running the business, you have a lot more opportunity to create value through efficiencies. Or let's say, efficiency improvements are generally easier to find then in more developed markets.

But overall, it's a different game, which means you probably should not follow 1 to 1 how people do search in mature markets.

Summary of Insights

Here are a few of the key takeaways from our discussion with Jan:

- Self-funded deals may allow you to be more opportunistic.
- You may not be able to conduct traditional due diligence in emerging markets. Thus, it should be reflected in the price.
- Jan spoke frankly about the emotional stress of the employees and himself in merging 2 unprofitable companies into 1 while doing the very necessary but quick changes to make them profitable.
- Organization structure decisions take time. So, when you need to move quickly, you have to accept that there may be wrong decisions that later may need correction.

- Once you start running a business in emerging markets, you have a lot of opportunity to create value through efficiencies.

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