Industry Consolidations
Financing Alternatives for Acquisition-Driven Companies

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This article focuses on the trends and financing opportunities for clients who are pursuing an aggressive growth plan driven primarily by horizontal acquisitions – i.e., those clients pursuing an industry consolidation (or "roll-up") strategy. Specifically, this article will explore the following questions:

- *What are the distinguishing features of industry consolidations?*
- *What are the characteristics of industry sectors that are appropriate for the consolidation strategy?*
- *What are typical financing structures for the acquisition and consolidation of smaller companies?*
- *What is the "life cycle" of a consolidation and the role of different types of financing at each stage?*
- *Summary: What opportunities exist for companies to participate in this trend?*

Industry Consolidations

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What are the distinguishing features of industry consolidations?

An industry consolidation in the United States middle market – sometimes referred to as an "industry roll-up" – is the agglomeration of many independent, local or regional participants into a larger umbrella company. The end objective is to become the dominant player in the industry through a "horizontal" acquisition strategy – i.e., the acquisition of competitors in the same or different geographic markets.

An industry consolidation is a powerful strategy for building value, but is only feasible under certain conditions including:

- A stable industry comprised of mature companies
- A highly fragmented industry comprised of many smaller players
- The nature of the industry must be conducive to scale economies.
- A consolidator with an adequate critical mass and a strong management team

The consolidator generally attempts to build value in several ways: (i) building a strong national or global brand in an industry that has not previously had one; (ii) nailing down the synergies and efficiencies that should come with consolidation; (iii) transferring management's values, methods and best practices to newly acquired companies; and (iv) capitalizing on this strategy by ultimately taking the new company public.

Because larger companies usually trade at higher multiples than smaller ones, the market rewards the work of building a large business. For example, a successful consolidator might acquire small companies at a multiple of 5 times EBITDA, integrate them and then sell the combined business for 7 or 8 times EBITDA.

Like leveraged buyouts, industry consolidations have become an important trend which has changed the financial landscape and market structure of certain portions of the economy. However, in contrast to many leveraged buyouts which primarily created investor returns through financial engineering, industry consolidations focus on value creation through growth.

To investors, consolidations present entry points into a variety of industries that heretofore had not been open to public investment. To former owners of acquired companies (many of them part of a vast generation of baby boomers approaching retirement age), consolidations offer the attraction of an exit strategy and potentially stock in a future IPO. Through their stock ownership, these former owners will continue to benefit from the possible synergies and competitive advantages involved in creating a larger regional or national organization. In addition, they have the potential to continue to work in the companies that they once owned (in some cases with a fair amount of autonomy) and contribute to the growth of the consolidation.

What are the characteristics of industry sectors that are appropriate for the consolidation strategy?

In order to be successful as a consolidation candidate, an industry must have three primary characteristics – attractive industry economics, the availability of a platform acquisition with an experienced management team and the availability of add-on acquisition opportunities.

***Attractive industry economics*.** An industry consolidation strategy will only be successful if the industry economics are fundamentally attractive. There are two types of economic issues that will impact the success of an industry consolidation – macro issues (i.e., market environment) and micro issues (i.e., economies of scale or benefits from increased scope at the company level).

Many questions must be addressed to assess the market environment. Is the market served by the industry large enough or growing quickly enough to support a substantial consolidated company? Is there a dominant competitor in the market or is it a very fragmented industry? Do government regulations permit growth through an acquisition strategy? Do the suppliers and/or customers of the industry exercise substantial power over the margins and growth of the industry participants? Is there a significant threat of new entrants that may dominate the market? Is it possible that the market may become obsolete due to a substitute technology?

Assuming that the industry is attractive from a macro perspective, then significant economies of scale or other benefits must be achievable at the company level in order to create value in an industry consolidation. Economies of scale often result from the cost side through operating leverage. The consolidated company is able to spread its fixed SG&A cost across a greater volume of sales (e.g., the health care industry which is able to split leasing space, regulatory expertise, phone systems, and insurance costs across several practices). Savings of Cost of Goods Sold may be realized by the greater purchasing power of a larger organization (e.g., the funeral services industry is able to obtain volume discounts on caskets and flowers). An important economy of scale, especially for service businesses, is the opportunity to leverage advanced information technology systems (e.g., the temporary help industry is able to consolidate data entry, billing, hiring and resume searching). The increased scope of operation can also create marketing advantages and allow a company to create a brand identity in an industry where a dominant brand does not exist. Finally, in some industries, a larger sales volume will allow a company to diversify its customer base and its market risk. For this reason, even companies whose sales are very concentrated can be valuable add-on acquisitions as a part of a consolidation strategy.

Conversely, many industries have characteristics which can create diseconomies of scale and prevent the successful implementation of a consolidation strategy. In some industries, the margins are not improved by adding more volume to the top line through acquisitions. For example, in the dry cleaning industry, the expenses associated with customer interface at each location represent a high percentage of the costs and these expenses are not reduced by adding locations. Also, if the uniqueness of a facility is the key to its success, then add-on acquisitions may not be able to replicate the uniqueness (e.g., 5-Star Restaurants). Similarly, if the owner is critical to the operation of the business, a consolidation is more difficult (e.g., Bed and Breakfast facilities). In some cases, customers may have an affiliation with an existing brand name that would be difficult to transfer to a different facility (e.g., Universities). Finally, in markets where new facilities offer distinct advantages over existing facilities (e.g., Dance Clubs), the consolidation premise of buy rather than build is clearly invalid.

The debate over the superiority of internal growth versus acquisition-based growth really comes down to one of industry and company structure. In some industries, investment in plant and equipment, sales personnel or new locations will yield the highest returns. In other industries that are somewhat mature, particularly highly fragmented ones, money is sometimes better spent on acquisition-based growth, because the necessary infrastructure is already in place and does not need to be duplicated. Instead, an acquirer can buy existing capacity and simply "tuck" the assets into its existing asset base.

Available platform acquisition. A platform acquisition is the first acquisition or series of acquisitions in a consolidation strategy. The platform provides the base upon which the company can continue to grow through multiple future add-on acquisitions. With a strong platform, even a financial buyer gains the advantage of strategic buyers in seeking additional acquisitions.

Although platform acquisition strategies have become increasingly common, identifying the right platform is a difficult task. The key determinants of what defines a successful platform acquisition are the quality and replicability of the target's business model. The platform effectively defines the "franchise" of the industry consolidation. Characteristics of an optimal platform would include an innovative and efficient business model, a strong local market position, an ability to be replicated in many different geographical locations and a management team with either the capability to run a larger organization or a willingness to work for a new CEO. Conversely, characteristics of an ineffective platform would include a lack of standard operating procedures, unproven ability to succeed, reliance on a unique local asset or capability and operating managers with a short term commitment.

Available add-on acquisitions. The third factor which determines the consolidation attractiveness of an industry is the availability of add-on acquisition opportunities. The necessary number of potential add-on targets in order to make an industry attractive is dependent on several factors including: (i) average revenue per company; (ii) the number of companies required to achieve critical mass; (iii) the level of value creation created by the consolidation strategy (and hence the ease of reaching consensus on purchase prices); (iv) the maturity of the industry and the resultant average age of the owners/operators; and (v) the difficulty and cost of executing due diligence. For example, the availability of targets with easily definable cash flow streams will enable the consolidated company to execute due diligence and integrate add-ons rapidly and effectively.

What are typical financing structures for the acquisition and consolidation of smaller companies?

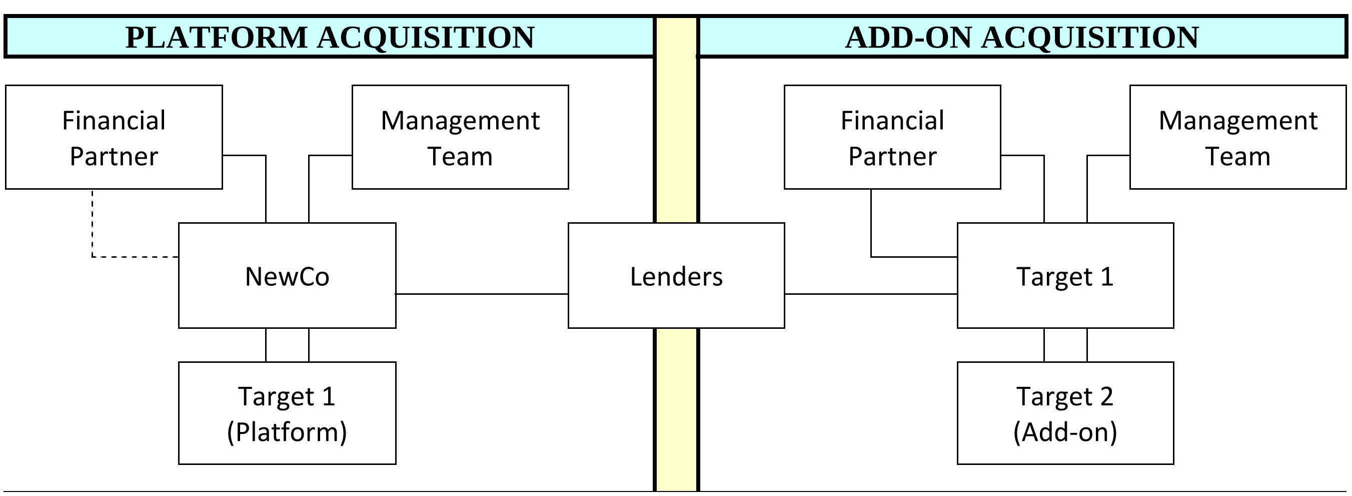
There are many different financing structures used to implement an industry consolidation strategy. All of these financing structures use a combination of debt and equity to accomplish the consolidation objectives and ultimately many industry consolidations go public. However, the financing of consolidations are typically accomplished by building a critical mass through debt financing initially and then gradually adding additional layers of debt and equity financing at different stages of the consolidated company's development (e.g., a leveraged build-up approach or "LBU").

Since the great financial crisis, the real challenge for many private equity investors has been finding a prudent way to put capital to work. Rather than pure financial engineering, a common theme has been a heightened focus on businesses with strong growth prospects – leading to a significant rise in the so-called buy-and-build model.

However, an increasingly competitive acquisition marketplace has induced financial sponsors to consider more creative strategies. With the increased focus on value creation, leveraged build-ups have become increasingly common. The LBU structure enables financial sponsors to compete with strategic acquirers on a more level playing field. By allowing financial buyers to derive the benefits of operating efficiencies and economies of scale, the consolidation strategy has narrowed the historic gap between acquisition multiples by strategic buyers compared to financial buyers.

The transaction structure for a leverage build-up is shown in Exhibit 1. An LBU is effectively an industry consolidation which is funded primarily with debt rather than equity; hence, the central location of the lender in Exhibit 1. A financial sponsor and the management team (which may or may not be the management of the platform) contribute a small amount of equity into Newco in order to initially capitalize the consolidation. The financial sponsor also provides a "sponge" equity commitment to Newco. The sponge equity represents a commitment by the financial sponsor to inject additional equity capital, if necessary, into the company for add-on acquisitions. The acquisition of the platform is primarily funded by the lenders.

Exhibit 1: Leveraged Build-up – Transaction Structure



One advantage of initially capitalizing the consolidator with equity is that subsequent "add-on" acquisitions can also be financed primarily with debt. For this reason it is important for the consolidator to have strong relationships with both senior and subordinated lenders.

Although each target will have different characteristics and therefore a different debt capacity, a popular consolidation model is to have the senior/subordinated lenders commit to lending a set multiple of cash flow.

In this arrangement, for example, a lender may commit $100,000,000 for add-on acquisitions and agree to provide 3.5 times the target's EBITDA for each add-on acquisition. If an acquisition costs the consolidator 5 times the target's EBITDA, the lender provides 3.5 times and the equity sponsor funds the additional 1.5 times.

Another possible arrangement is to agree on a ratio of debt to equity to fund each acquisition.

What is the "life cycle" of a consolidation and the role of different types of financing at each stage?

Financing structures for leveraged build-ups have evolved to fit the management's and sponsor's growth plan for the acquired company. The financing structure is primarily driven by the industry (e.g. cyclicality and capital intensity, competition and margins), the sponsor's return requirements, the availability of alternative sources of capital and the track record of the platform.

While there is no standard financing strategy, the following guidelines are generally considered when designing a leveraged platform capital structure: (i) leverage ratios are lower than a typical LBO, with equity comprising a larger percentage of the capitalization; (ii) subordinated debts provide stable long-term capital; and (iii) senior debt makes up the rest of the acquisition financing and usually provides the financing for growth.

Exhibit 2 shows the financing alternatives which are accessible to a company at different points during the life cycle of a leveraged build-up. There are four basic stages in the life cycle of a leveraged build-up:

- platform inception/startup
- platform acquisition
- growth stage and
- maturity stage.

During the platform inception/startup stage, the management and the sponsor have identified an industry but have not necessarily found a complete platform (e.g., more than one company may be required to develop a platform with an appropriate critical mass). This represents a period of high business and execution risk where the company has limited cash flow (if not negative cash flow).

During the platform acquisition phase, a platform company in a fragmented industry has been identified. The platform may be acquired with or without the existing management team. This represents a period of medium business and execution risk. However, the company does have free cash flow to service debt and limited operating leverage.

Exhibit 2: Leveraged Build-up – Alternative Financing Structures

Stage	Typical Transaction Values	Alternative Methods for Financing an LBU		
		Senior Debt	**Mezzanine**	**Equity**
Platform Inception/ Start-up	Less than $20 million	LBU loan (committed loan financing which allows for fundings at increasing levels of Debt/EBITDA over time)		Sponsor's equity with limited asset-based lending fuels initial company growth
Platform Acquisition	$20 million to $40 million	Traditional Senior HLT; maximizes senior debt available for initial transaction or LBU loan	Either senior structure with a layer of mezzanine financing provides more debt capacity	
Growth Financing	$30 million to $100 million	Growth in platform business and/or attractive add-on purchase price allows for 100% senior financing of add-on acquisitions	Stability of cash flows of combined companies allows for more debt but exceeds capacity of senior debt	Faster growth rate may result in combined companies having inadequate cash flow for 100% debt financing
Maturity Financing	More than $120 million	Senior acquisition credit line which allows for add-on acquisitions at pre-established credit criteria	Public high-yield debt issue above $100 million; can be enhanced by senior credit line	Initial public offering; reduces leverage and provides a currency for acquisitions

During the growth stage, the company is implementing an aggressive plan of intermediate add-on acquisitions. This represents a period of moderate business risk and continuing execution risk. Free cash flow is growing with each new acquisition, as well as the impact of operating leverage. During this period of the life cycle of the consolidation, the company has a large need for additional financing to continue the funding of add-on acquisitions.

During the maturity stage, the industry strategy and the management team have proven themselves. Although additional acquisitions continue to be available, this is a period of limited business risk and execution risk. The company has substantial free cash flow and operating leverage.

Summary: What opportunities exist for companies to participate in this trend?

Companies can participate in the industry consolidation trend in many ways.

As a platform company, the entire spectrum of financing products – including credit, syndications, debt capital markets, mezzanine financing and equity – play a role at some point during the life cycle of the consolidation transaction.

In the current market environment, there is a high level of interest by all of these financing sources in the growth possibilities provided by platforms in consolidating industries.

Companies can also position themselves as potential add-ons for existing platforms. A significant development in the marketplace – and one that appears to be a long-term shift in the private equity model – is the increasing proportion of add-on deals in the PE mix.

A primary motivation for these add-on deals is to achieve different scale or scope economies. Consolidators are able to eliminate redundancies, gain price advantages with suppliers and standardize systems.

For example, the health care industry has been an active area for consolidation – particularly for facilities like outpatient clinics and centers that provide targeted care. In this highly fragmented industry, add-on deals have been quite popular and have enabled consolidators to create operational efficiencies.

Final Thoughts: Industry Consolidations

Before embarking on a consolidation, consider these key questions:

1) Is the industry segment appropriate for this strategy?
2) Is the strategy more than just an aggregation of companies?
3) Are target companies easily identified?
4) Do target business owners have a compelling reason to sell or merge?
5) Is the valuation process of the partner companies fair?
6) Are the capital structure and sources of financing appropriate?
7) Does consideration (cash, notes and/or stock) balance the personal and business needs of all parties?