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VIDEO SERIES

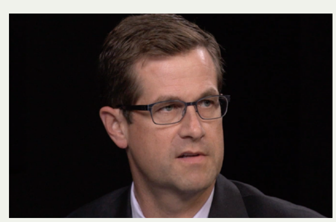
Briefing

Buy and Builds Done Right

An executive summary of the Privcap thought-leadership series “Inside the Buy-and-Build Strategy”

Gregory Belinfanti
One Equity Partners

Dennis Cail
RSM



Jay Jester
Audax Private Equity

Buy and Builds Done Right

Key Findings

1. Buy and builds make sense—if executed correctly
2. A successful buy and build requires the right skill set
3. Some industries lend themselves to a buy and build, and some don't
4. There is a process to mapping out a buy-and-build strategy
5. Firms use different sourcing techniques to find add-ons

The Panelists

Gregory Belinfanti
Senior Managing Director
One Equity Partners

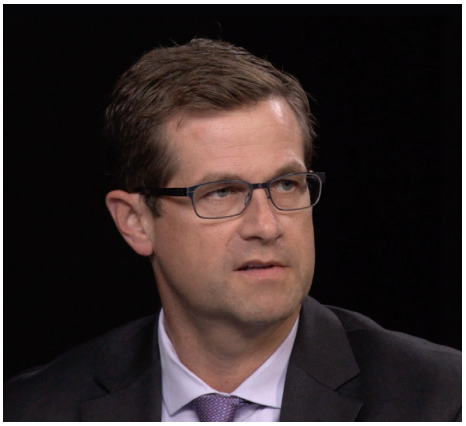
BIO

Belinfanti joined OEP in 2006 and is a senior managing director and a member of the investment committee. He has worked on a number of investments in the healthcare and business services industries. He is a member of the board of directors of Celltrion Healthcare and EGS.

Dennis Cail
Director, Management Consulting
RSM

BIO

Cail specializes in complex mergers, acquisitions, and divestitures at RSM—with emphasis on M&A integration, carve-outs, TSA, M&A playbooks, and complex transformational projects. He has more than 20 years of combined industry and Big 4 management consulting experience across information technology, operations, human capital management, and finance, in various industries.



Jay Jester
Managing Director
Audax Private Equity

BIO

Jester joined Audax in early 2000, is a managing director with the private equity business, and runs the business development team. He was previously a general partner with Florida Capital Partners, focused on developing new platform investments and assisting portfolio companies with add-on acquisitions. He also worked at Bowles Hollowell Conner & Company where he focused on middle-market M&A.

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1 A BUY AND BUILDS MAKE SENSE—IF EXECUTED CORRECTLY

More private equity firms are embracing the buy-and-build blueprint to speed up growth. The strategy is to obtain a platform company with good management and infrastructure, then build it out with add-on companies to achieve growth. A firm looking to increase revenues and get to exit can usually do it quicker via a buy-and-build approach than by organic growth, which means the firm can find success with shorter holding periods.

Another advantage of a buy and build is the number and variety of opportunities the strategy opens up. "We're focused on platform companies as small as $5M of EBITDA and as large $35M of EBITDA," says Jay Jester, managing director at Audax Private Equity. "That's a huge market—hundreds of thousands of companies in the United States. There's an opportunity to help those companies grow from the small-deal market into the really crowded, very competitive, and very expensive middle market."

Gregory Belinfanti, senior managing director at One Equity Partners, says a buy-and-build venture at his firm begins with a close look at selling, general, and administrative expenses (SG&A). Can costs be taken out by putting two businesses together? If a firm can combine business A with business B and take out two to three percentage points of SG&A, this value accrues to shareholders.

"If you do that, what you're doing is telling potential strategic acquirers, 'What we've just done, you're going to be able to do. We've already laid out the road map for you; we've put these businesses together,'" Belinfanti says. "Then the strategic says, 'Well, that's interesting. I know this can be done.' Then they're going to pay you for the synergies they've gotten."

But a buy and build must be executed correctly. The strategy is not a get-rich-quick scheme. "The PE firms that do add-ons well are in that niche of identifying good CEOs who have add-on and acquisition-integration expertise," notes Dennis Cail, director of management consulting at RSM.

2 A SUCCESSFUL BUY AND BUILD REQUIRES THE RIGHT SKILL SET

Firms that embark on buy-and-build strategies need certain skills. The first is vision. Many managers are up to their eyebrows in their business and don't have a chance to step back and think about where they should be in five years and how they're going to get there. A firm that

The Trouble With IT Integration

Dennis Cail
RSM

When it comes to an add-on strategy, acquiring companies is the easy part. The real work starts when you bring two businesses together under the same roof. And one of the trickiest pieces is IT integration.

"Usually the most costly portion of any acquisition-integration effort is IT," Cail says. "Typically what you see with add-on companies is they have their own set of back-office and ERP systems, and the platform company has its own set of systems. The goal is usually to bring the new company over into that existing platform system."

This type of integration works about 80 percent of the time, he says. Other times, there is an application or process that is unique to the add-on company and that can't be easily integrated by the platform company.

"The real trouble starts when a PE firm says, 'Look, we're just going to leave those guys on their system. We're going to let them do their thing,'" Cail observes. "That never works. One of the first things we do is look across the entire set of operations, whether it's HR, payroll, finance, you name it. And then we make sure we have the right systems in place to support all of those processes."

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> **"Real estate tends to be a place where the buy-and-build strategy doesn't make any sense. Because when you buy two office buildings, you haven't made anything better."**
>
> –Gregory Belinfanti, One Equity Partners

does buy and build must be able to help managers plan that future.

"The second thing we spend a lot of time with our folks on is, 'What do I want to be when I grow up? Who's going to be the buyer for this company?'" Belinfanti says. "We're out there calling on companies and actively bringing targets back to our management teams to say, 'Is this something we should be interested in?'"

"The leaders we interact with at the lower end of the middle market, these are small companies, a lot of times in small towns," Jester notes. "They're incredibly lean leadership teams. They say, 'Guys, I don't want a board member. I need help in the trenches."

If a firm is going to dig in and help out, it should have expertise in areas like capital markets—finding the right lender for the situation—and in deal sourcing, Jester says. "Finding exactly the right lender for exactly the right situation is really important. Sourcing is incredibly important. I think there are almost 4,000 different deal-sourcing firms just in the United States. Having a lot of transaction experience with that massive universe of deal sources is really important."

The Human Factor

Jay Jester
Audax Private Equity

One of the most complex aspects of any roll-up is the human element. How do you get people from different companies to work together as a team? And how do you assure members of the acquired company that they're valuable members of the new organization?

The HR difficulties come in various sizes. To head these off, you must be alert to subtle indications, such as if your best employees start taking jobs elsewhere in the wake of the integration.

"That may be a signal of uncertainty. People are thinking, 'This could be interesting, but I also might end up being synergized away,'" Jester says. "And they leave for what they perceive as better opportunities."

Many common pitfalls can be avoided by creating a culture of transparency and accountability around the integration. Jester says that a lot of private equity firms make the mistake of pulling away too early and settling into a comfortable routine of 90-day board meetings.

"What you really need to do is set weekly and monthly goals driven by a tried and tested checklist of what needs to get done," he notes. "That transparency and accountability is one of the most important things we do. And it's one of the hardest things to execute, because it requires a lot of face to face meetings."

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3 SOME INDUSTRIES LEND THEMSELVES TO A BUY AND BUILD, AND SOME DON'T

The goal of a buy and build is to assemble a business that is greater than the sum of its parts. That's doable in some industries; in others, not so much. "Real estate tends to be a place where the buy-and-build strategy doesn't make any sense," Belinfanti says, "because when you buy two office buildings, you haven't made anything better. You've not been able to drive revenue growth. You just own two office buildings."

Belinfanti says One Equity Partners focuses on companies that have a high gross margin—north of 30 percent—and a high cost of supporting that margin. The firm looks for companies with high selling expenses, high general administration expenses, and high R&D, then puts them together to rationalize the SG&A line. "We think the fundamental problem of our time is that the SG&A—the cost of supporting your revenue growth—has continued to expand. Gross margins are fine now. The problem is the cost of supporting the gross margin has ballooned. What we're trying to do is bring companies together and rationalize that number.

Star-Crossed Lovers

Greg Belinfanti
One Equity Partners

What does a poorly executed buy-and-build process look like? It looks like two ships passing—or crashing—in the night. Like star-crossed lovers who thought they were meant to be together and ended up on Judge Judy.

Belinfanti tells the story of a laboratory-glass manufacturer that was purchased by his firm and plucked from a bad relationship with its owner, a large industrial-glass manufacturer. On the surface, that relationship made good sense. Both companies made glass. In reality, it was not working out.

"Yes, they're both glass manufacturers. But they sell to completely different end markets," Belinfanti says. "One is a high-volume operation selling to consumer-based businesses like IKEA. The other does smaller volumes and sells to very targeted laboratory-products companies. So while they seem like logical buyers, they're not logical at all. They were just ships passing in the night."

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4 THERE IS A PROCESS TO MAPPING OUT A BUY-AND-BUILD STRATEGY

Like most PE investments, a buy-and-build process starts with a thesis. This thesis is important not only to the firm but to the companies that the firm plans to approach.

"Once we have a thesis, we start calling people," Belinfanti says. "We'll start with a company that's the size we want to invest in. 'I'm Greg Belinfanti from One Equity, and I'd like to talk to you about an idea—and that idea is, we think your company should merge with Company X.' If you call that guy and just say, 'I want to buy your company,' he'll say, 'Take a number. There are 100 guys out there who want to buy my company.' What we try to do is sell the fact that we're thinking strategically, long term, about where the business should go."

Often in a buy-and-build project, the process determines the final product. Thesis in hand, GPs approach an industry sector and try to meet as many managers and companies as possible. Over time, new introductions are made, and soon a GP has met with 15 or 20 companies in the industry and is putting together a new thesis of who should merge with whom.

5 FIRMS USE DIFFERENT SOURCING TECHNIQUES TO FIND ADD-ONS

The techniques run the gamut: cold-calling, using intermediaries, or firms establishing teams to find companies complementary to their current buy-and-build platform.

"Most of our PE firms focus on acquisitions between $50M and $500M, and what we're seeing now is that they're creating their own in-house business-development teams that go out and evangelize the firm and the investment thesis," RSM's Cail says.

That can be a tall order, Cail adds. A lot of operator-owners are skeptical of PE firms—and consulting firms—and have a hard time seeing value in the firm's thesis. "So what you're selling is the value of the deal, and it takes time to nurture that relationship and change the owner's perception."

On the flip side, Cail says, firms must convince LPs that their sourcing techniques are sound. "GPs are lobbying for the same dollars as all the other PE firms when they're raising money. And one of the things these LPs want to know is how you source your deals. What's your strategy? What makes you unique versus the other firms that have come in and asked us for these same asset dollars?"

"There are companies we've had conversations with for 15 years before they finally become a platform investment. It's important to have a dedicated sourcing team…"

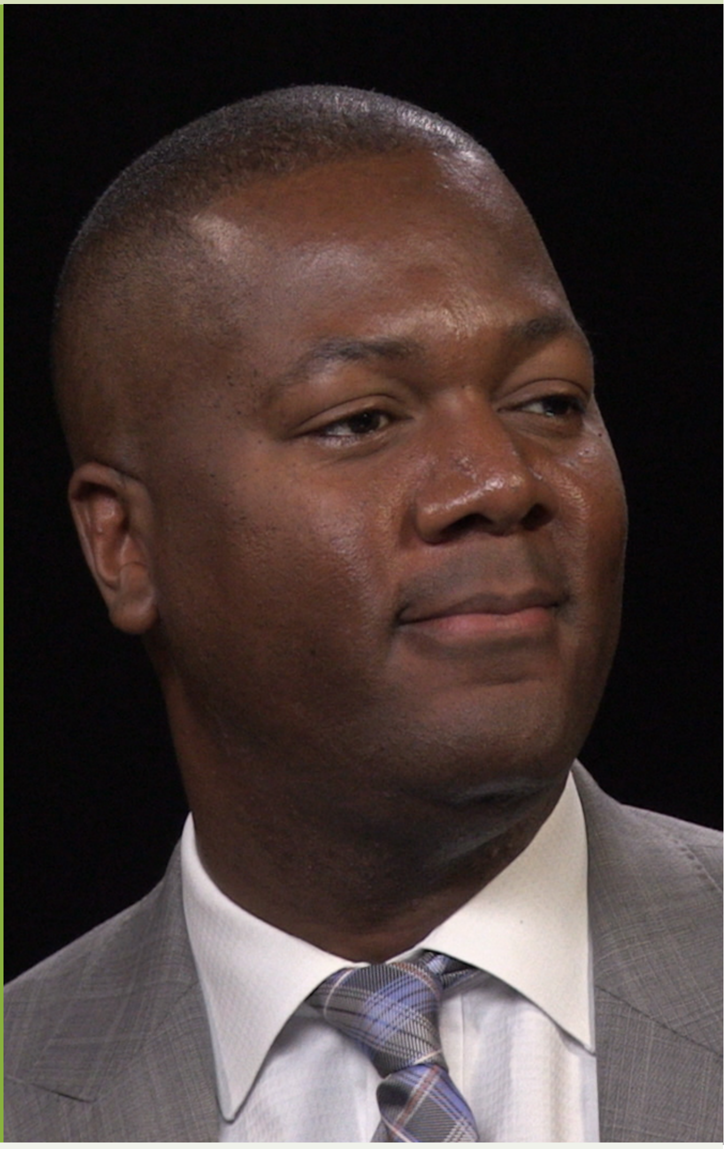
–Jay Jester, Audax Private Equity

Jester notes the distinction between hunting and farming. The hunters source big deals and target the companies they want to put together. The farmers, like Audax, must nurture many potential companies to maturity and then make their pick.

"At our end of the market, we're planting thousands of seeds across an enormous field, and they don't always grow up in the same year," he says. "There are companies we've had conversations with for 15 years before they finally become a platform investment. It's important to have a dedicated sourcing team that has not only visibility across all the different plantings, if you will, but visibility across years, across different cycles and different industry groups."■

Expert Q&A

With Dennis Cail
Director,
M&A Complex Delivery Lead
RSM



How does your firm help private equity firms succeed in combining and integrating portfolio companies?

Cail: We start by setting up the integration management office. Then we want to create a very detailed integration plan to make that happen. And then we focus on identifying all the key business processes from end to end, and that includes coming up with the functional and technical specifications.

We have a proven framework and methodology that's been tweaked and tested time and time again.

Beyond integration management, how else does RSM work with PE firms?

Cail: We actually offer a range of services. In fact, RSM is the only firm within this space that offers financial advisory services, risk advisory services, and technology and management consulting. All of these things are important because that means that we can be involved, and we are involved, throughout the life cycle of that fund, and make sure that the companies within their portfolio are successful. ■

RSM

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Privcap is a digital media company that produces events and thought-leadership content for the global private capital markets. Privcap Media offers communications services to market participants.

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