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Private Equity Rollups: Strategic Considerations

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Industry consolidation is a well-known private equity (PE) acquisition strategy to enhance value and drive higher earnings. The typical strategy involves acquiring a business within a specific industry or sector followed by "add-on," "bolt-on" or "tuck-in" acquisitions within the same industry or supply chain. Similarly, PE firms may attempt to execute a "roll up" strategy by acquiring several businesses in a particularly fragmented industry in order to build a business capable of benefitting from economies of scale and increased efficiencies.

Consolidation acquisition strategies are continuing to gain greater traction in Canada in sectors that range from manufacturing, automotive parts and supply, retirement homes, dental practices and veterinary hospitals. PE firms are also targeting a wider range of sectors for consolidation as competition for assets intensifies, including businesses that operate in regulated industries. Expansion of this nature opens up new opportunities for growth, but it can also expose PE firms to new or unforeseen risks.

Looking forward – and backward

Successful consolidators tend to share a number of attributes, such as advance research and preparation. Developing an effective consolidation strategy requires taking the time to investigate the target sector and understanding both the available monetization opportunities as well as the applicable regulatory framework. It is equally important to identify other value enhancing measures, such as talent acquisition, improved management efficiencies, technological improvements, advancements and cost savings.

A successful consolidation strategy also respects legacy constraints that are unique to an acquired business as well as those that are industry wide. Founders may be more inclined to sell to a PE firm if the purchaser can demonstrate a record of respecting the needs of customers, employees and the regulatory realities in which a business operates. Founders often want to know that an acquiring PE firm will not compromise years of hard work through short-term cost cutting rather than on building long-term value. Such concerns from founders are more acute in cases where the purchase price includes an earn-out component.

Understand the regulatory issues

PE firms need a comprehensive understanding of statutory or regulatory rules that may restrict the ownership or operation of one or more businesses prior to deploying a consolidation strategy.

Regulations in certain industries may limit how revenue is distributed – making a roll-up acquisition strategy less economically feasible or mandating the adoption of a less-than-optimal deal structure. Ownership restrictions may require the adoption of different ownership structures, such as a limited partnership or contractual joint venture rather than the use of a corporation. Corporate structures may require the use of a dual class share structure (e.g., voting and non-voting shares), which may limit the ability to effect transformational change. Alternatively, a purchaser may seek to accomplish a synthetic acquisition by entering into one or more contracts that result in a purchase of economic attributes.

Ontario's veterinary industry is a useful example of the foregoing constraints and considerations. PE firms are permitted to hold a financial interest in veterinary practices in the province; however, PE firms cannot hold equity interests. Consolidating veterinary practices would require, among other things, entering into management agreements, premises and equipment leases and/or debt arrangements in order to execute such a strategy. Industry roll-ups financed by acquisition debt may also need to adhere to industry-specific financial ratios and operational covenants.

Planning for exit

Exits generally involve considering how and when the owners/founders will depart and when the PE firm itself will exit its investment.

Exits by current owners or founders require consideration during the initial acquisition stage by the PE firm. Will the owners or founders enter into a phased transaction by selling portions of their equity or will the transaction consist of a complete sale with an earn-out and post-closing consulting, employment or transitional services agreement? The PE firm will need to determine how long the contractual arrangement will remain in place if the owners or founders remain involved post-acquisition. If applicable law requires that operators obtain and maintain specific qualifications or certifications (e.g., you cannot operate dental practices without dentists), consider adopting appropriate compensation mechanisms – such as equity participation plans – early in the process to incent key persons to remain. Compensation, however, is often not sufficient to retain entrepreneurial founders for various reasons, including reduced autonomy, lender and investor restrictions and a loss of operational control. As a result, cultural fit is often an intangible driver of success in the acquisitions market.

A consolidation plan can shrink the size of the purchaser market in terms of a PE firm exit by reducing the number of purchasers as well as affecting valuations. PE firms may wish to position the consolidated entities for sale well before it plans to exit to provide additional time to source a qualified purchaser.

Keeping an eye on the prize

Competition for desirable assets in specific sectors is intensifying as a growing number of PE firms pursue industry consolidation as an acquisition strategy. Investors may be at

risk of paying untenable multiples as well as potentially exhausting a specific market. PE firms may be able to mitigate these risks by strengthening their operational capacity through enhanced talent development, customer acquisition and satisfaction, technical investment and responding to disruption with agility.

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