THE Lead Left
Your Tour Guide to the Middle Market

Churchill Asset Management
A TIAA Company

# The Art of the Add-On

The Lead Left - A Special Report

Beginning in October 2016 The Lead Left published a series of articles on add-on. This report consolidates those articles.

*Copyright © 2017 The Lead Left LLC, All Rights Reserved*

## Introduction

"It's been a relatively slow year for us," one managing partner related to us recently. His middle market private equity firm had just completed a successful fundraise, but was finding investing opportunities scarcer than last year. "We've only completed four new platform buyouts."

Then he smiled. "But we have done eighty-seven add-ons."

The prevalence of add-on acquisitions – variously called "roll-ups," "bolt-ons," "tack-ons" and "tuck-ins" – has increased over the past several years in leveraged finance. Private equity sponsors are increasingly taking advantage of (or being compelled by) market conditions to drop smaller companies onto their existing platform businesses.

There are several reasons for this. First, purchase price multiples for new buyouts have remained at lofty levels. According to S&P LCD, middle market prices as a multiple of ebitda are 10.7x through September 30. This is up over a turn from the full year 2015 number. That's identical to the multiple sponsors pay for large cap LBOs.

With that kind of price going in, it's a lot tougher to meet a twenty-something hurdle rate on an exit, particularly in the low growth economic environment we've seen since the recovery began six years ago.

One approach that's found favor has been to buy much smaller companies to add on to existing platforms. These typically carry significantly lower purchase price multiples, so that when averaged into the initial LBO price the result is a lower overall multiple.

Additionally, as one middle market lender has noted, "the accretive impact of an add-on acquisition is often immediate." He continued, "The Ebitda value of the add-on automatically gets written up to the same value as the platform that absorbed it."

Then when the enhanced-ebitda business is finally sold, the sponsor has the best chance of maximizing their returns.

In this report we explore the various aspects of add-on acquisitions. We'll look at how different equity sponsors view the strategy of bolting on new businesses onto existing platforms. We'll cover how they think about the challenges of integration risks. We'll discuss how management teams identify acquisition targets and how they manage them post-transaction.

Finally, we'll examine how lenders finance add-ons, how arrangers set up the initial financing package to allow sponsors maximum flexibility in executing their build-up strategies, and what financing options are available to get the job done.


## About The Lead Left

*The Lead Left* reviews deals and trends in the capital markets with a unique focus on the mid-market space and is read by thousands of influential industry participants.

- Original commentary backed by thirty years of capital markets experience
- Weekly interviews with top decision makers in banking, private equity, and credit investing
- Data and commentary from four of the leading global capital market research firms
- Detailed information on deals in the market
- Plus our popular Charts and Quotes of the Week

More about us


## Private Equity Strategies

First, let's take a closer look at how different sponsors view and implement this strategy.

## Churchill Asset Management

Churchill Asset Management is a leading provider of senior and unitranche debt financing to middle market companies, primarily those owned by private equity investment firms. The firm currently manage approximately $3 billion in committed capital and are part of Nuveen (formerly TIAA Global Asset Management), one of the largest global asset managers across multiple asset classes with over $900 billion in assets.

Benefits to Borrowers and Sponsors

Reliable partner for both private equity sponsors and other middle market lenders

One-stop capability across the capital structure

Senior management involved in all aspects of deal process

Agile and responsive team with consistent investment approach

More about us

For many firms, it starts with management. “For us,” one managing partner reported, “it starts with finding the right team. Sometimes our teams will bring add-ons with them. These are often smaller companies they’ve been competing with for years. Now they have the ability to take them out of the market and bring them on to our platform.”

Another PE chief agreed. “Our management teams run their own add-on strategies,” he told us. It also depends on the size. “The larger platforms can run their own modeling. They have their own debt relationships and business development. The smaller companies don’t have these capabilities. That’s where we can help.”

The managing director at a top middle market NY-based firm walked us through their process in more detail. “Our add-on strategy is very active and proprietary,” he said. “We’re not big on roll-ups. And we’re not built to finance companies less than $5 million in cash flow. It’s key having a platform with a well-networked CEO in the space.”

That view was shared by another NY principal. “Our operating partners can really help cut through the noise. These experienced executives have competed with the add-ons. That’s tough for a VP or associate to match.”

Assembling a board with relevant experience is also critical, he went on. “We typically go deep in industry conferences. Our CEOs swap notes with other CEOs. We don’t use business development teams. Our managers have a checklist of items they’re looking for with add-ons. It’s hugely more efficient in sorting through the opportunities.”

Everyone seems to agree that the target universe for add-ons isn’t always apparent. And integration sounds straightforward, but it isn’t. Sometimes smaller companies are the most challenging. They often don’t have the experienced personnel or financial infrastructure in place to expedite the process. Make strategic decisions at the board level, many say, but let the management teams execute them.

Behind these decisions, of course, lies the holy grail for private equity, which is growth. Each company, each industry, presents a different challenge when it comes to creating growth through add-ons. Yes (one partner told us), you need a strategic vision. Yes, synergies are nice. But it doesn’t need to be a slash-and-burn strategy.

In many cases, sponsors use add-ons as opportunities to expand into areas their platform companies themselves don’t represent. Add-ons can also turbocharge revenues and cash flow beyond what organic growth alone can achieve.

## Checklist for Successful Add-Ons

The process of identifying successful add-ons is a complex one. Each sponsor has developed over the years a different style and methodology depending on their investing approach. As we’ve noted, it’s also very sector-specific. Not every portfolio company needs to, or should, have the same acquisition strategy.

One partner walked us through two scenarios. “We have one company in the logistics space. Our management team has doubled ebitda over the past four years, mostly through organic growth. They’ve only done two add-ons during that time.

“By contrast,” he went on, “we have a building products business that’s a leader in its space. They have earned a reputation as an acquirer. Smaller competitors eventually realize that you need scale in this business, or you’re eventually toast. People come to us when they realize there’s no other way out.”

Which leads us to the question, how do you help sellers get comfortable that your firm is the right fit for them?

The mid cap PE managing director told us bankers can be helpful. "Some of these companies will hire an advisor after the fact to help them through the process," he said. "We actually encourage that. It helps them get to the finish line."

Another managing partner of a NY-based healthcare focused firm agreed. "It's tough to know when these add-ons come to market. Or when sellers change their minds. We have seen processes last over three years, only to have the owner decide not to sell."

"Sellers are also getting smarter," he went on. "They're figuring out what bigger comps are getting. We're seeing add-on multiples about one turn less than platforms themselves. But depends on the brands and sectors. Things have gotten pretty toppy. Add-ons multiples were five times ebitda. Now they could be 7x or as high as 10x!"

Our first partner agreed. "Competing with strategics is tough right now. They are flush with cash and overall economic growth is anemic. Plus these acquisitions take a long time. We are often their first institutional investor. The timelines tend to be very elongated. Sometimes we can go direct on add-ons, but advisors are helpful."

So what's on your checklist for which add-ons make sense for your platforms?

Our NY partner gave us a few questions his firm considers. "First, you ask, what are the current customers and your capabilities? What are the cross-selling products and opportunities? Where are the holes in your company's portfolio? Do we need to make an addition to the customer selling process? It differs by industry.

"Pharma, for example," he continued," has been a very active sector. Firms are collecting add-ons in that space like they're baseball cards. In the medical device sector, not so much."

## Beyond the Numbers

Sponsors have check-lists they tick off when sifting through acquisition candidates for their platform companies. Many items are company and sector-specific. How will product lines complement each other? Will different brands confuse customers? If so, can you benefit from synergies by maintaining separate identities?

But one private equity partner highlighted the most critical characteristic to finding the right add-on. "You need to find people you want to work with," he told us.

"It's really all about the culture," he continued. "You often spend more time with your colleagues than you do with your family. If you're working with people you don't get along with, it creates a headwind that's counterproductive."

The partner went on. "Their management team needs to understand and be aligned with how the platform's management team thinks. If you're not on the same page with the growth strategy, for example, you can't make it work. And sometimes we need to change horses if things aren't working out. Everyone needs to buy into the vision."

A principal at a Boston-based firm added a nuance. "There's a misconception that add-ons are just about adding ebitda. But there should be a rationale. Is it geographic? Is it more products? You have to figure out the why before you deal with the what."

We asked the first partner about integration issues. What's your priority when you think about putting two or more companies together?

"First, deal with the back office," he said. "Unless the systems are speaking to each other, you can't even begin integrating. That's particularly true on the financials. Everything flows from there. The worst thing you can hear from your team on the ground is: 'We're having trouble getting the numbers.'"

Our principal agreed. "Don't be in a rush to integrate. Sometimes it takes two or three years to complete the job. It really depends on how complex the operations are, how many plants or separate locations you have. Lenders also need to understand that."

Indeed, integration risk is much on the minds of lenders we spoke with about add-ons. "It's our biggest worry," one top credit officer of a middle market shop told us. "We look very closely at the M&A experience of both sponsor and borrower. If they don't have teams who have successfully managed acquisitions, it's a big red flag."

Another banker identified due diligence as the key. "So many add-on strategies founder because the acquiring company didn't do its homework on the capability of the target's existing management. Or they didn't do a

deep enough dive on the accounting systems and find they can't even track the cash. You'd be surprised the kind of basic stuff that trips up even the best sponsors. These add-ons are often very small companies with very weak back offices. Of course, that's also the opportunity."

## Sealing the Deal

One partner at a NY-based private equity firm emphasized to us why the right culture matters.

"The key is retaining talent," he wrote us. "Even when it's not apparent where they'll be a fit. We had one executive who had been part of an add-on we did last year. He impressed us a lot, but I didn't have anywhere to put him back then. But you never know so we kept him on in a consulting role.

"Then a couple months ago, we found a logistics company. Coincidentally our manager had an extensive background in that sector. It was a perfect fit, and he's now running our platform company. The lesson is you never know when someone's skill set will be a match for an add-on down the road."

Finally let's examine how lenders structure financings to support these acquisitions.

In general, lenders are eager to finance add-ons. There are several reasons for this. First, they provide another bite at the apple in terms of fees earned on new transactions. They also allow new lenders to come into the credit, and existing lenders to increase their exposures. That's particularly helpful for those accounts which had been under-allocated in the initial syndication; they can now fill out their commitments.

And as we've covered above, it's often the case at the time of the buyout, that platform companies need to diversify customers, products, and geographies. From a credit perspective, the sooner the borrower achieves that enhanced level the better.

Lenders use several tools to help private equity clients finance add-ons. Traditionally, revolving credits had provisions for smaller acquisitions. Today it's more common to address the acquisition financing by providing delayed draw term loans (DDTL). These facilities have a relatively short draw period – one to two years – then term out with a final maturity that matches that of the term loan.

DDTLs are favored by lenders over RCs because there's pretty much guaranteed usage with minimum required amounts to be drawn during the draw period. Also the "ticking fee" of 1% charged during the draw down period is double the unused fee for RCs. And the draw period is limited to two years max vs. RCs' six year maturity.

As we've seen in this report, there's more to add-ons than meets the eye. It's not just about adding sales and cash flow, as one of our sources told us. It's about figuring out ways to make two often very different companies work together on a complementary strategy.

Organic growth, as one private equity partner summed it up recently, is the holy grail of the industry. And achieving it can be just as elusive.

## Contact

**Randy Schwimmer**

Senior Managing Director, Head of Origination & Capital Markets

**Churchill Asset Management LLC**

**T 212-478-9203**

randy.schwimmer@churchillam.com

**Liz Perreten**

Principal, Head of Investor Relations & Business Development

**Churchill Asset Management LLC**

**T 212-478-9211**

liz.perreten@churchillam.com