PitchBook

Additive Dealmaking

An analysis of the evolution of the buy-and-build strategy

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Contents

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Key Takeaways

- Nearly 30% of PE-backed companies now undertake at least one add-on acquisition, compared to less than 20% that did so in the early 2000s.
- Heightened add-on activity in recent years is largely being driven by prolific buyers that pursue numerous add-ons per platform. More than 25% of add-ons are now being acquired by platforms with at least five total add-on deals.
- It takes time to execute deals and integrate businesses; as such, the median time to exit tends to be about a year longer for companies that undergo at least one add-on.

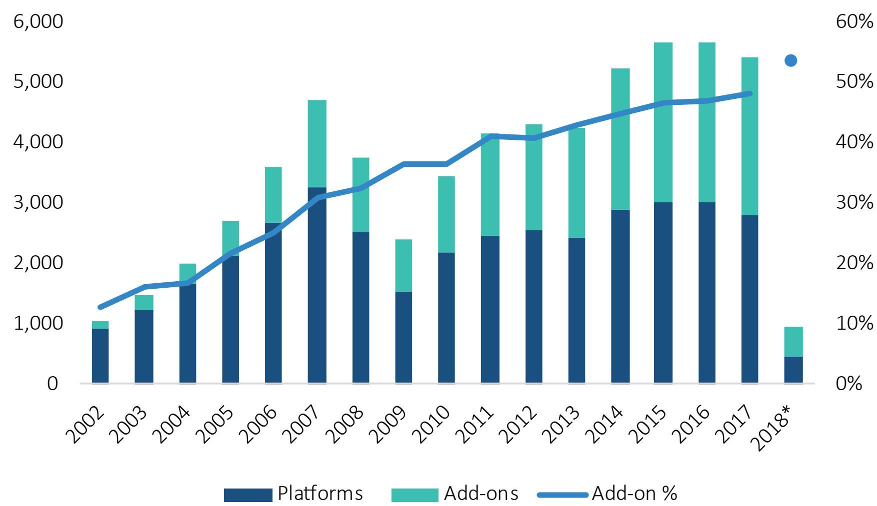
Note: In this note, "platform company" refers to any PE-backed companies that are not add-ons. The geographic scope of the data is global.

Introduction

As PE investors have come to terms with the stark reality that the use of leverage, financial engineering and multiple expansion are no longer adequate to deliver strong returns, they have become more willing to pursue value creation initiatives that are more capital- and labor-intensive—and that take longer to bear fruit. Perhaps the most tangible example of this willingness is the explosive growth in add-ons, which now account for roughly half of all buyouts globally and more than two-thirds in the US.

Add-ons are integral in PE

Global add-ons (#) as % of buyouts

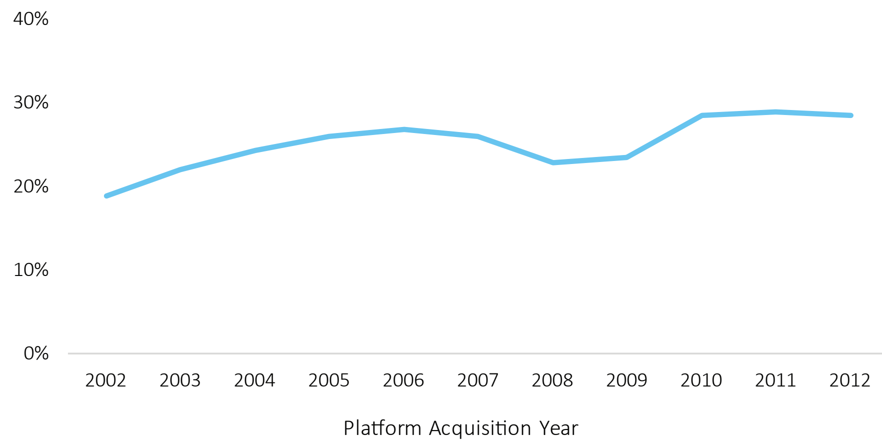


Source: PitchBook
*As of 3/31/2018

Add-ons have been a fundamental component of the PE playbook for some time, but over the last decade the "buy-and-build" strategy has morphed from a common tactic into a cornerstone of PE value creation. Less than 20% of PE-backed companies acquired in the early 2000s undertook an add-on deal, but that rose sharply to nearly 30% for platforms acquired in the mid- to late 2000s. More recently, however, the percentage of platform companies undertaking add-ons has stabilized while overall add-on activity has continued to climb.

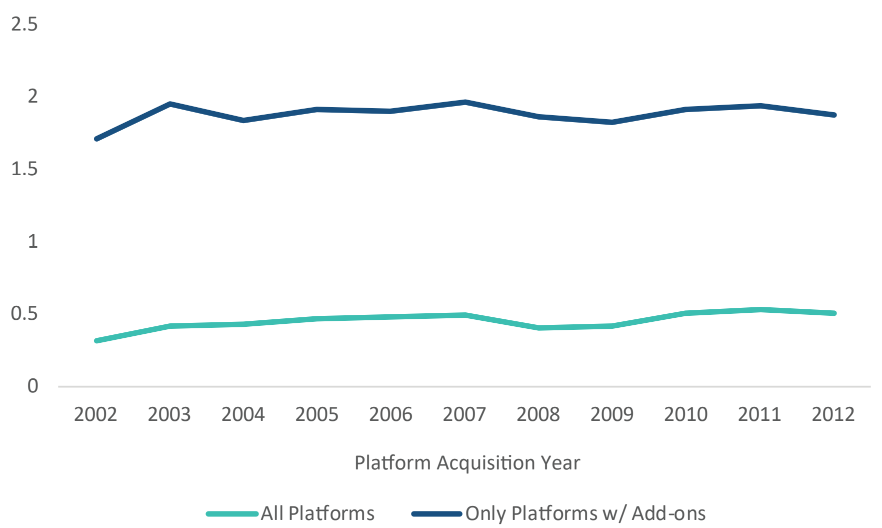
While add-ons have grown more pervasive, a relatively small number of the most prolific buy-and-build investors have increasingly driven activity.

Global % of platforms w/add-ons



Source: PitchBook
*As of 3/31/2018

Global average add-ons (#) per platform



Source: PitchBook
*As of 3/31/2018

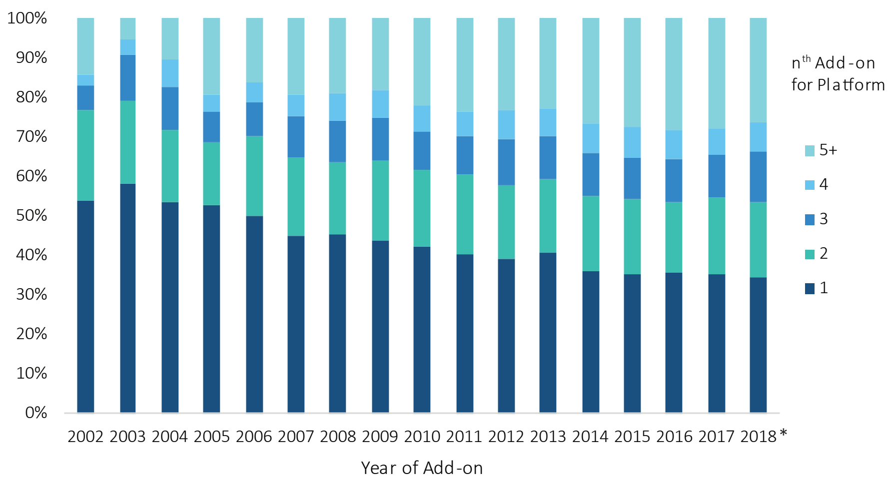
Buy, Build, Repeat

Interestingly, both the median and average number of add-ons per platform company have been little changed.[1] As such, while add-ons have grown more pervasive, a relatively small number of the most prolific buy-and-build investors have increasingly driven activity.

1: Outliers have been removed using the interquartile range.

Roughly one-quarter of the add-on deals completed since 2014 were at least the fifth deal in a platform's buy-and-build strategy.

Global add-ons (#) by sequence in platform lifecycle



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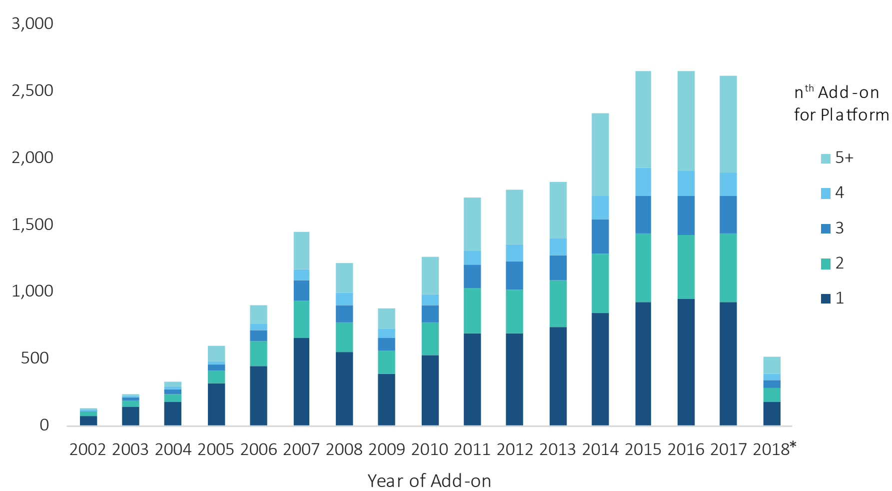
Global add-ons (#) by sequence in platform lifecycle

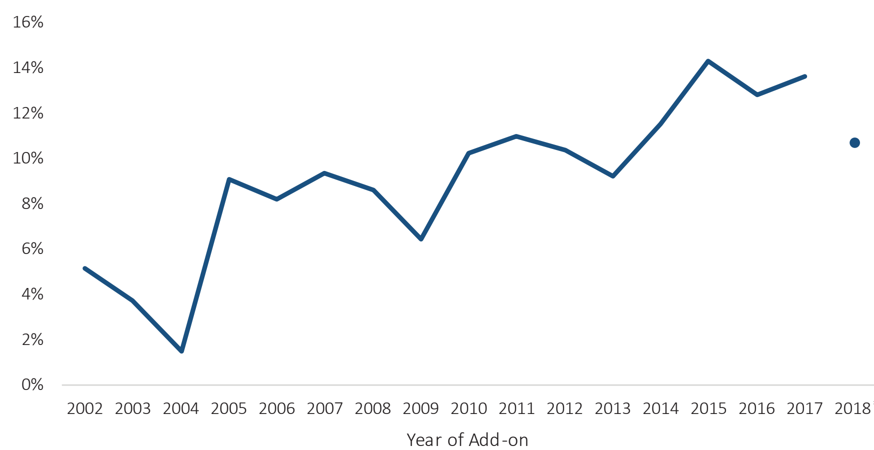


Source: PitchBook
*As of 3/31/2018

The accompanying charts show add-on activity by year, categorized by the order in which the add-on was acquired by the platform (i.e., the first add-on is "1," the second add-on is "2," etc.). Roughly one-quarter of the add-on deals completed since 2014 were at least the fifth deal in the platform's buy-and-build strategy. Conversely, only about one-third of the add-ons executed in recent years have been the first acquisition for the platform, compared to more than half in the early 2000s. As such, it has been a relatively concentrated group of platform companies that have been the driving force behind the rise in add-ons; more than 10% of add-ons are at least the 10th add-on for the respective platform.

This development is particularly evident in the financial services sector, especially insurance. Hub International—an insurance brokerage now under its second regime of PE ownership—has completed more than 200 add-ons and shows no sign of stopping, with 10 deals closed YTD through the first week of April. It's a similar story for many other PE-backed companies in the space, including Assured Partners, USI Insurance Services and Confie Seguros.

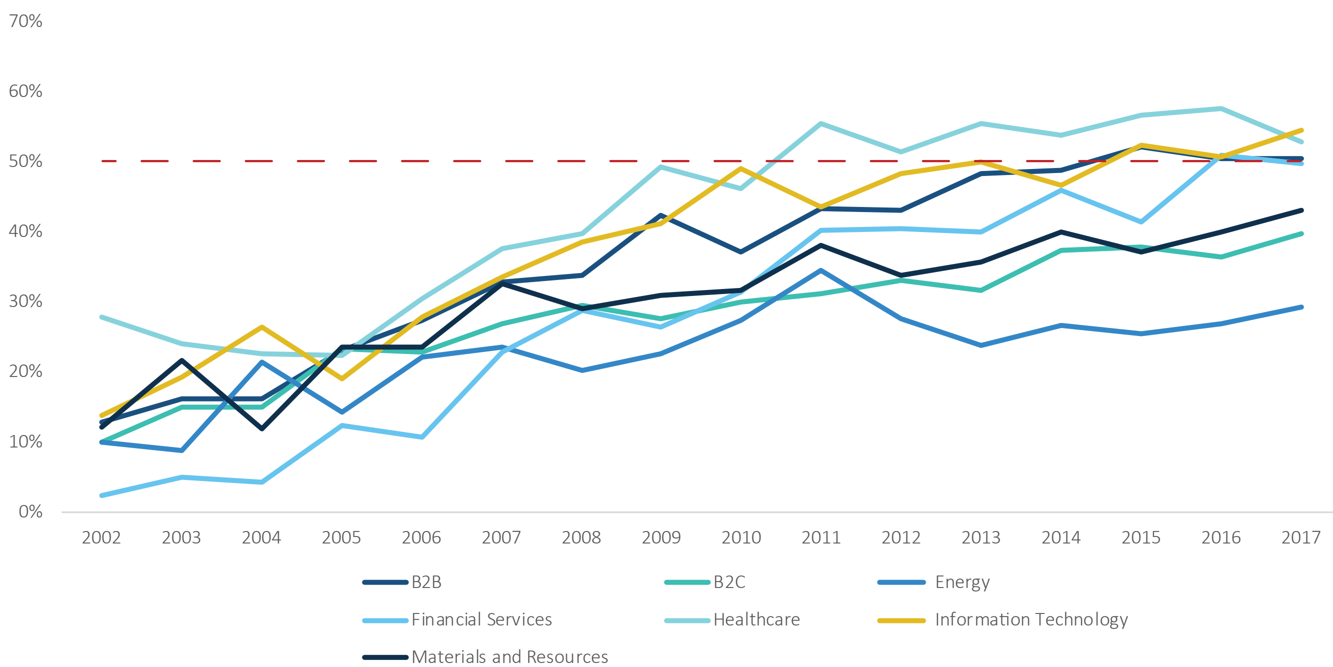
Global % of add-ons (#) that were at least the 10th add-on for the platform



Source: PitchBook
*As of 3/31/2018

Buy-and-build is used differently depending on the sector, but the strategy naturally tends to be most prevalent in areas of the market that are highly fragmented. Healthcare—a sector in which add-ons have represented more than half of buyout activity every year since 2011—is a prime example, particularly when it comes to patient care. A popular strategy has been for PE firms to roll up dozens of small, regional diagnostic centers and specialty care facilities, allowing them to achieve scale and expand their geographic footprint. Some notable examples include Advanced Dermatology & Cosmetic Surgery, Aurora Diagnostics and Team Olivia. The targets for these add-ons often have fewer than a dozen employees, making them unsuitable for platform deals and leading to less competition for the acquirer.

Global add-ons (#) as % of buyout activity

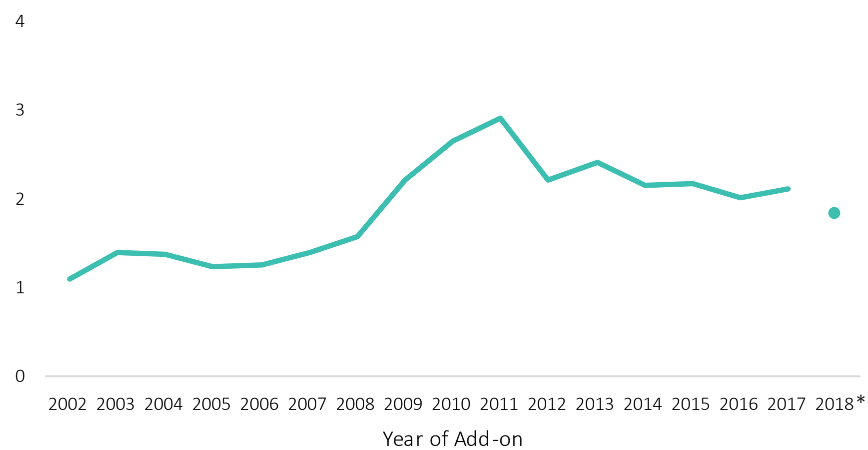


Source: PitchBook
*As of 3/31/2018

Construction Delays

Many PE textbooks claim that PE-backed companies are held for three to five years, but that has become the exception rather than the rule. Add-ons are one factor contributing to the extended timelines; the median time between platform and add-on spiked to nearly three years in the wake of the financial crisis (although there has been some mean reversion).

Global median time between platform and add-on (years)



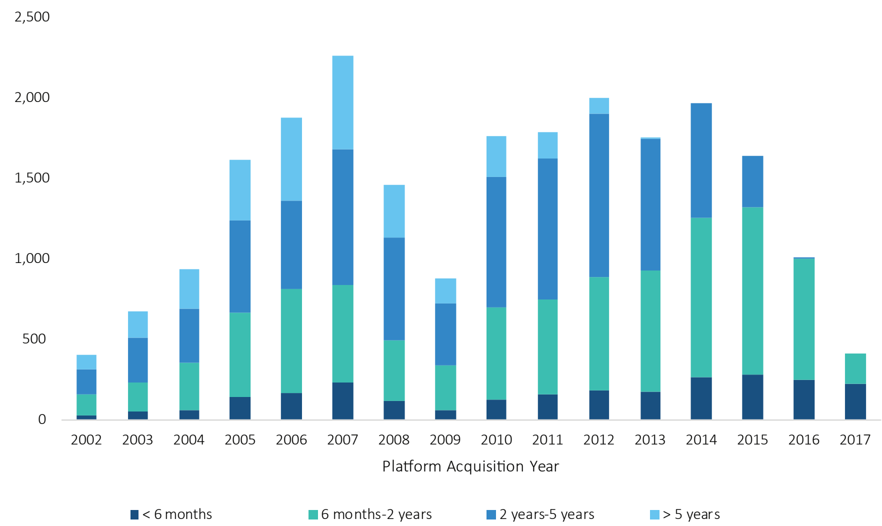
Source: PitchBook
*As of 3/31/2018

Platforms acquired in 2006 and 2007 have the highest level of add-ons acquired more than five years after the initial platform, on both an absolute and relative basis.

One reason add-ons boomed during this period was that platform companies were facing macroeconomic headwinds and performance issues, making it difficult to spur organic growth. We posit that add-ons executed later into the platform company's hold period were used as a means of boosting revenue in a struggling post-crisis environment, while averaging down the acquisition multiple (as purchase-price multiples were at record levels in the run-up to the crisis).

To that end, platforms acquired in 2006 and 2007 have the highest level of add-ons acquired more than five years after the initial platform, on both an absolute and relative basis. The proportion of add-ons executed more than five years after the initial platform acquisition is naturally lower in more recently; however, given the prevailing trends, we expect to see a substantial uptick in the coming years.

Global add-on count by time since platform acquisition



Source: PitchBook

The Sum of the Parts

Enhancing operations at a single portfolio company is difficult, and combining multiple businesses only complicates the matter. Inking the deal is just the beginning of the process—once the transaction is finalized, work must be done to integrate the companies and realize the benefits for the merger. Historically, it has taken about one year longer to exit a PE-backed company with add-ons compared with one that does not, though that margin has shrunk in recent years. Predictably, the average hold time lengthens as a platform company's number of add-ons increases.

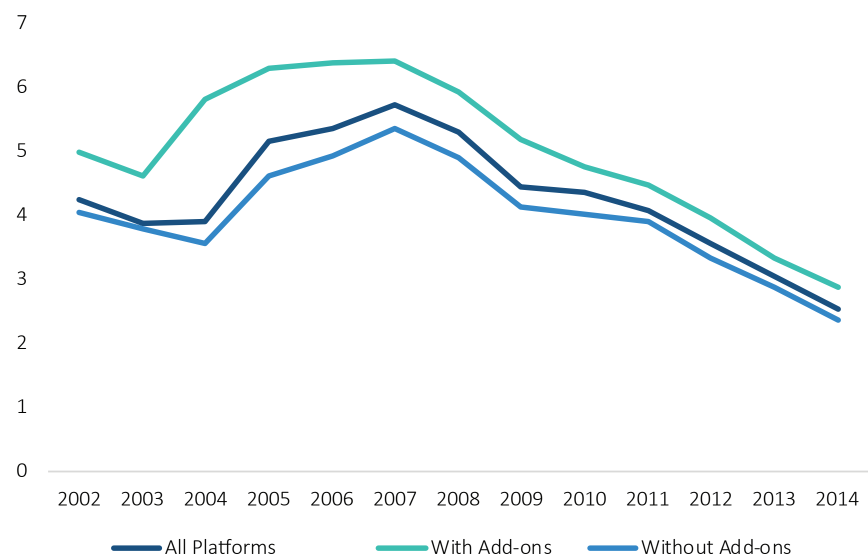
With buy-and-build strategies becoming more prevalent and longer hold times now the norm, how should limited partners (LPs) respond? We think that the PE industry in general will benefit from general partners (GPs) spending more time and resources on operational improvements, but LPs need to be cognizant that this shift will impact fund timelines. For their part, many GPs are launching funds with extended lives and adopting a "Buffett-like" approach to long-term value creation. Many LPs, particularly endowments and SWFs that have indefinite investment horizons, are warming to this idea and are now locking up capital with coveted managers for two decades or more.

Additive Dealmaking

In many instances, add-ons are viewed as a straightforward way to expand into new product lines, geographies or customer channels. When pursuing an add-on, PE sponsors can also adopt a more strategic mindset to dealmaking by factoring in synergistic savings in areas like SG&A expenses. Indeed, many GPs are making an add-on acquisition strategy part of their initial investment thesis for platform companies and baking it into their 100-day plans; it's becoming increasingly common to see add-on deals announced in the same month as a platform deal.

As discussed in a previous analyst note, another reason GPs have gravitated toward add-ons is that they tend to be smaller companies and thus transact at lower multiples. The potential benefits of add-ons have been internalized to the point that some PE firms consider their add-on prowess a badge of honor; Audax even issued a press release in December 2017 celebrating its 100th add-on of the year.

Global median time to exit (years)



Source: PitchBook

But for other LPs, extended fund timelines remain a concern. When committing to closed-end PE funds, it's important to have a deep understanding of how the GP plans to drive performance. If add-ons are a key component in that strategy—as is increasingly the case—the GP should contemplate potential targets as they conduct due diligence on platform companies. Not only will this help to streamline the buy-and-build process, it may also allow the GP to formulate a more competitive bid for the platform company.