ZacharyScott

IN$IGHT
PERSPECTIVES ON THE CAPITAL MARKETS

REPRINT
SPRING 2019

The Anatomy of a Roll-Up

Common patterns for value creation through consolidation and scale.

by David Working

Whether as a business owner, investor, advisor, or customer, most of us have observed "industry roll-ups" in action. The mechanics are relatively simple: an investor or strategic platform enters a fragmented industry by buying a cornerstone business, then buys several similar businesses in quick succession. Soon, a marketplace of many small businesses is replaced by a larger chain or conglomerate, and the investor has "rolled up" the sector.

While the concept is simple, the rationale for embarking on such a strategy is more nuanced. The common refrain repeated in transaction announcements is a desire for additional "scale," or shorthand for "economies of scale." Scale is often incorrectly used as a synonym for "size," and the difference between the two is material: readers will remember from our discussion about "Staying Smart About Growth" (Winter, 2015) that with special exceptions, size itself is not a value creator – but economies of scale are.

Picture a manufacturing plant running below maximum capacity, or any other system with significant fixed cost and suboptimal utilization – if more volume is run through the system, revenue can grow without an equal climb in cost, increasing profit margin. The margin profile of the system becomes more attractive by growing, so the structure of the business is a "scalable model," and growing it "achieves scale."

An industry roll-up is one way to achieve scale, one that requires a vision, some knowledge of industry dynamics, and familiarity and comfort with transaction execution. Although any multiple-acquisition model that allows significant cost reduction or revenue growth could be effective, a few patterns have emerged as common playbooks:

- **BUYING A BOOK OF BUSINESS.** In this scenario, a company has the infrastructure to support significantly more business volume, or can add the infrastructure at a low marginal cost. Acquiring customers, however, is slow or expensive. The acquirer buys the target essentially to buy customers, which the acquirer then bolts on and services through its own variable cost infrastructure. This is common in professional services businesses or other people-heavy enterprises, like insurance administration.
- **CONSOLIDATING EXCESS OR HIGHER VARIABLE COST BUSINESSES.** When there is excess capacity and a variable cost differential among industry participants, consolidation eliminates fixed costs and redirects volume to the lowest variable cost. This can occur when a growing market is addressed through new, more efficient capacity—like state-of-the-art manufacturing facilities—thereby creating an advantage for customer acquisition as well as for buying less efficient operations.
- **STREAMLINING VALUE CHAINS.** In this scenario, multiple businesses with similar supply chains or end customers overlap in their service of a market segment, and combining allows them to achieve better pricing power either forward or backward in their supply chain. Examples include grocery stores (to consolidate buying pipelines) or health insurance companies (to build power against growing hospital chains).

While the concept is simple, the rationale for embarking on such a strategy is more nuanced. The common refrain repeated in transaction announcements is a desire for additional "scale," or shorthand for "economies of scale."

- **GEOGRAPHIC EFFICIENCY.** Services businesses that have significant geographic overlap – like home services businesses (plumbing, HVAC, contracting, etc.) can find efficiencies in customer coverage, marketing, and labor acquisition by increasing the geographic density of their customer base.
- **BACK-OFFICE CONSOLIDATION.** This is the classic healthcare provider scenario – a group of professionals without a business or administration background who nonetheless encounter significant business and administration problems are acquired by a platform that relieves that burden. IT, payroll, billing, and administrative functions are consolidated at the "parent," redundant systems are retired, and the professionals are freed to concentrate on their specialty – patient care. This is a common model for healthcare specialists, especially those where a primary care referral may not be needed – ophthalmology, dermatology, fertility, dentistry, and others.

In these cases, the value created is as a result of the economies of scale inherent to the business models. Interestingly, there are also industry rollups that have been successful and resulted in significant value creation for their ownership without such scale attributes. These are the exceptions to the rule that size in and of itself does not create value, and are the result of very specific industry or market conditions. While they are not the norm, they are nonetheless worth examination:

- **SERVICING A DIFFERENT CUSTOMER.** Some rollups have created value by adding locations in such a way that allows them to win different services contracts – if those contracts are larger, higher-margin, or longer, then the business has added value even if there is no other operational synergy to acquisitions. An example is in billboards – while the economics of operating thousands of billboards across multiple states are not much different than owning and operating a single billboard, a national presence can win national accounts – which through their relative length and low turnover lowers the maintenance cost and improves utilization of the space.
- **CAPITAL STRUCTURE AND DIVERSIFICATION.** Lenders have size thresholds, and a business with identical profitability attributes but more size, customers, or locations may be seen as less risky as a result of diversification. If a business can get better advance rates or financing terms, real value creation can accrue to equity holders.
- **ATTRACTING A DIFFERENT BUYER GROUP.** Investors, especially in private equity, have size thresholds for making investments that fit in their fund's portfolio. For example, if a firm is operationally-focused, has 2-3 partners, and is investing a $500mm fund, it would be difficult for it to hold more than 8-10

(continued p. 2)

investments in its portfolio at any given time. That creates an effective "investment floor" where writing equity checks under about $30-35mm doesn't make sense for its strategy – even if a potential target is otherwise attractive. There are enough capital sources in the middle market with similar restrictions that growing a business to reach into their purview, and therefore accessing a competitive buyer market, is in and of itself valuable even if there's no additional scale economics realized.

Anyone who may participate in a roll-up —especially a business owner targeted by an acquirer—would be well-served to understand the market dynamics within its industry sector, the investment thesis driving the rationale for the rollup, and the economic contribution of the individual business. The primary driver of value in these strategies is scale, and while an investor should be rewarded both for the vision and execution of completing multiple acquisitions and integrating them, the management team, ownership, and advisors of a roll-up target will be better-positioned to capture value by understanding the value they're playing a part in creating. **ZS**

ZacharyScott

1200 Fifth Avenue, Suite 1500
Seattle, Washington 98101
ZacharyScott.com

ABOUT ZACHARY SCOTT

Since 1991, Zachary Scott has assisted owners of privately-held businesses in the greater Pacific Northwest to plan and execute major business or ownership transitions through three service lines: sell-side M&A, acquisition and investment advice, and direct investing. For more information on Zachary Scott, go to **ZacharyScott.com.**

Brian Bergsagel
206.838.5527
bbergsagel@zacharyscott.com

Frank Buhler
206.224.7383
fbuhler@zacharyscott.com

Nathan Chandrasekaran
206.838.5529
nchandrase@zacharyscott.com

Doug Cooper
206.224.7388
dcooper@zacharyscott.com

Mike Dannenberg
206.838.5531
mdannenberg@zacharyscott.com

William Hanneman
206.224.7381
bhanneman@zacharyscott.com

Ray Rezab
206.224.7386
rrezab@zacharyscott.com

Jay Schembs
206.838.5524
jschembs@zacharyscott.com

Kapil Sharma
206.224.7387
ksharma@zacharyscott.com

David Working
206.224.7850
dworking@zacharyscott.com

Mark Working
206.224.7382
mworking@zacharyscott.com