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The Art of the Add-On (First of a Series)

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“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.

Over the next several weeks we’ll 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 explore 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 look at 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.

Next week, we begin with the different private equity strategies on add-ons.