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

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Last week we began our series on acquisitions by platform companies of private equity sponsors ("add-ons") by examining the various roles they play in enhancing value of the underlying businesses. This week we take a closer look at how different sponsors view and implement this strategy.

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.

Next week we ask what questions sponsors ask to ensure a successful add-on