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

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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."

Next week we continue our checklist for add-ons, and how lenders finance them.