Understanding the Roll-up Strategy

EXECUTIVE SUMMARY

What is a roll-up? A roll-up is a business venture which entails acquiring a number of small businesses in a fragmented industry in order to create a larger company.

Why execute a roll-up? A successful roll-up strategy has the potential to create value three ways:

- ***Attractive Entry Pricing***: Smaller, individual businesses can generally be acquired at lower valuations than that which would be attributed to a larger integrated company.
- ***Economies of Scale***: Using scale to derive improved profitability; and increasing volume by creating a more competitive, more visible company;
- ***Premium Exit Valuation***: Allowing for the sale of the combined entity at a premium multiple.

When/where is there an opportunity? Ideal markets for roll-up exhibit some or all of the following characteristics:

- Increasing volume by creating a more competitive, more visible company;
- Using scale to derive improved profitability;
- Allowing for the sale of the combined entity at a premium multiple; and
- Mature industries with simple commodity products are often well-suited (as the entry pricing tends to make for compelling cash flows during the hold period).

Examples of Successfully Executed Roll-Up Strategies:

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OVERVIEW

Definition: The business term "roll-up" refers to the strategic acquisitions of multiple businesses with similar or complementary operations to derive incremental value by capturing various economies of scale via the combined entity. There are several mechanisms by which the consolidator may unlock value upon implementation of the strategy, some of the most typical are: rationalizing expenses/margin expansion, increasing volume via competitive pricing, and selling the combined business at a premium multiple to market prices for individual assets or small portfolios. Closely linked to this strategy is the so-called "buy-and-build," approach, where the PE buyer starts with the purchase of an existing business as a platform to grow their consolidation efforts upon.

Targeted Industry Characteristics: Generally speaking, the more diffuse or fragmented existing ownership in an industry is, the greater the opportunity there is for the consolidator to acquire cheaply and glean the necessary scale to enhance profitability. In some instances, there may be a premium valuation in the marketplace for a larger assemblage – for instance in an industry that is consolidating, the largest consolidators may be willing to pay a higher multiple for larger portfolios of assets that have already been brought up to institutional standards. Businesses with low margins tend to perform well in roll-up structures, as their financial structure provides incremental opportunity to optimize centralized costs. In the era of contemporary technology, industries where technology can impact growth and profits are also attractive to consolidators.

Timing Considerations: A maturing industry or market is often an accommodating environment for consolidation. As industry growth plateaus, existing operators make look to propagate their existing ("organic") growth with external growth from acquiring competitors. These slower growth industries with commodity-type products may also allow for attractive entry pricing Use of roll-ups may also increase as part of the shakeout process during an economic downturn. Rollups may also be employed to rationalize competition in crowded markets, where there are often many small participants but room for only a few to succeed, or in markets that are dominated by a single competitor leveraging their scale to the competitive disadvantage of smaller peers.

Rationale and Implementation: There are myriad reasons why achieving scale in an industry may be a profitable strategy. One of the most common is the opportunity to reduce marginal costs. A larger operation spreads centralized fixed cost across a greater number of units, thereby improving profit per unit. A larger business may also be able to negotiate better pricing with vendors. Turning to revenue, a

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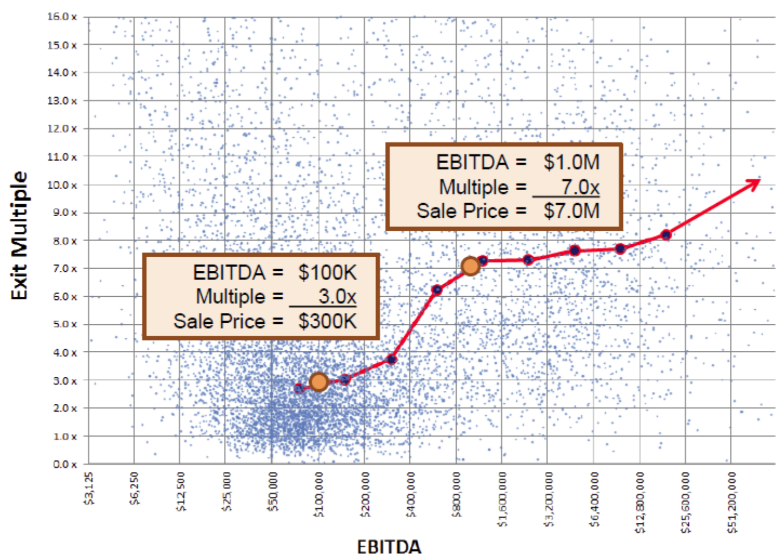
larger entity may benefit from greater name recognition and increased media exposure. In a commodity market, greater cost efficiencies (as detailed above) may permit the business to price more competitively and drive improved sales volume. Larger companies can often deliver a wider array of products or services than a smaller competitor. Larger companies are often valued at premium multiples to smaller competitors, reflecting the safety in the diversification that scale can provide as well as better access to cheaper financing in the capital markets. In fact, a subset of private equity investors have arisen that focus primarily on aggregating small businesses only to sell the rolled-up firm at a profit.

Example: Multiple Expansion in a Fragmented Industry



Source: Pratt's Stats and Brookwood Financial Partners

Risks and Challenges: While a successfully implemented roll-up can be quite profitable, executing the strategy can be challenging and failure to do so can compromise expected returns. In some instances, it may be difficult to generate synergies across entities with disparate business cultures, infrastructures and legacy employees with distinct objectives. There is also the potential for a roll-up platform to endure "diseconomies of scale" if the business grows too quickly or becomes too large to operate efficiently.

Examples: Consulting firm McKinsey and Company provides a salient example using Service Corporation International: "Beginning in the 1960s, Service Corporation International, for instance, grew from a single funeral home in Houston to more than 1,400 funeral homes and cemeteries in 2008. Service Corporation's funeral homes in a given city can share vehicles, purchasing, and back-office operations, for example. They can also coordinate advertising across a city to reduce costs and raise revenues. Size per se is not what creates a successful roll-up; what matters is the right kind of size. For Service Corporation, multiple locations in individual cities have been more important than many branches spread over many cities, because the cost savings (such as sharing vehicles) can be realized only if the branches are near one another. Roll-up strategies are hard to disguise, so they invite copycats. As others tried to imitate Service Corporation's strategy, prices for some funeral homes were eventually bid up to levels that made additional acquisitions uneconomic."

Other notable examples of roll-ups include: Kraft Foods (now renamed Mondelēz International) - which commenced acquiring businesses in the dairy business in the 1920s, Waste Management – which assembled a network of garbage collection services into a business tallying over $13-billion in annual revenue, Clear Channel Communications (now renamed iHeartMedia) – which rolled up more than 900 radio stations in the US during the 1970s through 1990s, and Public Storage, the publicly traded REIT which was acquired over 2,200 self-storage facilities.

CONCLUSIONS:

A roll-up is a simple strategy, often implemented by Private Equity firms, which involves acquiring a series of similar or complementary businesses. By deriving cost-savings and other economies of scale, the consolidator is often able to improve profitability meaningfully. And given premiums for larger businesses, there may also be an opportunity to exit the investment at a wider multiple on those enhanced cash flows.
