The Anatomy of a Business Roll-up – Scancorp Overview

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Definitions

- *Rolled-in Business:* the company or business assets that are acquired by the Group
- *Group:* the organisation that acquires the individual businesses
- *Business Owner:* the owner(s) of an individual business that is targeted for acquisition by a Group
- *Group Controller:* the directors and/or shareholders of the organisation that is acquiring the individual businesses

What is a roll-up?

A roll-up occurs where 2 or more smaller companies or business assets ("Rolled-in Businesses") are combined to create a larger company ("the Group"). Roll-ups can be initiated by financial buyers - in which case they are often comparable to a multi-company acquisition. Alternatively, a roll-up could be initiated by an existing industry participant - in which case they typically resemble a multi-company merger.

Unlike a traditional sale to a third party, from the perspective of the Business Owner – we advise our clients to consider a roll-up transaction as a simultaneous sale and investment. The Business Owner gets reasonable consideration to sell their business, then they reinvest some or all of this consideration in the Group.

During a roll-up the Group may acquire the shares of the Rolled-in Businesses or it may acquire the business assets.

My business is rolled-up – what will my deal look like?

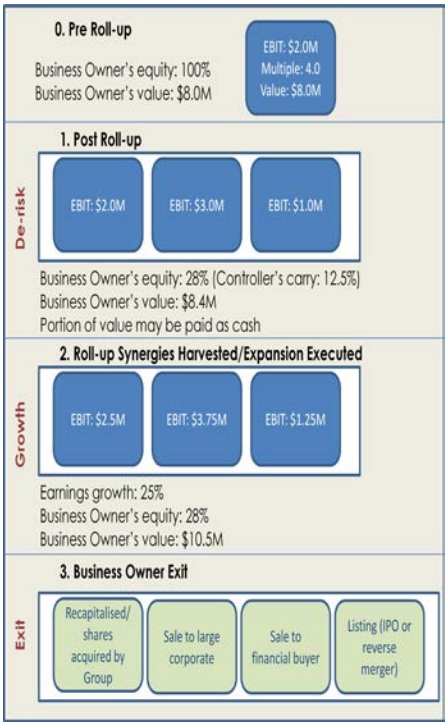
When the Business Owners sell their company shares or business assets into a roll-up, they typically receive equity in the Group. From the acquirer's perspective using Group shares as (partial) consideration for payment achieves two key objectives:

1. Aligns the interests of the Business Owner with the Controllers and funders of the Group
2. Reduces the immediate cash requirements of the Group – thereby enabling them to fund more acquisitions

In many cases, the Business Owners will be required to work within the Group for at least a transitional period. While this is not necessarily dissimilar to a standard acquisition (where an earn-out may apply), as the Business Owner obtains equity in the Group it is in their interest to continue to work within the Group to protect and enhance the value of their shares.

In addition to equity in the Group, the Business Owner will often receive some cash consideration. The Controllers of the roll-up transaction typically attempt to balance the following competing objectives:

- The acquired Business Owner's desire to receive as much cash as possible on completion,
- The need to have the Business Owner substantially co-invested in the Group to ensure they remain motivated to enhance the value of the Group;
- The need to leverage limited cash across multiple acquisitions, and
- Ensuring some cash is available to harvest synergies (refer below).

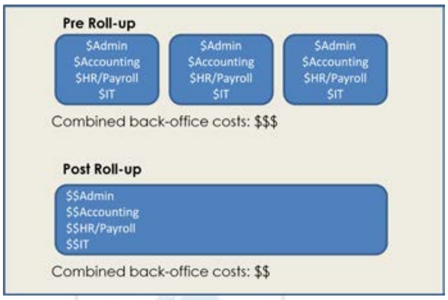


Roll-up as a transition to exit

Synergy - the key to a successful roll-up

The single most important motivation for orchestrating a roll-up is the synergy the individual companies create once they are combined. The synergy can take several forms but some of the most common examples include:

1. *Expanded geographic reach* - applies to businesses that are location specific and have current customers or could attract new customers if their service was offered from additional locations. Geographic synergy is most powerful when the barrier to enter a new geography (such as the capital cost or the need for local knowledge or network) is prohibitive for a single business owner. Example: roll-up of geographically spread equipment maintenance companies that can subsequently attract large clients who operate nationally.
2. *Complimentary capabilities / complimentary clients* – synergy can be achieved where individual businesses provide complimentary services that may be offered to clients of other businesses within the Group. Example: roll-up of individual risk, planning and accounting practices, a roll-up of graphic design, advertising and public relations firms that are subsequently able to offer broader services across their combined client base.
3. *Consolidation of costs* – combining businesses that could share common fixed costs, such as infrastructure, compliance and backend processing, could lead to substantially reduced Group overheads. Additionally, by consolidating the purchasing power of individual businesses within a similar industry, the Group will be provided cost reductions through its economies of scale. Example: a roll-up of smaller planning practices that benefit from leveraging the compliance function across multiple practices.
4. *Scale advantage* – in some cases combining the resources of individual businesses into a single Group can generate opportunities that were not otherwise available. This may be the case where large corporate or government clients have established purchasing criteria that would otherwise prevent an individual business from bidding for work. Example: multiple property developers must combine land holdings to achieve approval for a redevelopment; multiple manufacturers combine to achieve the minimum benchmark capacity required to bid for large corporate projects.

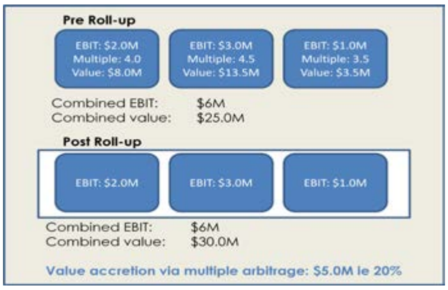


Consolidation of costs via a roll-up

Advantages of a roll-up

Some of the major benefits sought from rolling multiple businesses together include:

1. *Enhanced value through synergy* – if the synergies (outlined above) are harvested, this should lead to an intrinsic improvement in earnings of the Group. For example, as a result of its scale, the Group will typically have human, cash and marketing resources that were not available to the individual businesses. Rolling individual businesses into a larger group presents the Business Owners with an opportunity to expand their business beyond a level they could have independently achieved.
2. *Valuation multiple arbitrage* – by consolidating earnings of multiple businesses, the valuation multiple applied to the Group is typically larger than the individual multiples applied to the individual businesses. This is because larger revenues and earnings generally attract a higher multiple, as the portfolio of earnings is generally more desirable, is less volatile and hence lower risk.



Multiple arbitrage

3. *Improved exit options* – increasing scale generally enhances the options available for exit. Many financial investors such as private equity funds and large strategic players will have minimum revenue/EBIT benchmarks for target acquisitions. Similarly, revenues and potential earnings are required to list successfully on a securities exchange. Combining the earnings of multiple businesses may enable the shareholders of the Group to exit via a sale to private equity or corporations buyers, or by listing (via an IPO or reverse merger).
4. *Reduced risk via a broader investment* – in many cases, Business Owners have a high concentration of their wealth invested in their individual business. A successful roll-up enables the Business Owner to spread their investment across a broader portfolio of businesses – thereby reducing their investment risk.
5. *A transition to exit* – in the ideal scenario, the roll-up presents a Business Owner with a short-term opportunity to expand their business, thereby re-energising the Business Owner. In the medium term, the roll-up should offer the Business Owner a clear exit path. As such, the successful roll-up provides the Business Owner an excellent transition to exit.
6. *Friends close and enemies closer* – as consolidation continues to gain momentum throughout many industries, some Business Owners prefer the prospects of being part of a major market player, rather than competing against it in the near future.

When is a roll-up not an appropriate exit strategy?

Even a successful roll-up, defined as one that achieves its roll-up strategy, is not suited to every business owner. For example, we would not recommend that a business owner consider a roll-up in the following cases:

1. *A need to sell for 100% cash, now* - in many cases a roll-up does not offer the business owner a complete exit in the short-term. At the very least, the transaction will likely require the owner to reinvest in the Group. It may take several years before the Business Owner can sell all of their equity in the Group. This will largely depend on the secondary market available to sell the shares as well as any escrow provisions imposed when the business was acquired by the Group.
2. *A need to control* – the Business Owner who participates in a roll-up will usually have a reduced level of control over the scope of their individual business. Even if the owner continues in a key management role overseeing their business, they will normally be required to gain approval from Group management for major purchases, hiring and the execution of inorganic expansion strategies (such as acquiring new businesses). Additionally, they will likely adopt the standardised financial and management reporting requirements to the Group.

Scancorp's Critical Success Factors of a successful roll-up

Scancorp defines a successful roll-up as one which achieves its articulated roll-up strategy. We have identified several characteristics that contribute towards a successful roll-up:

1. *A compelling roll-up strategy* – as a minimum, a compelling roll-up strategy would include the following:
    a. states the case for consolidation within the industry (particularly in fragmented industries),
    b. specify the synergies that will be generated through multiple acquisitions,
    c. identifies the types of targets that would be sought,
    d. defines the valuation methodology to be applied to acquisitions,
    e. describes key post-merger integration issues such as alignment of culture, branding etc,
    f. explains how the synergies will be harvested,
    g. defines the ongoing expansion strategies of the Group,
    h. outlines the resources required to acquire and harvest synergies,
    i. explains how shareholders will realise their investment in the Group via an exit, and
    j. forecasts target returns to investors.
2. *The perception of fairness* – as the owners of the rolled-in business are likely to continue to work within the Group, it is critical that they are comfortable that they have received a fair deal through the acquisition. A fair deal will be assessed against their view of how they were treated by the Controllers and also against the deal that other Business Owners receive (refer below regarding optimising the roll-up deal).
3. *Post merger integration* – failing to harvest the synergies available from multiple acquisitions is a major issue in roll-ups. Key to the success of the Group is the integration of the individual businesses, alignment of culture, systems and processes consistent with the roll-up strategy as well as the rigorous approach to harvest the synergies available within the Group.
4. *Availability of resources post acquisition* – many roll-ups fail because they lack sufficient resources, such as cash and management talent, to harvest the synergies and to execute the growth strategies identified within the roll-up strategy. This often occurs when the Controllers have planned their resources to the point of completing their acquisitions but do not budget sufficient resources to execute the complete roll-up strategy.
5. *Plan for the market impacts that occur post roll-up* – because of their visibility, roll-up strategies are readily identified by competitors and can be replicated. A successful roll-up strategy will consider "copy cats" and address this risk, such as by securing the most ideal targets and by moving fast enough to build scale ahead of competitors. Another major issue encountered by acquirers is that increased demand for target acquisitions may result in the bidding up of their price. Once this becomes uneconomical for the acquirer, this may limit the growth the Group can achieve via acquisition.

Optimising the roll-up deal for the Business Owner

For the Business Owner, a well structured transaction can deliver exceptional outcomes. Some of the elements that a Business Owner and their adviser should consider include:

1. *Transparency and fairness in the valuation methodology* – the approach to valuing each individual acquisition should be made transparent by the Controllers. While some Business Owners will likely believe their business was worth more than other acquired businesses, transparency in how the acquirer valued each business will promote a sense of fairness.
2. *Adopt an investor's mindset* – while the Business Owner is effectively selling their business into the Group, it is important that they also adopt the mindset of an investor. As a material portion of their consideration will be provided as equity in the Group, they need to understand the medium term prospects of the Group. For example, the seller must be comfortable that the Group will acquire other businesses well and has strong growth prospects post acquisition (refer to the Critical Success Factors of a successful roll-up above).
3. *The pros and cons of being first* – when a Business Owner is attracted by the prospects of a roll-up, a key consideration for them and their adviser is where in the queue of acquisitions they wish to be. There are pros and cons of being early in the acquisition cycle such as:
    - Minimal discount on valuation multiple (advantage) - at the early stage of acquisition, the Group will likely be an empty shell or include one or two other businesses. As one of the first business to be acquired by the Group, the rolled-in business should be valued using a similar multiple as the Group. As such the Business Owner should receive substantial equity in the Group once their business has been acquired.
    - Acquisition "teething problems" (disadvantage) – a downside of being the first business to be acquired by the Group is that the acquisition process may be prolonged. Two common examples of start-up issues include: [i] the Group has a mandate to acquire multiple companies before it can launch the roll-up and as such initial acquisitions become co-dependent; and [ii] initial fund raising activities are required in order to fund the initial acquisitions.

4. *A considered exit from the roll-up* – it is critical that the Business Owner and their adviser establish a clear exit from the roll-up. This will include a short to medium term understanding of how the Business Owner will sell down their equity in the Group. Where the Group is a listed company, this will include consideration of the liquidity of the stock as well as any escrow provisions. Where the Group is unlisted, the Business Owner and their adviser may negotiate a put and call option to force the Group to acquire the their stock. In the longer-term, the Business Owner must understand how the Controllers intend to exit the Group – be this via a sale to a financial or strategic company or through a public listing.

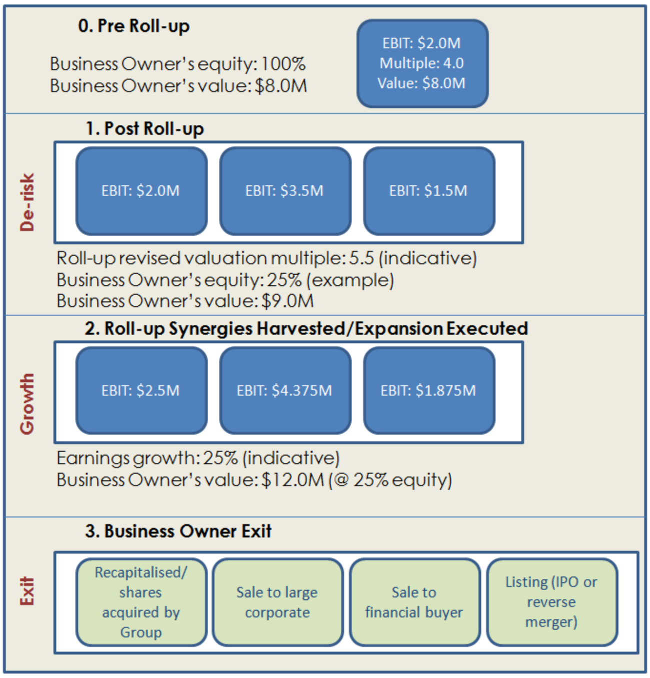
Scancorp Observations

Scancorp is seeing a substantial appetite for roll-ups from financial investors and industry participants. We are seeing the roll-up strategy employed by acquirers as a defensive play (ie to more effectively compete against larger companies), in response to general industry consolidation within fragmented markets (such as is occurring with accounting practices) and as an opportunistic strategy (where the facilitator identifies "white space" within an industry that exists between small businesses and large corporates).

While a sale to a third party was once the clearly preferred exit strategy of most business owners, we now observe the roll-up strategy is attractive to Business Owners who are planning their exit but are not looking to exit immediately. The roll-up can be an effective transition stage prior to a complete exit.

An effective roll-up strategy can offer the Business Owner:

- *the opportunity to de-risk* by taking some money off the table and by exchanging their large stake in a concentrated asset to a smaller stake in a larger portfolio of businesses,
- *expand their business* via the synergies and additional resources offered by the roll-up, and
- *a transition to exit* as the Group will generally have broader exit options and substantially greater management capability to enable the Business Owner to be replaced.



Roll-up as a transition to exit