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Capability Statement   Scancorp's M&A Approach   Forward to a Friend

Industry Scan

Issue #3: 2014
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Anatomy of a Roll-up

In our previous newsletter (click here for Part I) we commenced our 2 part series on the structure of the business roll-up. This edition completes the series with Part II below.

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

Part I

- What is a roll-up?
- My business is roll-up – what will my deal look like?
- Synergy – the key to a successful roll-up

Part II

- Scancorp's critical success factors of a successful roll-up
- Optimising the roll-up deal for the Business Owner

- Advantages of a roll-up
- When is a roll-up not an appropriate exit strategy?
- Scancorp Observations

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 as well and has strong growth prospects post acquisition (refer to the Critical Success Factors of a successful roll-up above).

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

3.

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 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.

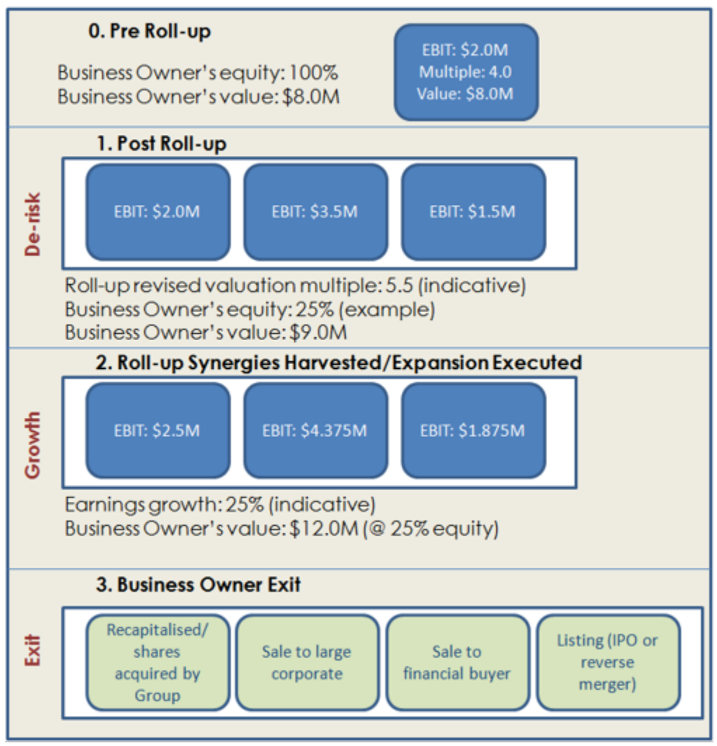
Scancorp Observations

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

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Exit Alliance Insight Seminars

During the month of May, the Exit Alliance Team hosted 5 Insight Seminars across Perth, Adelaide, Melbourne, Brisbane and Sydney. The seminars were facilitated by local Exit Alliance Planning Partners and attended by local professionals from the accounting, planning, legal and advisory industries. The Exit Alliance Insight Seminars were oversubscribed, drawing more than 200 attendees across the 5 seminars from around the country.
During the course of the seminars an estimated $30M of immediate business opportunity was identified.
The format of the seminars included:

1. The compelling need for exit services for private business owners
2. Exit Alliance's holistic solution which can be offered by accountants, lawyers and advisers
3. M&A case studies
4. The Exit Alliance membership model for advisors

Scancorp is pleased to have served as the keynote speaker providing insights around two M&A case studies:

1. Exit preparation - resulting in a substantially improved divestment outcome for a business owner, and
2. The importance of a robust sales campaign – focusing on maximising awareness while maintaining client confidentiality to achieve an outcome for the client.

For more information regarding Exit Alliance or preparation for sale, contact: marcus.salouk@scancorp.com.au

Industry Spotlight: Commercial Cleaning Services

With the continued trend towards the outsourcing of non-core business activities, the commercial cleaning industry has stable revenues. This industry predominately provides interior and exterior cleaning services, industrial cleaning services and washroom services for commercial (34%), education and medical (14%), retailers (12%), industrial (9%) and residential (6%) customers. There are some 27,000 cleaning businesses throughout Australia generating $7.7bn in revenues p.a.

Industry performance

Performance of the Commercial Cleaning sector is stable with growth generated from the increasing trend towards outsourced facilities management services (of which cleaning is a major part) and supported by general GDP growth. Growth for the industry is anticipated for each of the key sectors that it services:

- ***Commercial:*** while price competitive, this sector is anticipated to generate growth through the increasing number of establishments (via new businesses as well as growth in commercial construction) and increased outsourcing.
- ***Education and medical:*** these sectors are supporting revenue growth - as enrolments in the education sector require the development of new campuses and an increased focus on enhanced medical services and reduced wait times results in new medical facilities.
- ***Industrial companies:*** despite the challenges faced by the manufacturing sector and the end of the mining boom, revenues generated from the industrial sector will increase for commercial cleaning providers through increased outsourcing and a return to growth in the sector.

The commercial cleaning industry is seen as stable. As such, IBISWorld forecasts that industry revenue will grow by 2.4% in 2014-15.

Scancorp's Predictions for the Industry

We predict that while demand for services will remain strong, the following considerations must be taken into account by the owners of commercial cleaning businesses:

1. ***Scope for vertical integration:*** we believe that commercial cleaning services offered to larger corporate, government and industrial customers will increasingly be delivered as part of a broader facilities management solution. As a result, we believe high quality commercial cleaning service providers will expand their service offering, form alliances, merge with or be acquired by facilities management operators to offer a broader solution. The broader facilities management solution could then offer security, maintenance, catering, cleaning services and other relevant services.
2. ***Industry consolidation:*** Scancorp anticipates that some level of consolidation will be required within the commercial cleaning industry. It is likely that larger providers will seek to acquire small operators who offer niche services (such as a specialised industrial or medical cleaning). It is likely that providers will need to be able to competitively tender for contracts in the future and small cleaning operators will lack the scale and business development infrastructure required to remain competitive.
3. ***Profit improvement:*** wages account for over 40% of the total expenses of the commercial cleaning industry. We believe that industry profitability should improve in the short term as a result of a combination of factors: reduced wage pressure; increased demand for outsourced cleaning services; improved businesses conditions; an increased focus on quality adopted by clients (which they will be willing to pay for) and only a modest increase in the number of commercial cleaning providers (0.7% increase p.a).

Valuation Considerations

Commercial cleaning businesses are typically valued based on a multiple of earnings before interest, tax, depreciation and amortisation (EBITDA). As they are typically not capital intensive businesses, EBITDA for a commercial cleaning business is usually close to EBIT.

EBITDA multiples can vary between say 3 to 5 times, with larger multiples achieved for commercial cleaning businesses which exhibit the following characteristics:

- Contracted revenues with a diversified client portfolio
- Operated under management by an experienced management team
- Scale such as revenues > $5m p.a
- High Gross Profit margins and EBIT margin at or above the industry average of 13%
- Business development capability including the ability to tender for competitive contracts

While difficult to generalise, commercial cleaning businesses that exhibit these criteria will likely achieve capitalisation rates of 20% to 30%.

For more information contact: marcus.salouk@scancorp.com.au

Scancorp Victoria Launched

Scancorp is pleased to announce the launch of its subsidiary Scancorp Victoria.

Scancorp Victoria will service Scancorp's growing referral business across Victoria and will be led by Ian Knight.

The Victorian entity is an integrated part of Scancorp's business, will operate under Scan Capital's AFSL and will offer Scancorp's range of services including:

- Mergers, acquisition and divestment support
- Business sales
- Preparation for business exit – via Scancorp's proprietary Divestment Readiness Assessment (DRA) product
- Corporate advisory services
- Financing (debt and equity)

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A brief summary of Ian's experience:

Ian Knight started his professional career in 1972 as an auditor with a precedent firm of Deloitte's. Moving into industry in 1975 he worked as a financial accountant for Monsanto, then joined American International Group as the surety underwriter for Victoria. In 1978 Ian joined Citibank in Melbourne, moving later in the year to Perth as Regional Head of Credit for WA, SA & NT. From 1982 to 1989 he was involved in a number of businesses with partners in the financial broking, wealth management, superannuation administration, property, business broking and corporate finance areas, culminating with the listing of the business, Charthill Limited, on the ASX where Ian held the position of Managing Director/CEO.

After the takeover of Charthill, Ian returned to Melbourne to join KPMG where he became a Partner in their Corporate Finance division. In 1998 after the merger of the state based partnerships Ian became National Head of Mergers & Acquisitions and established offices in each state. In 2002 Ian established the Private Equity Division becoming Head of Private Equity (Corporate Finance) and held this role until his retirement in 2012. During his time at KPMG Ian was lead advisor on over 150 transactions across 30+ industries with a combined value of over $5bn.

Ian is an experienced executive director, CEO and chair with over 25 years board level experience. He has sat on the board or committees of over 15 separate organisations spanning: listed; private; not for profit; and government (State & Federal) sectors. He has managed listed and private companies and divisions.

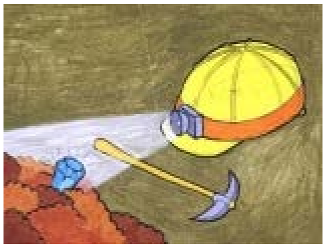
Key areas of experience:

- Strategy formulation and implementation
- Corporate Governance
- Acquisition strategy, negotiation and implementation
- Divestment strategy, negotiation and implementation
- Schemes of Arrangement and restructuring
- Public Listings
- Cross Border Divestment Transactions
- Private Equity based transactions
- Capital raisings
- Debt finance

Ian serves on a number of boards and advisory boards of private, public and not-for-profit businesses.

Other News

- Ross Greenwood: Budget not bad for small business
- Six nuggets of advice from the World Business Forum
- Why local marketing is important for SMEs
- Buying your business premises in your superannuation fund



Featured Investment

Exceptional ROI - Leading Provider of Fluid Transfer Solutions (Northern Territory)

- Prime location
- Strong customer relations
- Large customer base with a number of long term contracts in place
- Skilled team of management and technicians
- Record levels of private sector investment expenditure in the area
- Enviable reputation for providing customers with high quality products and superior standards of customer service and support
- Tangible opportunities for growth and expansion
- Turnover FY14 on track for circa $2.15m
- Achieving industry leading Gross Profit margins consistently in excess of 55%
- EBIT to owner/manager FY13 circa $341k and FY14 EBIT on track to reach $424K (representing 24% EBIT growth)
- Based on the acquisition price, the business represents an impressive indicative return of 34.8%

***Total business investment:* $1.1m plus stock (34.8% ROI based on the future maintainable EBIT of $383K)**

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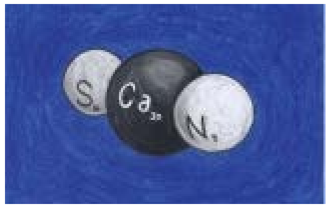

Featured Investment

Engineering Manufacturer and Service Provider with 40 year history

- Established 40 years
- Significant capability in engineering, fabrication and erection
- Servicing agriculture, transportation and construction sectors
- Diversified customer base including education and blue-chip corporate clients
- Holder of required licensing
- Offers an end-to-end service including value added services
- Not impacted by GFC
- Centrally located within its key markets
- Exceptional reputation for high quality service
- Tangible opportunities for growth
- Strong revenues: 2014 Turnover on target for $2M+
- Exceptional value: 85% Return on Investment on 2014 expected EBITD
- Highly profitable: 49%+ Gross Profit margins consistently across 5 years
- Sustained growth: 18.5% compound EBITDA growth over past 3 years

Total investment: $975K including stock & WIP

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SCAN
Scan Business Brokers

Our Mission

We provide the highest quality advisory services and solutions, previously inaccessible to the small to mid market.

Our Vision

To be the leading boutique provider of advisory services to fellow small and medium companies.

Our Services and Capabilities

Scancorp's Business Exit Approach
Scancorp Capabilities