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Industry Scan

March 2014
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Anatomy of a Roll-up

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

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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.

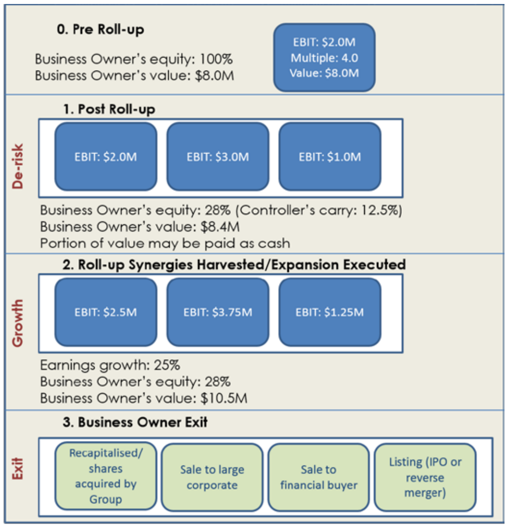
Unlike a traditional sale to a third party, from the perspective of the Business Owner – we advise our clients to consider a roll-up transaction as a simultaneous sale and investment. The Business Owner gets reasonable consideration to sell their business, then they reinvest some or all of this consideration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



Roll-up as a transition to exit

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)

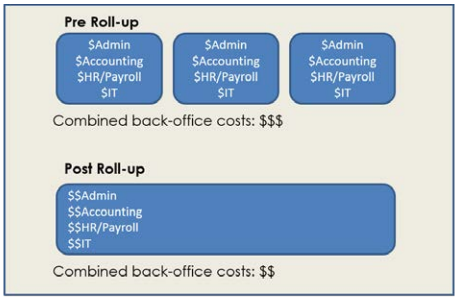
Synergy - the key to a successful roll-up

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.



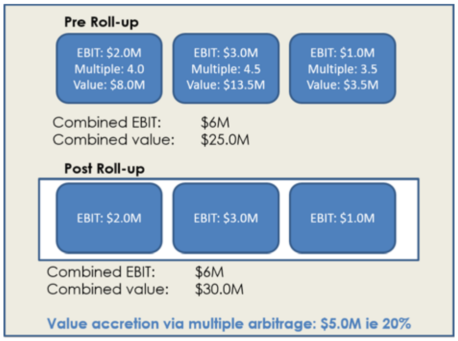
Consolidation of costs via a roll-up

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.

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.



Multiple arbitrage

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.
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.

In the next edition - Part II:

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

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Client in Focus: Sarina Clinic

The team at Scancorp would like to congratulate Dr Marsh Godsall and Mr Peter Shearing for completing the sale/purchase transaction for Sarina Clinic this month. Sarina Clinic (established nearly 40 years ago by Dr Godsall and his wife Von Godsall) is the region's leading and largest medical centre. The strong management and leadership provided by the Godsalls has allowed the clinic to enjoy continual growth and profitability over the past five years. As an investor, not a medical professional, Mr Shearing has recognised both the current strength and future potential of this profitable business and has acquired it as a fully managed investment.

With the key staff well established and the current practice manager now in their 12th year, the transaction was structured to factor appropriate management support and medical expertise to enable the business to operate under full management. Dr Godsall will continue to work within the clinic to support Mr Shearing. By signing a 10 year lease (with further options), Mr Shearing has secured the clinic's position as the leading provider of health care services in Sarina for the next decade.

After considerable financial forecasting and financial due diligence, Mr Shearing is delighted to be the new owner of the clinic. Mr Shearing is keen to continue the legacy created by the Godsalls to provide the highest level of care available in this thriving regional community. Dr Godsall's ongoing engagement with the clinic is expected to sustain and enhance the loyalty of the local clientele.

Although the financial details of the sale will remain confidential between the parties, the transaction was quite complex and both parties have expressed an appreciation for the quality and level of service delivered by Scancorp throughout the entire sale process.

The next stage of the campaign undertaken by Scancorp for Dr Godsall involves the sale of the Sarina medical centre freehold. The freehold includes a modern, well equipped facility in a premium location.

Combined with a 10 year lease and yielding 9.85% in the secure medical industry, this is anticipated to present an exceptional investment opportunity. Scancorp will formally invite interest for the freehold from April 2014.

Scancorp is delighted to have facilitated the transaction on behalf of Dr Godsall and congratulate both parties on the successful outcome.

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Industry Spotlight: Plastic Surgeon Clinics

In the wealthy baby boomer's quest for eternal youth, the plastic surgery industry has enjoyed solid revenue growth, reduced competition and burgeoning demand. This industry predominately provides surgical and non-surgical procedures within the cosmetic and reconstructive realm. Plastic surgeons primarily focus on cosmetic injections, laser hair removal, microdermabrasion, chemical peels, breast augmentation/reductions and liposuction. There are some 350 Plastic Surgery businesses throughout Australia generating $790m in revenues p.a.

Industry performance

The plastic surgery industry is set to outpace Australian GDP growth over the next 5 years. Industry revenue and profit margins are expected to progressively increase due to:

1. Increasing levels of disposable income: with expensive and discretionary procedures not covered by Medicare, higher incomes will help boost demand for plastic surgery procedures,
2. An aging population: especially in females over 35 looking for a way to reverse the physical and visual effects of age,

3. Growing levels of obesity: as more overweight Australians look towards cosmetic surgeries and liposuction to combat rising obesity, and
4. An undersupply of graduates: extensive educational requirements coupled with limited training institutions controlling the quality of graduates has led to an undersupply of budding new entrants to the industry. This has facilitated higher demand and should sustain the high profitability of the industry.

As such, IBISWorld forecasts that industry revenue will grow by an annualised 4.7% over the next 5 years and profit margins are expected to widen from an estimated 20.3% in 2012-13 to 20.8% in 2017-18.

Scancorp's Predictions for the Industry

We predict that while demand for services will remain strong in the years to come, the following considerations must also be taken into account for plastic surgery business owners and their employees:

1. *External competition:* due to ongoing technological advancement, the plastic surgery industry will continue to see increased competition for non-surgical procedures such as laser hair removal and injectables from businesses that offer similar services. We see beauty and health spas, store bought at-home microdermabrasion kits as providing some competition to plastic surguery businesses. Additionally, the industry must tackle the increasing trend of Australians looking abroad to Asia and South America where surgical procedures are offered as packaged holidays at a lower price.
2. *Location, location, location:* practices located close to hospitals and within densely populated areas will continue to strongly benefit from accessibility for patients who require reconstructive surgery, clients who enjoy frequent non-surgical procedures. Premium locations (including surgeries located in wealthy demographics) will also help to combat the potential reduction in revenue from a high turnover rate of customers.
3. *Reputation is paramount:* as plastic surgery procedures and services do not tend to come cheaply, a practice must maintain an exceptional reputation if it is to thrive and build its customer base. Also, a continued increase in social acceptability of plastic surgery procedures will allow for satisfied clients to aid customer growth through word of mouth referrals.
4. *Increased demand for succession-planning services:* many owners of plastic surgery businesses are reaching retirement age and will be looking for mechanisms to exit their business. Where the owner of a practice is the sole surgeon, when the time comes for the owner to seek to exit, he/she will be very limited as to their options for divestment. In many cases, plastic surgeons will simply close down their practice. As such it is critical that plastic surgeons establish formal succession strategies which will may include plans for adding additional surgeons in order to facilitate a sale in the future.

In response to the anticipated demand for succession planning services, Scancorp has developed a customised version of its Divestment Readiness Assessment (DRA) for the medical industry – click here for more.

Valuation Considerations

Plastic surgery businesses are typically valued based on a multiple of earnings before interest and tax (EBIT). Where a surgery is owned by one or more practicing doctors, it is critical to understand the proportion of revenues that are generated by the current doctors and whether they will remain with the practice once sold.

In such cases it may be appropriate to normalise the EBIT to ensure the owner's remuneration is included as an expense going forward (in some cases this may represent 60% of their billings). This enables the business to be presented consistently to potential buyers, be they practicing doctors, owner/managers or investors.

The multiple applied to EBIT depends largely on the size of the practice, independence from the current owners, revenue and profitability trends, location of the practice, differentiation from competitors, breadth of services offered and diversification of revenues. While difficult to generalise, capitalisation rates of recent transactions have ranged from 25% to 40%.

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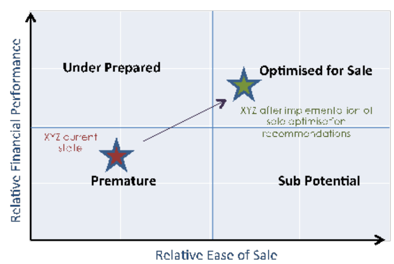
DRA Update - Case Study

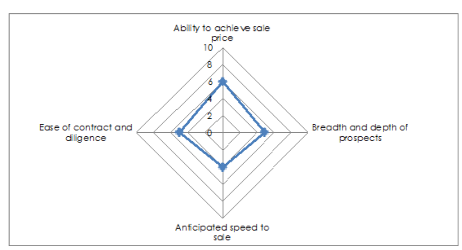
As outlined in a previous Newsletter click here, Scancorp has developed the Divestment Readiness Assessment (DRA) as a product that assesses the readiness of a business for sale. The DRA identifies any specific actions required to optimise the sale outcome for the owner - whether or not the owner intends to sell in the near-term. The Divestment Readiness Assessment is a rigorous and focused process that was developed over 30 months leveraging over 30 years of M&A expertise. It draws on Scancorp's “5 Pillars” which identifies critical characteristics that buyers look for in a business acquisition – be they trade buyers, owner operators or investors.

The following case study summarises the outcomes of a recently completed DRA:

- *Client Objective:* to optimise their business for investment (immediate) and to ensure the business is prepared for sale (medium term)
- *Client Industry:* niche professional services
  - *Key DRA Findings:*



    - Preparedness for sale - assessed to be at a moderate level of Relative Ease of Sale and at an unacceptable Relative Financial Performance based on its potential
    - Indicative Value Range - appraised at an indicative value of: $2.4m to $2.9m
    - Key Divestment/Investment Optimisation recommendations:
      1. Reduce labour associated costs (more detailed recommendations provided),
      2. Implement proactive business development strategies (specific recommendations provided)
  - *Client Investment:*



    - Execution of DRA: $15,000
    - Support for implementation of recommendations: $45,000
    - Total investment: $60,000
    - Total project timeframe: 8 months
  - *Target Client Outcomes/ROI:*
    - Target re-assessed value range: $3.0m to 3.6m
    - Target improvement in earnings: $250,000 p.a (ie DRA payback period: 3 months)
    - Target improvement in valuation: circa $600,000 (ie DRA ROI: 10x)

Scancorp anticipates the DRA process will generally deliver a substantial ROI to the business owner.

Most importantly, the execution of the DRA process may be the difference between a business owner being able to sell and retire versus having their wealth captive within the business.

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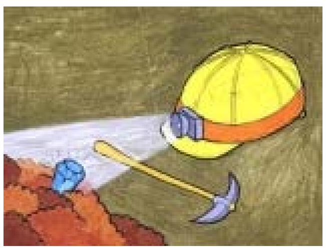
Other News

- Pent-up wave of sales looms as boomers are ill prepared for sale
- ANZ announces $2 billion in small business lending
- SMEs' international trade outlook on the rise
- $50m boost to help small businesses export

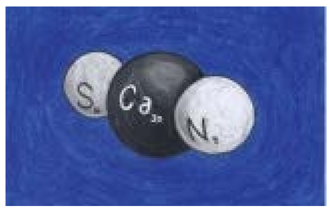
Featured Investments



Featured Investment

Highly profitable cabinet and board manufacturer and distributer

- Exceptional brand established 40 years
- Diversified, long term clients with a high level of repeat business
- Operationally fully managed by competent staff
- Recent significant investment in state of the art technology systems
- Exceptional compound revenue growth of 64% p.a since 2010
- Turnover FY14 on track for circa $3.7m
- FY14 EBIT (under



Featured Investment

Leading power tool and storage IP licenses and distribution

- BluCave is a range of modular products and accessories - refer to: http://www.blucave.com.au/
- BluCave's award winning products are unique in the market
- After completing product development and commercialisation over the prior 10 years, the shareholders are inviting interest from parties who wish to:
  - Acquire the current distribution contract and an exclusive Australian license to distribute the Products,

Scan Business Brokers

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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

Sellability Score Link

management) circa $969k
- Average EBIT over FY13 and annualised FY14 (under management) of $765k

Total Business investment: $2.4m plus stock - 32% ROI based on the on the average EBIT over FY13 and annualised FY14 (under management and net of depreciation)of $765k

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For more information click here **to view a Teaser**

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