Additive Dealmaking: Part II

An analysis of add-ons' effect on fund performance

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Key takeaways

- PE funds that complete more add-on transactions generate better cash-on-cash returns across most vintages. For vintages 2000-2003, two samples of add-on-heavy funds posted median total value to paid-in ratios (TVPIs) of 2.06x and 1.89x—both outperforming the PitchBook Benchmarks' median TVPI of 1.79x over the same timeframe. We find similar outperformance for vintages 2004-2007 and 2008-2011.

- Portfolio companies with add-ons are held longer than those without, providing more time for the general partner (GP) to increase the TVPI multiple; however, add-on funds also outperform on an internal rate of return (IRR) basis. 36.3% of add-on funds beat the top-quartile hurdle rate, while just 10.0% of funds fell into the bottom-quartile, indicating that funds that employ the buy-and-build strategy generate superior returns.

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How we got here

Add-on transactions (also called bolt-on transactions) have become a ubiquitous part of the PE industry. In a prior analyst note on the subject, we dissected the growing trend of add-ons within PE, establishing a few key points:

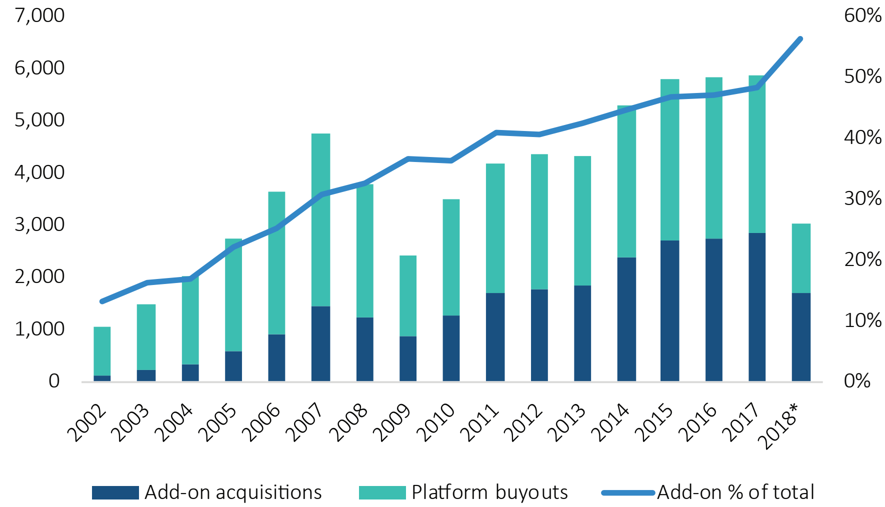
- Nearly 30.0% of PE-backed companies now undertake at least one add-on acquisition, compared to less than 20.0% that did so in the early 2000s.
- Prolific buyers that pursue numerous add-ons per platform have been driving heightened add-on activity in recent years. More than 25.0% of add-ons are now being acquired by platforms with at least five total add-on deals.
- It takes time to execute deals and integrate businesses; as such, the median time to exit tends to be about a year longer for companies that undergo at least one add-on.

There are many reasons for the growing prevalence of add-ons. Namely, they can provide opportunities for PE firms to acquire companies at lower multiples. Often smaller than a typical platform company, add-ons allow the sponsor to "blend down" the aggregate acquisition multiple, enhancing the potential to benefit from multiple expansion once the combined, now larger entity is sold or taken public. Add-ons also allow managers to flex their operational muscles and create unique business combinations. It is now commonplace for PE firms to employ operations specialists, either in-house or through a third-party advisor, to aid in the integration of subsequent acquisitions. Similarly, operating partners, who tend to have equity stakes in the investments, often have experience at the helm of similar companies and can provide specific expertise, or at least a second opinion, throughout the course of the holding period, including the due diligence and disposition phases.

GPs often tout their buy-and-build strategies as setting them apart from other buyout shops. One newcomer to the space, Soundcore Capital Partners, completed 20 add-ons across just two platforms as a fundless sponsor before holding a final close on a debut fund of $350.0 million in July 2018. The company's third platform, a street sweeping company, has already completed five add-ons. In a recent press release, Jarrett Turner, a managing partner at Soundcore, spoke of the firm's "approach of pursuing healthy, need-to-have buy-and-build investments in highly-fragmented, niche markets" and the platform's "unlimited potential to expand into hundreds of smaller, local territories… through multiple add-on acquisitions."[1] Given that add-ons have

1: "Soundcore Capital Partners Simultaneously Closes on Third Platform and its First Bolt-On Acquisition in the Company's First Deals of 2017," PR Newswire, Soundcore Capital Partners, March 2, 2017

Add-ons now account for more than half of all buyouts
Global add-ons as a % of platforms



Source: PitchBook
*As of June 30, 2018

become so widespread and that GPs will now cite add-ons as a key part of their strategy, we decided to measure how add-ons affect PE fund performance.

Methodology

To identify GPs most engaged in the buy-and-build strategy, we ranked every firm in the PitchBook database by the average number of add-ons per platform company, including only firms that have completed at least 10 deals since 2000 (to include only firms with an established track record of using a buy-and-build strategy). Next, we identified those firms that are most likely to complete add-ons (i.e. add-ons as a proportion of all buyouts). Then, we created a list of all buyout funds associated with those firms, using only the funds for which we have sufficient performance data (see inclusion criteria in PitchBook Benchmarks). Attempting to capture approximately the top decile of the population and create a reasonable threshold for future analysis, we chose the buyout funds of firms that have completed at least 2.5 add-ons per platform company, leaving us with 80 “add-on funds,” representing about 10.0% of the 804 total funds. Herein, we’ll refer to these 80 funds as “Sample 1.”

Select firms from Sample 1

- Parthenon Capital Partners
- Genstar Capital
- KRG Capital Partners
- Apax Partners
- Kelso Private Equity

In addition to the above, we created a similar list of add-on funds using slightly different criteria: buyout funds of those investors with at least 65.0% of platform companies completing one or more add-on transactions. Here, we were left with 90 funds, or just over 11.0% of the total distribution. These criteria allow us to assess the impact of add-ons while giving less weight to funds that pursue dozens of add-ons for one platform. We'll refer to these 90 funds as "Sample 2." Using the inclusion criteria in Samples 1 and 2, as well as the benchmarking techniques described in the next section, we attempted to control for potentially misleading factors including the declining absolute performance of PE funds over time and the increasing prevalence of add-ons over the same period.

Select firms from Sample 2

- Genstar Capital
- KRG Capital Partners
- Vista Equity Partners
- New Mountain Capital
- Hellman & Friedman

Summary of sample inclusion criteria

	Criteria	Number of funds in sample
Sample 1	Firm has completed at least 2.5 add-ons per platform company.	80
Sample 2	At least 65% of the firm's platform companies have at least one add-on.	90

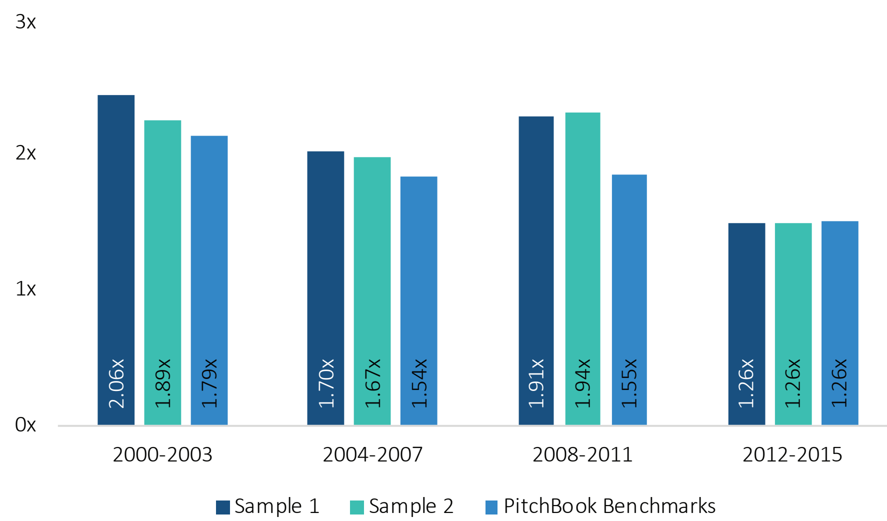
Source: PitchBook

Benchmarking performance

First, it's important to address how the funds in Samples 1 and 2 differ from the greater population of funds (in this case the PitchBook Benchmarks), both in terms of size and vintage. Sample 1 comprises older and larger funds, with a median vintage year of 2008 and a median fund size of $1.7 billion. Sample 2 has a median vintage year of 2010 (the youngest of the groups) and a median fund size of $900.0 million. Meanwhile, the PitchBook Benchmarks have a median vintage of 2009 and median fund size of $810.0 million (the smallest of the groups). To assess how the samples of add-on funds perform against their peers, we first compared cash-on-cash returns, specifically TVPI, to the PitchBook Benchmarks.

Buyout funds in aggregate exhibited higher absolute returns in the early 2000s, so we decided to group vintages into four-year buckets to mitigate any early-vintage bias, while maintaining sufficient sample sizes. Using this method, we find that Samples 1 and 2 produce higher TVPIs across most vintage buckets, indicating that buy-and-build strategies have a positive effect on fund performance. For vintages 2000-2003, Samples 1 and 2 (our add-on-heavy funds) posted median TVPIs of 2.06x and 1.89x—both outperforming the PitchBook Benchmarks' median TVPI of 1.79x over the same timeframe. We find similar outperformance for vintages 2004-2007 and 2008-2011, while all three groups

Median TVPI by vintage

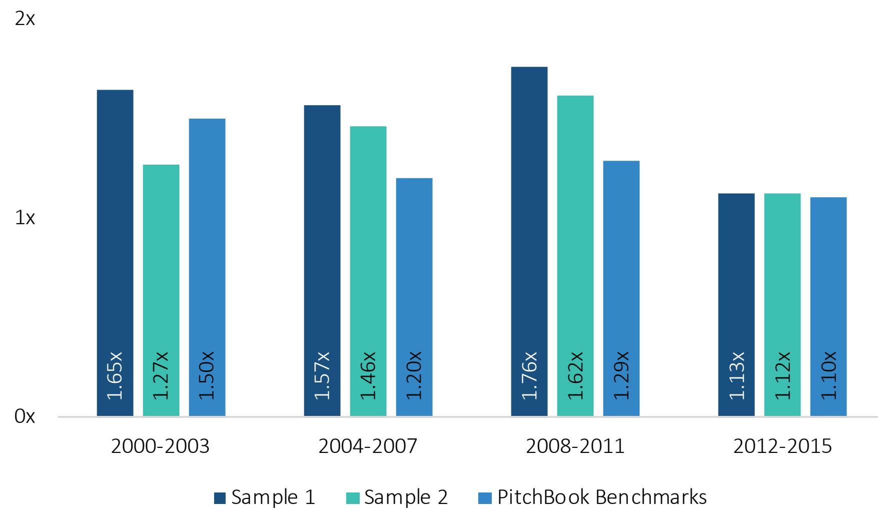


Source: PitchBook
*As of December 31, 2017

Top-quartile TVPI by vintage

Source: PitchBook
*As of December 31, 2017

Bottom-quartile TVPI by vintage



Source: PitchBook
*As of December 31, 2017

have a median TVPI of 1.26x for vintages 2012-2015. The trend continues across the distribution of returns, with top- and bottom-quartile funds in Samples 1 and 2 generally outperforming their respective peer group in PitchBook Benchmarks. The same is true for the best- and worst-performing funds; Samples 1 and 2 tend to have higher top- and bottom-decile hurdle rates.

Given these comparisons, it's clear that add-on-heavy funds generate better cash-on-cash returns. And while some may assume this is due to longer hold periods, add-on funds also outperform on an IRR basis. Comparing each fund's IRR to its peer group, controlling now for vintage group and strategy (buyout funds only), we find 36.3% of funds in Sample 1 performed in the top quartile, while just 10.0% ended up in the bottom quartile of their respective peer groups, a further indication that buy-and-build strategies have a positive effect on fund performance. All in all, Sample 1 performed above-median 66.3% of the time.
When we repeat this process using Sample 2 (i.e. using the highest proportion of platform companies that have at least one add-on, instead of the average number of add-ons per platform), we get similar—albeit slightly less compelling—results. Funds from Sample 2 perform in the top quartile of their peer group 30.0% of the time, compared to finishing in the bottom quartile just 14.4% of the time. Sample 2 ended up in the top-half of its peer group 64.4% of the time.

Distribution of funds by PitchBook Benchmark quartiles

	Quartile 1	Quartile 2	Quartile 3	Quartile 4	Grand total
Sample 1	36.3%	30.0%	23.8%	10.0%	100.0%
Sample 2	30.0%	34.4%	21.1%	14.4%	100.0%

Source: PitchBook
*Sample 1: n=80; Sample 2: n=90; quartiles based on terminal fund IRR as of December 31, 2017

Conclusion

As the PE marketplace becomes more competitive and prices remain elevated, the traditional tools of leverage and multiple expansion are unlikely to be sufficient for producing typical PE returns. Add-ons will be a key part of the growing focus on operational improvements, and managers are therefore likely to use their add-on strategies as a selling point with potential limited partners (LPs). There are, of course, many factors to consider when making allocation decisions aside from a manager's propensity for completing add-on transactions. However, the above results indicate that LPs may benefit from including the strategy among a broader list of considerations.