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Exploring Trends in Add-On Acquisitions

US PE sees the buy-and-build escalate, innovate, and sophisticate

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Published on April 13, 2021

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Key takeaways

- **Add-ons have steadily increased in importance as a PE strategy over the past two decades.** In 2020, 71.7% of US PE deals were add-ons. By pursuing inorganic growth for portfolio companies, PE firms can engage in multiple arbitrage, pursue specific strategic goals, or weather market downturns. Looking ahead, some GPs are eschewing traditional roll-ups in favor of more sophisticated, synergistic buy-and-build strategies.
- **Although GPs historically held platforms that completed add-ons longer than other portfolio companies, in recent years median exit times for portfolio companies with and without add-ons have converged.** GPs have become more adept at executing buy-and-build strategies using familiar playbooks. Additionally, buyers in high-growth sectors are increasingly willing to pay for the unrealized potential of recently-completed add-on acquisitions.
- **Buy-and-builds are more likely to be sold in sponsor-to-sponsor transactions than portfolio companies without add-ons.** More add-ons are correlated with a higher likelihood of sponsor acquisition. GPs prize platforms with M&A experience and are more tolerant than strategics of add-ons that have been minimally integrated.
- **This note also takes a deep dive into the financial services industry, where 84.8% of deals in 2020 were add-ons.** PE continues to drive consolidation in the insurance brokerage industry even in the face of rising multiples, while specialist firms are exploring opportunities in new verticals.

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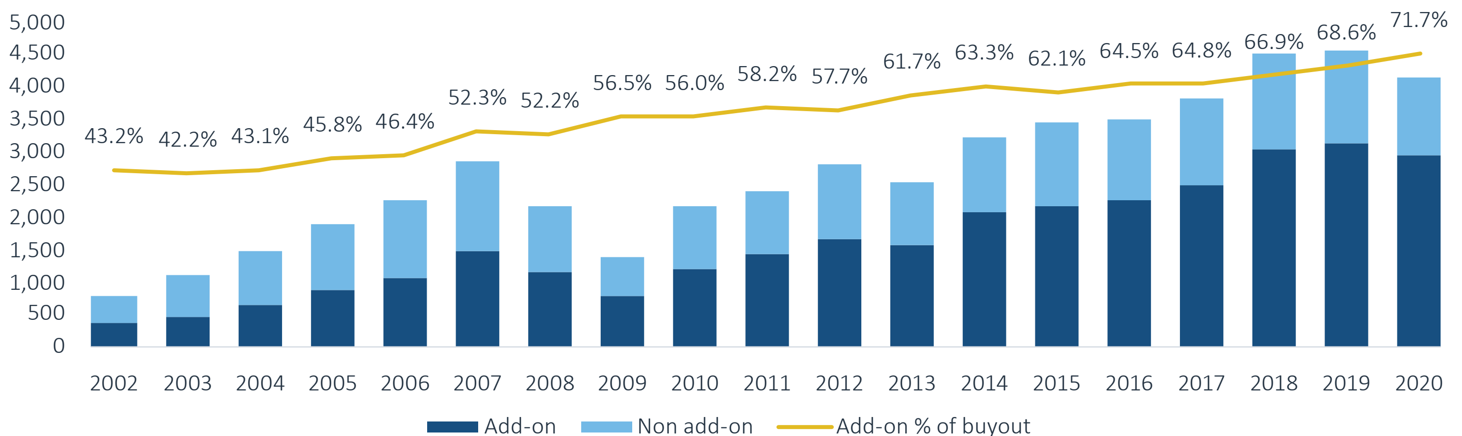
Overview

Add-on acquisitions have been increasing in popularity since the early 2000s. 71.7% of US PE deals in 2020 were add-ons, compared with 43.2% in 2002. Although overall PE deal count declined in 2020 because of the COVID-19 pandemic, 2021 will likely show the highest count of add-on deals on record. These buy-and-build strategies span a wide range of intentions. Some involve large-scale roll-ups in which a platform company in a highly fragmented market space acquires a large number of smaller, often founder-owned companies. Others seek more opportunistic M&A transactions that allow portfolio companies to pursue specific product or operational goals.

Add-ons as a share of buyout count



Source: PitchBook | **Geography:** US
*As of December 31, 2020

The unflagging growth of add-ons across two decades of macroeconomic ups and downs can be attributed to the numerous advantages they offer. Multiple arbitrage remains the most frequently cited incentive, particularly given the current environment of elevated valuations in many sectors. Since larger companies typically fetch higher EV/EBITDA multiples than smaller companies, affixing smaller add-ons to a larger platform effectively buys down the multiple that a GP pays to acquire a company while increasing the multiple it earns at exit.

Buy-and-build strategies can also give larger firms access to market segments that would otherwise be out of reach. For example, a hypothetical firm with a $1 billion fund may have a minimum check size of $100 million. However, the firm can buy a platform with an enterprise value of $200 million and then position it to make add-on acquisitions of companies below its minimum check size in the $50 million-$100 million range, eventually selling the combined company for, say, $500 million. This is particularly advantageous in sectors wherein large GPs have crowded the upper end of the middle market. The firm can acquire add-ons in a less competitive market and sell the scaled-up platform in a more competitive one. Finally, add-ons can also help portfolio companies enter new geographical markets, diversify their product offerings (often with a view to cross-selling), double down on more lucrative end markets, or acquire in-demand talent.

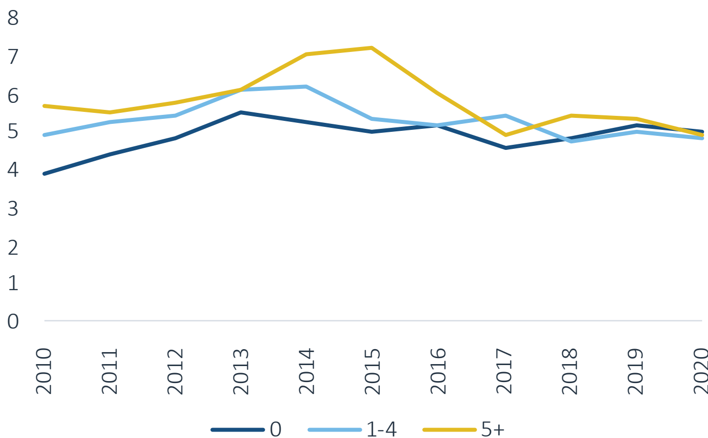
Add-ons also represent an attractive recessionary strategy. When GPs with significant dry powder reserves find themselves attempting to deploy capital in a down market—as they did in the global financial crisis (GFC) and briefly in 2020—they can invest in portfolio company growth through add-ons without assuming the risk of a larger purchase. Boosting a portfolio company's value through M&A also helps to improve net returns, providing a counterpoint to the deleterious effects of elongated holding times on IRR as GPs wait out the storm before exiting.

Executing and exiting buy-and-build strategies

GPs must consider whether the time and resources required to operationally integrate an add-on—and the associated execution risks—are proportionate to the strategic and financial upside. The extent of operational integration required varies significantly among verticals and platforms, ranging from consolidating wholesaler negotiations to standardizing IT and HR systems to integrating teams to reduce headcount. Although operational streamlining can yield some cost efficiencies, especially at scale, it requires significant time and effort from both GPs and management teams. Platforms also need a foundation of healthy organic growth and free cash flow to ensure they can financially support multiple acquisitions. For these reasons, not every portfolio company is a good candidate for additive dealmaking. Some may be better served by focusing on operational improvements or organic growth.

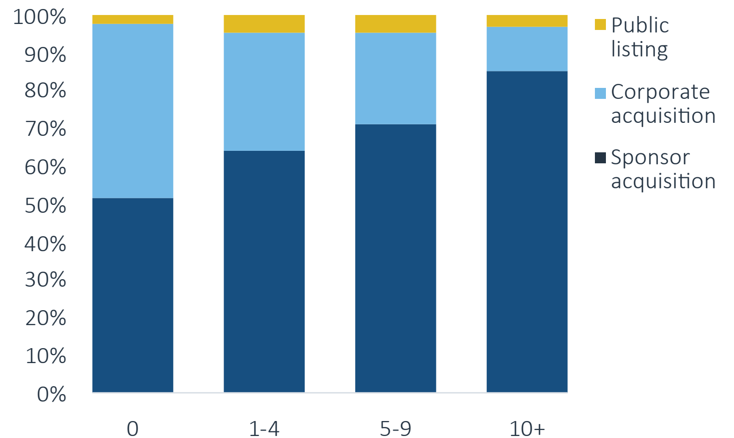
Historically, GPs have held platforms that complete add-ons longer than other portfolio companies, with greater numbers of add-ons correlated with longer holding times. The reasons for this are intuitive: Deal sourcing and execution, operational integrations, and the realization of synergistic advantages all take time. However, in the past several years, median exit times for portfolio companies with and without add-ons have converged at approximately five years.

Median time for PE-backed companies to exit (years) by exit year and number of add-on acquisitions



Source: PitchBook | **Geography:** US
*As of December 31, 2020

Share of PE-backed company exits by number of add-on acquisitions and exit type, 2018-2020 aggregated



Source: PitchBook | **Geography:** US
*As of December 31, 2020

There are several reasons for this convergence. First, both GPs and the management teams of platform companies have become more adept at executing buy-and-build strategies over time. As GPs double down on specific industries conducive to roll-ups, they can move quickly with familiar playbooks. Platform selection also plays an important role. GPs look for platform companies with sufficiently "professionalized" management teams and back-office operations to successfully execute add-ons, though they often bring in additional talent, such as a head of M&A, themselves.

In fact, companies that have grown through additive dealmaking are more likely to be sold in sponsor-to-sponsor transactions than companies that have not; more add-ons correlates with a higher likelihood of a sponsor acquisition. A company's track record of completing acquisitions under the first sponsor represents an attractive selling point for the second sponsor. Moreover, PE buyers tend to be more lenient than strategics when it comes to operational integration of add-ons, making them more likely to purchase platforms that have made many acquisitions. This is because they have the expertise to move integration forward and are likely intending to pursue further inorganic growth anyway. Platforms may be passed between GPs focused on successively larger deal sizes, acquiring add-ons as they go.

However, allowing sufficient time for operational integration within a fund lifecycle remains important for GPs operating in fundamental value industries, especially when targeting strategic buyers. John Stewart, founding partner at MiddleGround Capital, a firm that specializes in the lower-middle-market B2B industrials and specialty distribution, notes the risks of making add-on acquisitions late in a holding period: M&A diverts management team attention from the performance of the core business. Moreover, strategic buyers prefer to buy platforms that have standardized systems across bolted-on components because they will need to integrate the acquisition before realizing synergistic gains.[1] For these reasons, some GPs strive to complete add-on acquisitions at least 12 months before their desired exit date.

The logic around holding times is different for upper-middle-market companies in growth-oriented sectors, an area where PE is increasingly active. The current climate of excess dry powder, high valuations, and risk-on investor behavior means that GPs building this type of company may be less concerned about fully integrating add-on acquisitions before bringing a platform to market. According to John Mathis, partner at Harbor View Advisors, buyers of software and other technology-related companies are accustomed to paying premiums for yet-unrealized growth potential and may be content to value a recent add-on acquisition accordingly.[2] The glut of SPACs currently seeking reverse merger targets has created an additional exit route. Again, this has contributed to the convergence in holding times between companies with and without add-ons.

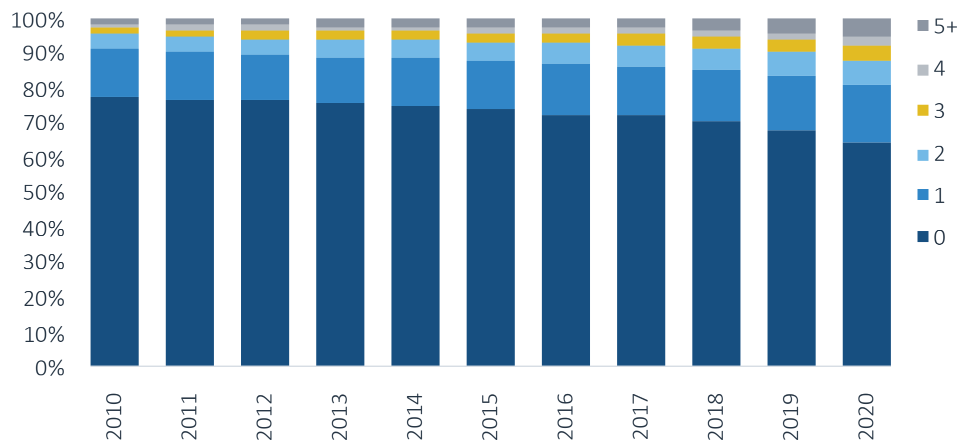
1: John Stewart, telephone interview, February 11, 2021.
2: John Mathis, telephone interview, January 18, 2021.

Going forward, the growing popularity of GP-led secondary transactions and long-dated funds will provide new options for GPs seeking to grow successful platforms beyond the traditional fund lifespan. We are already seeing examples of this. Bay Grove Capital, a firm committed to building on one platform company at a time over long time horizons, has completed 31 add-ons with Lineage Logistics Holdings since 2012. In 2019, Blackstone completed a single-asset restructuring of its 2012-vintage Tactical Opportunities Fund to move Phoenix Tower International, a wireless infrastructure operator, into a continuation vehicle. Phoenix Tower International has already acquired several additional add-ons since the fund restructuring. Finally, the Oak Hill Capital-Carlyle Group and Bain Credit insurance platforms discussed in the sector spotlight represent ways that firms are creating bespoke vehicles to facilitate large-scale roll-ups outside the traditional fund structure.

Trends in additive dealmaking

The growing importance of add-ons as a strategy within PE is evident in the data. Roughly one-third of portfolio companies that exited in 2020 had completed at least one add-on, with 5.2% completing more than five. If current trends continue, around half of the platforms that exit in 2025 will have at least one add-on. A growing subset of these companies are serial acquirers that complete dozens, or occasionally hundreds, of acquisitions via a single financial sponsor. Insurance brokerages dominate the list of serial acquirers; we dig into this vertical in the following section. Healthcare is another "classic" roll-up sector, with current serial acquirers in veterinary clinics and various specialty healthcare fields, and vertical SaaS is emerging as an increasingly popular option. However, any fragmented vertical can lend itself to rapid acquisitions.

Share of portfolio company count by number of add-on acquisitions



Source: PitchBook | **Geography:** US
*As of December 31, 2020
Note: Number of add-ons via the current sponsor at time *t*.

Platforms with the most add-ons acquired via the current sponsor, excluding insurance companies*

Company name	Creation date	Sponsor	# of add-ons	Industry
Mission Veterinary Partners	October 27, 2017	Shore Capital Partners	76	Hospitals/inpatient services
Integrity Marketing Group	May 16, 2017	HGGC	53	Other commercial services
Mister Car Wash	August 21, 2014	Leonard Green & Partners	44	Automotive
Ascensus	December 3, 2015	Aquiline Capital Partners, Genstar Capital	32	Specialized finance
Lineage Logistics Holdings	April 18, 2012	Bay Grove Capital	31	Logistics
MRI Software	June 23, 2015	GI Partners	31	Business/productivity software
Ivy Rehab	April 1, 2016	Waud Capital Partners	30	Clinics/outpatient services
Authentic Brands Group	June 2, 2010	Leonard Green & Partners	28	Media and information services (B2B)
Fullsteam	May 28, 2018	Aquiline Capital Partners	28	Holding companies software
U.S. Dermatology Partners	May 13, 2016	ABRY Partners	26	Clinics/outpatient services

Source: PitchBook | **Geography:** US
*As of December 31, 2020

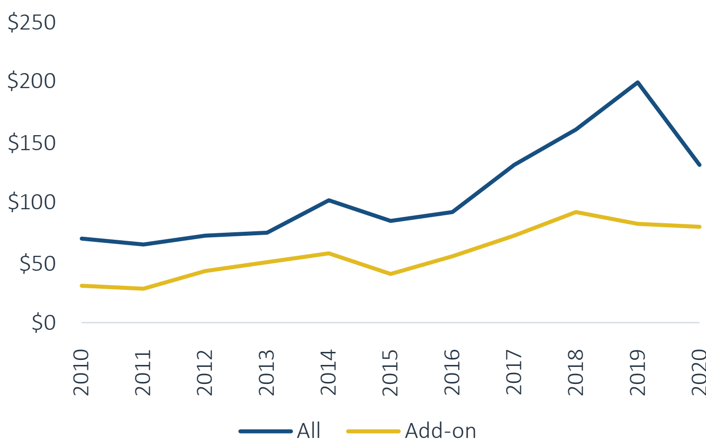
Insurance platforms with the most add-ons acquired via the current sponsor*

Company name	Creation date	Sponsor	# of add-ons
Hub International	October 2, 2013	Hellman & Friedman	241
NFP	July 1, 2013	Madison Dearborn Partners	100
Confie Seguros	November 9, 2012	ABRY Partners	84
Alera Group	December 31, 2016	Genstar Capital	58
Risk Strategies Company	October 21, 2015	Kelso Private Equity	53
AssuredPartners	May 13, 2019	GTCR	46
World Insurance Associates	April 1, 2020	Charlesbank Capital Partners	35
Alliant Insurance Services	June 23, 2015	Stone Point Capital	33
Patriot Growth Insurance Services	January 1, 2019	Summit Partners	29
USI Insurance Services	May 16, 2017	KKR, Caisse de dépôt et placement du Québec (CDPQ)	26

Source: PitchBook | **Geography:** US
*As of December 31, 2020

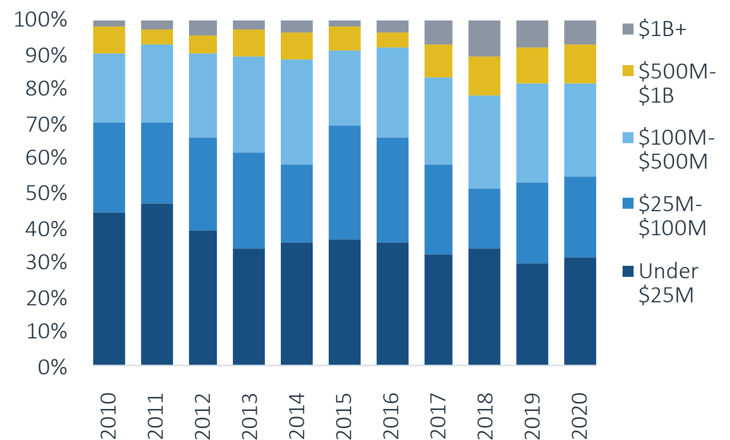
The median add-on deal size has more than doubled in the past decade, from around $30 million in 2010 to upward of $70 million for 2017 through 2020. This roughly tracks with gains in median PE buyout deal sizes overall, with the median add-on size hovering at around half the median buyout size in most years. After peaking during the GFC, deals valued at less than $25 million have declined to around 30% of add-on volume, while add-ons valued over $500 million are on the rise. Several factors underpin this growth in add-on sizes. First, valuation multiples have expanded across the board, especially for technology companies. Founders of "bootstrapped" technology companies that reach around $5 million-$10 million in ARR can now choose between raising growth equity capital and selling to the portfolio company of a large buyout firm. Second, some middle-market businesses in classic buy-and-build sectors, such as healthcare clinics and insurance distributors, pursue inorganic growth prior to seeking financial sponsor backing to make themselves more attractive as add-ons. (For example, a large veterinary clinic platform can save time and effort by adding on a local network of four veterinary clinics, as opposed to buying four individual clinics in separate transactions.) Finally, while founder-owned small businesses are classic roll-up targets conducive to multiple arbitrage, add-ons can also represent transformational M&A, and the added-on company need not be smaller than the platform.

Median buyout size ($M)



Source: PitchBook | **Geography:** US
*As of December 31, 2020

Share of add-on count by size bucket



Source: PitchBook | **Geography:** US
*As of December 31, 2020

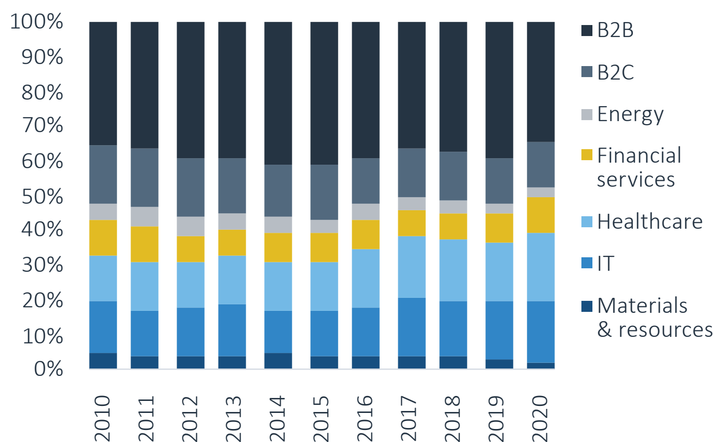
Looking to the future, more sophisticated, complex buy-and-build strategies may play an increasingly important role in the PE landscape. As we demonstrate later in this note's financial services sector spotlight, multiples are rising in many of the most popular buy-and-build verticals. This is a result of both the PE industry's maturation, meaning that more GPs are deploying more capital, and business owners becoming savvier about the prices they can command from PE acquirers. Because of this, some GPs are adapting their add-on strategies to look beyond mere multiple arbitrage. Although GPs will likely continue successfully executing traditional roll-ups for some time, we are also seeing them devising more sophisticated, vertical-specific buy-and-build strategies that leverage technological transformation, complimentary contract relationships, or

product synergies to drive outsized returns. Broader industry trends toward GP sector specialization and differentiated operational expertise should help to facilitate this innovation.

Sector spotlight: Financial services

The buy-and-build strategy plays an outsized role within the financial services sector. 84.8% of financial services deals completed in 2020 were add-ons. The insurance distribution roll-up is a classic play, and it has been a favorite of PE firms for the past half decade or so. Seven of the current top 10 most acquisitive platforms, measured by number of add-ons completed under the current sponsor, are insurance brokers. These include Hub International, which has added well over 200 brokerages since its 2013 buyout by Hellman & Friedman, and NFP, which has added around 100 add-ons since 2013 with the support of Madison Dearborn Partners.

Share of add-on count by sector



Source: PitchBook | **Geography:** US
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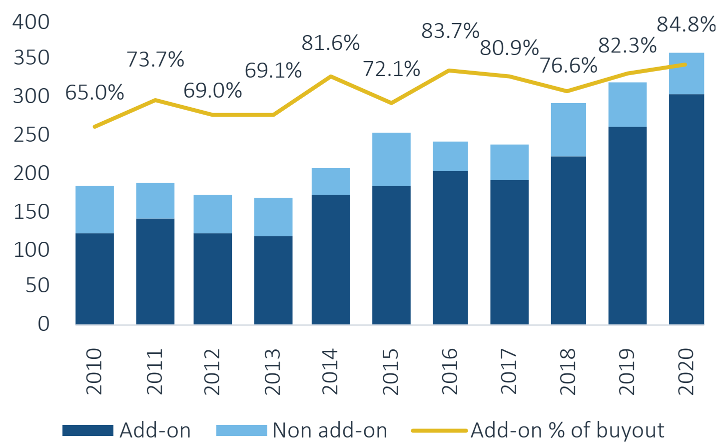
Add-ons as a share of financial services buyout count



Source: PitchBook | **Geography:** US
*As of December 31, 2020

Insurance distribution is attractive to PE firms because, unlike actually selling insurance, it eschews balance sheet risk, is not heavily regulated, and generates strong free cash flow. The sector is extremely fragmented, with around 36,500 independent insurance agencies and brokerages operating in the US, according to the most recent data. Moreover, the average age of brokerage executive is in the late 50s, which means that many business owners are amenable to selling.[3] This expansive supply of potential targets supports a crowded market, with both PE firms and highly acquisitive strategics, including Arthur J. Gallagher & Company (NYSE: AJG) and Brown & Brown Insurance (NYSE: BRO), competing for attractive assets and driving up valuations. In the mid-2010s, industry commentators were already excogitating about whether high, "bubble-like" valuations for insurance distribution businesses could be sustained, but multiples have only risen since then, and even the COVID-19 pandemic did not slow the trend. Insurance distribution platforms can now sell for 12x-14x EBITDA, while small add-ons in the $1 million to $10 million ARR range can fetch

3: "2018 Agency Universe Study," Independent Insurance Agents & Brokers of America, 2018.

8x-9x. The growing challenge of finding appropriate targets has driven some GPs to seek out brokers who specialize in niche markets, managing general agents (MGAs), third-party administrators, and other insurance services, pushing multiples for these assets even higher than those paid for traditional brokers. MGAs in particular are coveted by strategic buyers, including large brokers looking to enter specialized markets and insurance carriers seeking vertical integration.

Looking ahead, several of the largest PE firms are poised to continue driving consolidation in the insurance distribution industry as they chase the advantages of scale. In June 2020, Oak Hill Capital and The Carlyle Group announced their intention to combine two insurance distribution platforms, Oak Hill's EPIC Brokers and Consultants and Carlyle's JenCap Holdings, into a single holding company, Galway Insurance Holdings. Harvest Partners then purchased a majority stake in Galway in December, with Oak Hill and Carlyle retaining minority interests. The firms intend for JenCap and EPIC to pursue rapid growth while they also invest in data analytics and other strategic improvements via Galway. Also in mid-2020, Bain Capital Credit announced a partnership with Keystone Insurers Group, the US' third-largest independent insurance agency network, to create Keystone Agency Investors (KAI), a platform aiming to invest at least $500 million over the next several years by providing capital for acquisitions by existing network agencies as well as adding on additional agencies. KAI has already made five acquisitions.

Although insurance distribution looms large in the PE deal landscape, inorganic growth is also essential to achieving strong returns in other fast-growing financial services verticals. Payments is one example. According to Steve Kretz, principal at Corsair Capital, recent consolidation among the largest payments providers suggests that strategic acquirers are rarely interested in M&A transactions below approximately $2 billion, so middle-market payments companies need to scale up to achieve a strategic exit. This level of scale is most efficiently attained through add-on transactions due to the immense competition for organic growth.[4] (In this space, strategic buyers are generally willing to pay more than financial sponsors.) Other financial services verticals that are seeing significant additive dealmaking include wealth management, savings plan providers, specialty finance, and revenue management services (such as billing and invoicing). Although many firms see significant runway remaining in well-established verticals, GPs with expertise in financial and business services are also well-positioned to identify new, consolidation-ripe niches as they emerge. For instance, Lovell Minnick Partners was one of the first firms to invest in the wealth management industry (in the 2000s) and has developed a proven playbook for buy-and-build strategies in the space.[5]

4: Steve Kretz, telephone interview, February 11, 2021.
5: John Cochran, telephone interview, March 18, 2021.