Cooley | Private Equity

Dealology

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Watch: Three Key Issues in Private Equity Add-On Deals

Watch: Top 10 Issues in Private Equity Add-On Deals

Private Equity Add-Ons: Top 10 Issues

1. **Where is the money coming from?**
2. **How deep into the holding period is the add-on taking place?**
3. **Is seller rolling over equity?**
4. **Are the seller and key management team staying and what does retention look like?**
5. **What does integration look like?**
6. **Are there any special tax considerations?**
7. **Are there any antitrust considerations?**
8. **How did buyer and seller come together?**
9. **Who is negotiating on each side?**
10. **What advisers are being used?**

Add-on acquisitions have increased every year since 2013, accounting for two-thirds of all private equity deals, approximately 20% of all M&A and private equity deals combined and more than $300 billion of deal value in 2018 in the US. With more than $1 trillion of committed investor capital to PE sponsors (known as “dry powder”), high valuation expectations by sellers and fierce competition to find and win acquisitions of companies that are sizeable enough to stand alone, PE sponsors often use their first investment in an industry or market segment as a platform to acquire other companies in the same, similar, related or adjacent industries. These “add-on,” “tuck-in,” “bolt-on” or “roll-up” acquisitions introduce a host of unique issues for buyers, sellers and their advisers.

1. Where is the money coming from?

Determining how to finance the purchase price is critical in any acquisition and takes on added dimensions in add-ons. Buyer needs to determine if the funding will come from cash on hand at the platform company, an equity infusion from the PE sponsor, an existing or potentially new debt facility or some combination of these. Seller needs to pay close attention to this because if financing from the PE sponsor is involved, seller will want to insist on an equity commitment letter to ensure that funds are available at closing and that there is recourse to the PE sponsor, even though the PE sponsor likely isn’t signing the definitive acquisition or merger agreement. If debt is being used, buyer and seller will want to ensure that

debt commitment letters from lenders are in place to avoid a financing shortfall at closing. If seller is maintaining an equity stake in the combined company after closing (see rolling over equity below), seller will also want to get comfortable that the combined company remains creditworthy in the face of either using cash on hand or incurring debt to fund the purchase price.

2. How deep into the holding period is the add-on taking place?

PE sponsors hold companies in their portfolio for a handful of years – called a "holding period" – while working to increase value before seeking liquidity by either selling the company or bringing it public – called an "exit." Holding periods tend to be between three and seven years, with the average being a little longer than five years. By doing an add-on acquisition deeper into a holding period, the PE sponsor may be able to add the necessary market share, revenue streams or other metrics needed to increase the platform company's value and prime it for a successful near-term exit. Paying attention to this dynamic allows buyer to anticipate whether seller will – and allows seller to assess whether to – seek any price increase or other leverage in the negotiations by virtue of being the needed piece to complete the puzzle before the PE sponsor seeks an exit. Additionally, knowing how deep into the PE sponsor's holding period the add-on is taking place will help seller assess any opportunity to roll over equity into the combined company. Seller could find its rollover investment in the combined company to be either of limited upside due to lack of time for further growth or very lucrative due to a spike in a short period of time.

3. Is seller rolling over equity?

In private equity deals, sellers are often required or offered the opportunity to contribute a portion of their equity stake in the target for a stake in the combined company, known as an "equity rollover." This allows sellers to both cash out a portion of their stake in the target at closing and participate in future upside when the PE sponsor exits the platform investment. While this can be attractive, issues specific to add-ons exist. In a typical rollover when a platform company is first being acquired, there is no other company to consider and the value of the rolled equity is based on the valuation of the platform company being acquired. With rollovers in add-ons, sellers will hold a stake not just in the company they've built, know well and are now selling, but also in the platform company that someone else has built and run. Therefore, sellers need to do due diligence on the platform company and evaluate the prospects of the combined company. Also, sellers need to assess the valuation of the combined company that will be applied to the rolled equity rather than focusing on the value of the target company being acquired. The valuation discussion is typically a key item for negotiation.

4. Are the seller and key management team staying and what does retention look like?

Sometimes sellers are motivated to sell as a means of retiring or fully exiting to move on to a new venture. Conversely, sometimes sellers are motivated to sell as a means of achieving liquidity by partially cashing out and partially rolling equity and working toward the next level of growth and upside for the company and combined company. Each one introduces a host of issues that need to be faced upfront in add-ons. If seller and key management team members are leaving the company, then customer and supplier continuity needs to be planned for to avoid business erosion following closing. If seller and key management team members are staying, the parties need to openly discuss and implement clear lines of authority and decision-making that all employees of the combined company – both the platform company and add-on target company – know and agree to follow. Also, new equity incentives need to be discussed and scoped and a decision needs to be made as to whether anyone who rolls equity will also get to participate in the new equity incentive plan. Finally, redundancies and overlapping positions need to be addressed. When PE sponsors do platform acquisitions, the management team is often needed to run the business since there is no other management team to install. With add-ons, each company will have executives, sales teams and other key positions and some of them may no longer be needed or desired to achieve the synergies and cost savings contemplated by acquiring the add-on target.

5. What does integration look like?

As with management retention and redundancies, integration issues arise in add-ons as opposed to when a PE sponsor is buying a platform company and there is only one company in the equation. With add-ons where two or more businesses are combining, the parties need to assess IT systems, customer relationship management systems, pricing and ordering systems, tax and accounting controls and overall operational practices. These issues are regularly faced when strategic corporate acquirers do acquisitions and must be addressed upfront, planned for and well executed when PE sponsors engage in add-ons.

6. Are there any special tax considerations?

PE sponsors earn a share of the profits generated from their investments, known as “carried interest.” Generally speaking, if a PE sponsor holds an investment for at least three years, the carried interest is taxed at a more favorable capital gains rate rather than at a higher ordinary income rate. When a PE sponsor exits a platform investment that has done an add-on acquisition less than three years before the exit, any gains on the add-on are taxed as ordinary income. Tracking holding periods and planning for tiered tax results is critical to any PE sponsor engaging in add-ons. Sellers must also appreciate their tax situation when selling. Generally speaking, if sellers have held their equity in the target for more than a year, they are entitled to capital gains treatment. Structuring rollovers deserves close attention since the portion rolled can either be taxable or tax deferred. If tax deferred, sellers roll their equity into the platform company tax-free and then, so long as they’ve held their equity in the target plus their equity in the platform or combined company for more than a year in total, pay capital gains tax when the PE sponsor exits the platform investment, regardless of whether the PE sponsor is taxed at capital gains or ordinary income for the carried interest. Planning, structuring and execution are critical to achieve the desired results.

7. Are there any antitrust considerations?

Often times, PE sponsors doing a platform company acquisition have limited antitrust concerns because the acquisition of the platform company itself is the PE sponsor’s entry into the industry or market segment. With add-ons, the PE sponsor is expanding its footprint in the platform company’s industry and therefore has to pay close attention to antitrust considerations. This is particularly true when doing either a large add-on acquisition where big players in an industry combine or a series of add-ons where the PE sponsor is rolling up a fragmented industry and starts to gain critical mass. However, most add-on acquisitions are of smaller companies (at least smaller than those that are platform acquisitions: in 2018, the average size of a PE add-on deal was $116 million and the average size of a PE platform deal was $659 million) and don’t trigger competitive concerns even if they trigger antitrust filings. Nonetheless, the parties and their counsel should consider the issues to avoid expensive and costly delays or surprises.

8. How did buyer and seller come together?

Add-ons tend to be “proprietary” deals in that they result from relationships between the seller and the platform company management team or PE sponsor by virtue of being in the same or complimentary industries. PE sponsors like this because they can deploy capital while avoiding the time and expense of an auction, which is a common way platform acquisitions come about. By acting swiftly and offering attractive value, PE sponsors can minimize the potential for other suitors to offer a better deal. Sellers too like deals that are quick and certain. Sellers should still consider whether they are better off taking the proprietary deal for those reasons versus running a process – called a “market check” – to see if a better price or better deal terms are available. Depending on the shareholder base of the target company, especially if the company is not family-owned or otherwise closely held, sellers and their advisers should consider whether the target company is obligated to do a market check to see if a better deal is available.

9. Who is negotiating on each side?

Buyer – Whether the PE sponsor or the management team of the platform company is leading the charge on the buy-side will impact the deal dynamics. The buy-side needs to consider not only the team that is best suited to evaluate and negotiate the acquisition but also the signal that decision sends to sellers. Sellers will be focused on and will consciously and unconsciously develop a view of the deal and who they are partnering with based on the interactions with buy-side team. Sellers will ask themselves questions such as: “Is this a good deal for me, my team, my stockholders and my customers?”; “If I decide to stay with the company after closing, who will I really be working with and for – the PE sponsor or the platform company management team?”; and “If this is how the buy-side is approaching me, can I assume this is how my team and customers will be dealt with after we close, and does that sync with my approach to business?” The buy-side should anticipate these questions and how it wants to present and conduct itself to ensure a smooth deal process.

Seller – Since add-on acquisitions are often family-run businesses or smaller companies (at least smaller than those that are platform acquisitions), sellers often have not been through a sale process before. This, coupled with the fact that PE sponsors are supported by advisers who regularly engage in acquisitions, means that sellers must educate themselves on the complicated process of selling a company and must choose counsel and other advisers to adeptly guide them.

10. What advisers are being used?

Beyond choosing advisers with deep mergers & acquisitions, private equity and financing transactional skills, parties to add-ons should seek advisers with industry expertise. Add-ons inherently involve combining companies in the same, similar, related or adjacent industries. Advisers steeped in the business, legal and operational issues and who know the industry players are equipped to efficiently conduct diligence, navigate regulatory regimes, spot and resolve issues, close transactions and plan and execute successful integrations. Also paramount are the social issues, and advisers who can strike the right balance of negotiating against and teaming with the other side, especially in a situation where sellers in add-ons or their counsel have not been through the process as much as the buy-side has, will add value and help create successful investments and partnerships.