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The Art of the Add-On (Fourth of a Series)

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Last week we began a check-list sponsors tick off when sifting through acquisition candidates for their platform companies. Many items are company and sector-specific. How will product lines complement each other? Will different brands confuse customers? If so, can you benefit from synergies by maintaining separate identities?

But one private equity partner highlighted the most critical characteristic to finding the right add-on. “You need to find people you want to work with,” he told us.

“It’s really all about the culture,” he continued. “You often spend more time with your colleagues than you do with your family. If you’re working with people you don’t get along with, it creates a headwind that’s counterproductive.”

The partner went on. “Their management team needs to understand and be aligned with how the platform’s management team thinks. If you’re not on the same page with the growth strategy, for example, you can’t make it work. And sometimes we need to change horses if things aren’t working out. Everyone needs to buy into the vision.”

A principal at a Boston-based firm added a nuance. “There’s a misconception that add-ons are just about adding ebitda. But there should be a *rationale*. Is it geographic? Is it more products? You have to figure out the *why* before you deal with the *what*.”

We asked the first partner about integration issues. What’s your priority when you think about putting two or more companies together?

“First, deal with the back office,” he said. “Unless the systems are speaking to each other, you can’t even begin integrating. That’s particularly true on the financials. Everything flows from there. The worst thing you can hear from your team on the ground is: ‘We’re having trouble getting the numbers.’”

Our principal agreed. “Don’t be in a rush to integrate. Sometimes it takes two or three years to complete the job. It really depends on how complex the operations are, how many plants or separate locations you have. Lenders also need to understand that.”

Indeed, integration risk is much on the minds of lenders we spoke with about add-ons. “It’s our biggest worry,” one top credit officer of a middle market shop told us. “We look very closely at the M&A experience of both sponsor and borrower. If they don’t have teams who have successfully managed acquisitions, it’s a big red flag.”

Another banker identified due diligence as the key. “So many add-on strategies founder because the acquiring company didn’t do its homework on the capability of the target’s existing management. Or they didn’t do a deep enough dive on the accounting systems and find they can’t even track the cash. You’d be surprised the kind of basic stuff that trips up even the best sponsors. These add-ons are often very small companies with very weak back offices. Of course, that’s also the opportunity.”

Next week we conclude our series with more thoughts on financing add-ons.