Building Competition

How buy-and-build helps the American economy

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AMERICAN INVESTMENT COUNCIL

Data provided by PitchBook

Executive summary

Add-ons are a common transaction spearheaded by private equity (PE) sponsors. Investors can grow their portfolio companies both organically and "inorganically"—meaning add-ons—and typically use both strategies at the same time. Over the last decade or so, add-ons have become much more common in PE.

During those years, PE sponsors have employed something called the "buy-and-build" model, which investors use to acquire several smaller companies to create a new, more competitive business. "Buy-and-build" is a useful tool to help cost-intensive industries become more efficient and lower their costs, savings that are ultimately passed on to their customers.

Most add-ons are done in highly competitive, highly fragmented industries, where incumbents lack the market share to affect prices or create a monopoly. In fact, PitchBook data shows that more than 60% of today's add-ons are done by only a handful of fragmented industries in which PE is active. Buy-and-build is most common in industries such as insurance, where more than 400,000 brokers and agencies compete for customers in the United States.[1] It's also common in outpatient clinics, landscaping, construction, IT consulting, pest control and waste management services, among others. Not every "fragmented" industry is appropriate for buy-and-build, which is why PE sponsors look for predictability and reliable cash flows before investing. Sponsors look for companies and situations that can benefit from an institutional mindset, rather than simply buying a company and looking for cost reductions.

The buy-and-build model is often guided by operating partners, who are typically ex-CEOs or ex-COOs of big companies. Ex-CEOs tend to have extensive experience with acquisitions and integrating new products and services into a larger organization. They can also help PE sponsors look for operational shortcomings of unsponsored companies, given their backgrounds as former executives. While operating partners bring plenty of operational expertise, they also have significant industry expertise that can inform a PE sponsor's strategy and change the trajectory of a portfolio company. That's why LPs are looking to operating partners, rather than financial engineering, to drive value at private equity firms. In the same vein, it's also why PE sponsors use the buy-and-build approach: In the end, the sum is greater than all the parts put together, benefitting stakeholders, companies, employees and the communities that they serve.

1: "Insurance Brokers & Agencies in the US—Number of Businesses 2003-2028," IBISWorld, Updated June 23, 2022.

Why buy-and-build helps the American economy

What's an "add-on"?

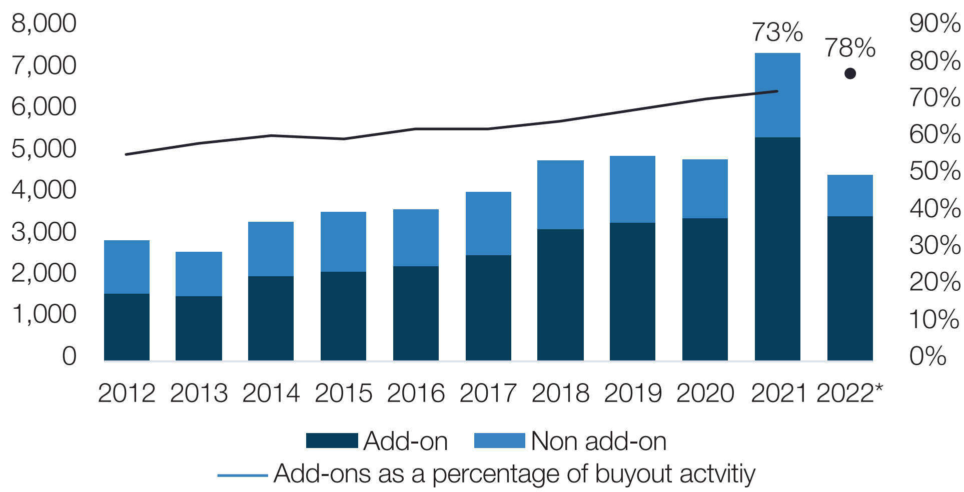
Add-ons refer to acquisitions made on behalf of PE-backed portfolio companies, and they're planned many months in advance by their financial sponsors. Sometimes they are done to bolster a portfolio company's product offerings. For example, a PE firm may invest in a dog food producer and identify a promising cat food producer to acquire; the combined company would be able to offer more products to their customers while reducing operating costs across the board. In the same vein, add-ons can be made on behalf of software companies so they can keep up with shifting customer demand more easily. In other instances, a brick-and-mortar company could "add on" a technology-based company operating in the same market.

The focus of this report is to highlight add-ons in fragmented markets, which are also common. In these cases, PE sponsors are looking to grow portfolio companies that operate in highly competitive markets, such as insurance or outpatient health care clinics, with reliable and sustainable cash flows and high operating costs. Fragmented markets have no dominant players and have virtually no risk of monopolization. In most cases, PE sponsors are looking to consolidate local companies into regional ones, creating more cost-efficient companies that can better serve their customers.

Today, about 78% of majority PE transactions are add-ons. That's up from 56% a decade ago. The Federal Trade Commission has expressed concern about this percentage, but the ratio requires context about the nature of the companies that are being acquired.

Using the same PitchBook methodology, 62% of add-ons are happening in 10% of the industry codes tracked by PitchBook. That indicates the 78% ratio is heavily influenced by a handful of markets. The nature of those markets is highly fragmented, which means there are tens of thousands, and in some cases hundreds of thousands, of similar companies operating in those industries. In every case, there is no

Add-ons as a percentage of PE buyouts



Source: PitchBook | Geography: US
*As of October 25, 2022

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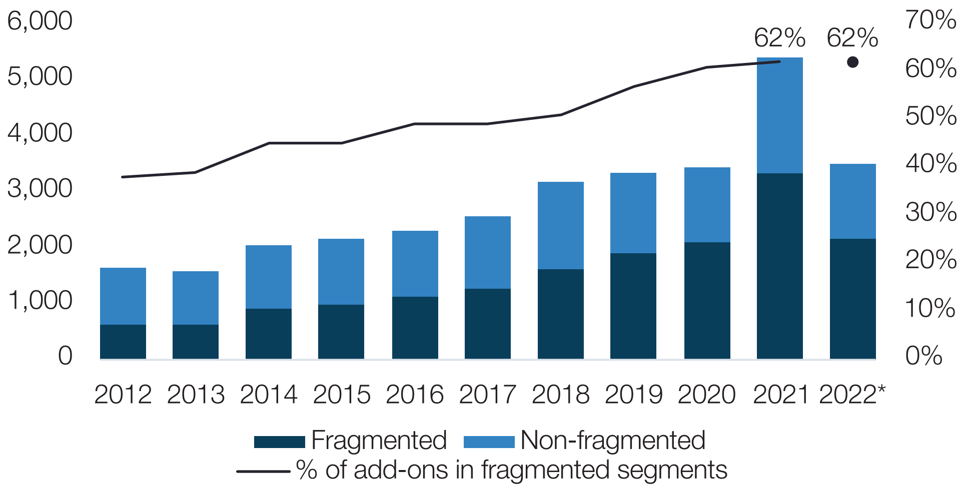
market participant that occupies a dominant position. To the contrary, 17 of these industries have at least 10,000[2] market participants, including eight with at least 100,000 market participants.[3]

In 2021, there were 5,392 PE-backed add-ons occurring in the US, which was a record. Of those, 3,321 were in fragmented markets favored by PE firms, and there were more than 7 million companies active in those industries around the country, according to IBISWorld.[4]

The buy-and-build model has to be geared toward fragmented industries to be used in the first place. PE sponsors take the buy-and-build approach seriously and only select companies that help the platform company grow its value. The results, if done well, are platform companies that are:

- More competitive and better organized for their employees
- Provide better goods and services at a lower price for their customers
- Create more channels of growth for the companies themselves
- Generate higher returns for long-term investors such as public pension plans.

Add-ons by industry fragmentation



Source: PitchBook | Geography: US
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Percentage of PE-backed platforms that added on in another state

88%

Among PE-sponsored companies that acquire other companies, almost 90% of them have acquired businesses in another state. While inter-state acquisitions are fairly common in M&A, they are usually deliberate for PE sponsors. Buy-and-build allows investors to transform portfolio companies into regional, more competitive businesses while producing economies of scale, which helps drive down costs. These acquisitions also mean new products and services are reaching new customers. For example, if a mental health provider is acquired in Ohio, that provider will receive the additional capabilities of the platform company, which could be a significantly bigger provider based in California. In this case, that means more patients have more access to more services than they did before the investment happened. For a detailed example, please see page 7.

2: Including insurance, landscaping, management consulting, IT consulting, manufacturing, construction & engineering, HVAC services, property management and wholesale distributors, advertising & marketing agencies, pest control, car washes, dry cleaners, elevator installation & services, business products and services software, and public relations firms
3: Including insurance, landscaping, management consulting, IT consulting, manufacturing, construction & engineering, HVAC services, property management, and wholesale distributors
4: 7 million figure compiled from the individual reports referenced in the graphic below. Individual reports can be searched at "Expert Industry Research You Can Trust," IBISWorld, Accessed October 28, 2022.

Common buy-and-build markets

Figures denote how many companies were in business in each market as of 2022

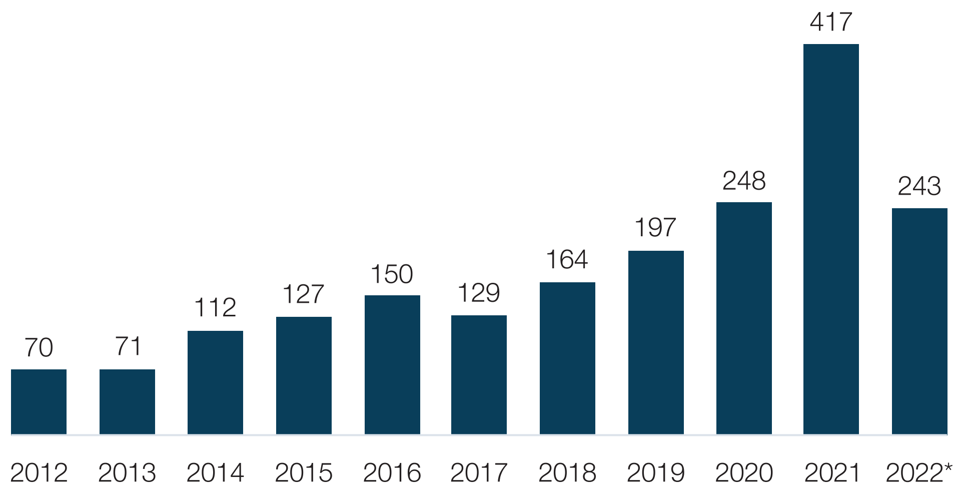
Market	Companies
Construction	2,128,809
Management consulting	1,121,512
Manufacturing	718,796
Distributors/wholesale	701,229
Landscaping	632,895
IT consulting	501,985
Insurance brokerages	415,446
Property management	307,621
Engineering	141,898
HVAC	122,638
Advertising & marketing	87,712
Car washes	67,163
Public relations	54,581
Outpatient health care clinics	34,752
Pest control	29,535
Dry cleaners	27,745
Elevator services	20,469
Software publishing	16,431
Urgent care centers	9,616
Waste management	8,352

All datapoints provided by IBISWorld, accessed October 28, 2022. Individual reports can be searched at https://www.ibisworld.com

Creating new insurance markets

The insurance industry is among the most fragmented industries in the US. The largest brokerage in the US, State Farm, commands just 16% of market share, according to the National Association of Insurance Commissioners.[5] Over 400,00 other brokerages compete for the other 84%.[6] Insurance companies span the spectrum in size, from large, multi-billion-dollar platforms to much smaller regional brokerages that do business on a more personal basis. Regional consolidation helps build economies of scale and reduce operating costs—savings that can be passed on to retail and commercial customers.

PE-sponsored add-ons in insurance brokerages



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Confie Seguros

Confie Seguros is one of the most underreported success stories in PE's history. It began with an unexpected insight from an insurance executive, Mordy Rothberg. While researching insurance trends in the US Hispanic community, Rothberg realized that the fastest-growing demographic in the country was wildly underserved as insurance customers. In 2008, he set about to change that by creating the country's first Hispanic-focused insurance company.[7]

Thanks to its financial resources and industrial know-how, Rothberg decided to partner with PE to achieve that goal. After acquiring a "platform company" in California alongside a PE sponsor, he renamed it to Confie Seguros, which means "trust insurance" in Spanish. With Confie Seguros in place, the platform began acquiring hundreds of insurance brokerages where Hispanic customers were underserved. Staff were retrained or hired to provide bi-lingual, personalized services to Hispanic customers, who preferred face-to-face meetings and translated insurance policies before purchasing insurance products.[8] More than a decade later, Confie Seguros grew into the first leading Hispanic insurance brokerage in American history while ranking first in every category in which it competed between 2016 and 2021, according to Insurance Journal.[9]

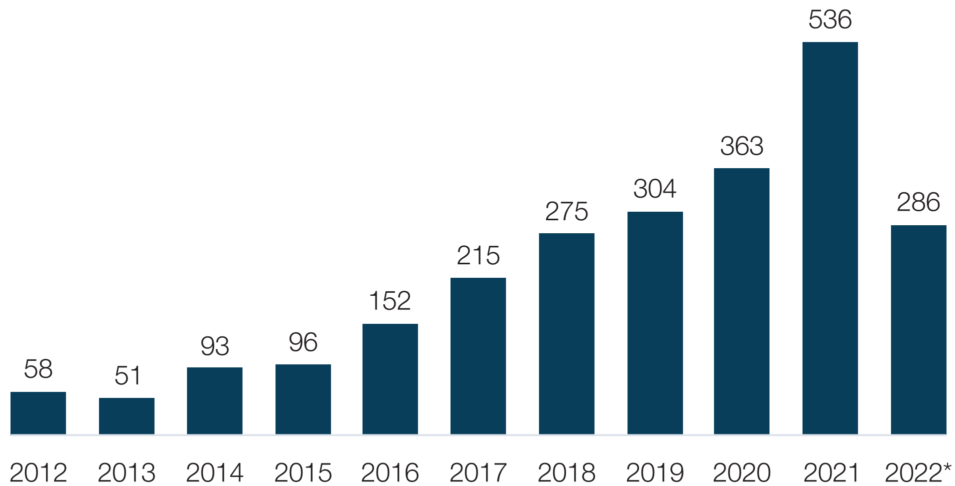
5: "Property and Casualty Insurance Industry 2021 Top 25 Groups and Companies by Countrywide Premium," National Association of Insurance Commissioners, 2022.
6: "Insurance Brokers & Agencies in the US—Number of Businesses 2003-2028," IBISWorld, Updated June 23, 2022.
7: "Storefront Marketer Grows by Acquisition: Confie Seguros Reaches $200 Million in Revenues Catering to the Hispanic Market," Rough Notes, Susan R.A. Honeyman, April 2012.
8: Ibid
9: "Closer Look: Personal Lines Leaders," Insurance Journal, September 6, 2021.

Streamlining health care costs

The buy-and-build model is used extensively in outpatient health care services. Specialties such as dermatology, cardiology, and oncology are often small, local providers that employ five or fewer doctors. In many cases, specialized clinics only have one doctor after whom the practice is named. Especially in the smallest cases, doctors in single-practice providers must perform their medical duties while also weighing in on administrative matters. Sometimes they even help hire new staff. But the country's physicians weren't trained in business management—they were trained to be doctors. In the real world, that means their most valuable skills are underused, their hours are longer, and they're performing business-related functions at which they might not be very good. It's also exhausting.

That's why PE investors are helping these industries—and ultimately helping patients while reducing their bills. When physicians can focus on their patients, and the organizations that employ them can become more efficient, health care providers can streamline costs and pass those savings into patients' pocketbooks.

PE-sponsored add-ons in outpatient healthcare clinics



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Greater scale at the provider level leads to improved relationships with payors, further reducing costs at the patient level. It also creates a more welcoming environment for new physicians, who can join efficient regional providers without having to build a practice from scratch.

Representative markets

Veterinary services, dermatology, dentistry & orthodontics, radiology, oncology, cardiology, orthopedics, mental and behavioral health

PE at work: BayMark Health Services

BayMark Health Services is based in Lewisville, TX, and specializes in treating opioid addiction. It was acquired by Webster Capital Management in 2015 and set about expanding into more pockets of the country. Webster's buy-and-build strategy wasn't limited to geographic expansion, as important as that was. The plan also included expanding into new service lines to better serve BayMark patients. In 2017, BayMark acquired a Louisiana-based provider called AppleGate, which offers office-based buprenorphine treatments. "With the state of opioid abuse in the country, BayMark is focusing on providing care through multiple approaches in as many areas as possible to address the epidemic," the firm said.[10]

10: "Webster Capital-Backed BayMark Health Services Makes Two Acquisitions," Citybizlist, February 6, 2017.

Bringing urgent care to rural communities

According to the Urgent Care Association, only 1% of urgent care centers operate in rural communities. Metropolitan areas, by contrast, account for 86.2% of all urgent care operations.[11] While urgent care facilities aren't the only health care providers around, they have become ubiquitous in wealthier communities across the country and help lighten the load for local hospitals and emergency rooms.

How PE is helping

Even with those barriers in place, PE is actively addressing the problem. Urgent care centers are natural candidates for growth capital and the buy-and-build model, since the model is scalable, replicable, and in high demand. PE firms start by investing in urgent care providers that have identified business models that work in their communities. Once partnered with PE, they can use their new capital to open new locations in underserved areas. Using a "buy-and-build" approach, PE-sponsored providers can increase the number of care facilities under their umbrella, reducing overhead costs and, ultimately, patients' bills. For many patients without urgent care options, relatively "local" hospitals are their only option, and emergency room bills can be stratospheric. A 2017 study from West Virginia University, which analyzed the impact of one urgent care chain—MedExpress—on the Appalachian area, found that "MedExpress's entry would seem to be freeing up valuable resources for more serious medical situations" and that urgent care centers "lead to a substitution to a lower cost option" for patients.[12]

Usually under the radar, PE firms have been leading the charge on rural health care expansion. According to The Journal of Urgent Care Medicine, there is "probably the potential for another 1,500 urgent care centers in rural/secondary markets" across the country,[13] and that pent-up demand would be welcomed with gratitude and loyalty by local towns. To meet that demand, PE firms are partnering with entrepreneurial physicians who have built sustainable business models and want to see their companies expand into underserved markets. As they often do, PE firms also bring experienced managerial help to urgent care portfolio companies. Sverica Capital, for example, acquired Med First in Jacksonville, NC, in 2016. As part of the partnership, two former CEOs of major hospitals joined the company's board. Sverica aimed to expand the company's model into other rural markets in the southeast and has almost doubled the number of Med First clinics over the span of five years.

PE at work: Fast Pace Urgent Care

Fast Pace Urgent Care has been under PE sponsorship for almost ten years, first with Shore Capital and now with Revelstroke Capital Partners. Under Shore Capital, Fast Pace executed an accelerated growth plan, resulting in 29 new locations across rural Tennessee and Kentucky. It also increased foot traffic from 40,000 patients in 2012 to about 400,000 in 2016. That success allowed Fast Pace to increase employee headcount from 50 to 700 in the same time span.

11: "Benchmarking Report," Urgent Care Association, 2022.
12: "The Effect of Health Care Entrepreneurship on Local Health: The Case of MedExpress in Appalachia," JRAP, Joshua Hall and Amir B. Ferreira Neto, July 24, 2018.
13: "Rural and Tertiary Markets: The Next Urgent Care Frontier," JUCM, Alan A. Ayers, December 2, 2019.

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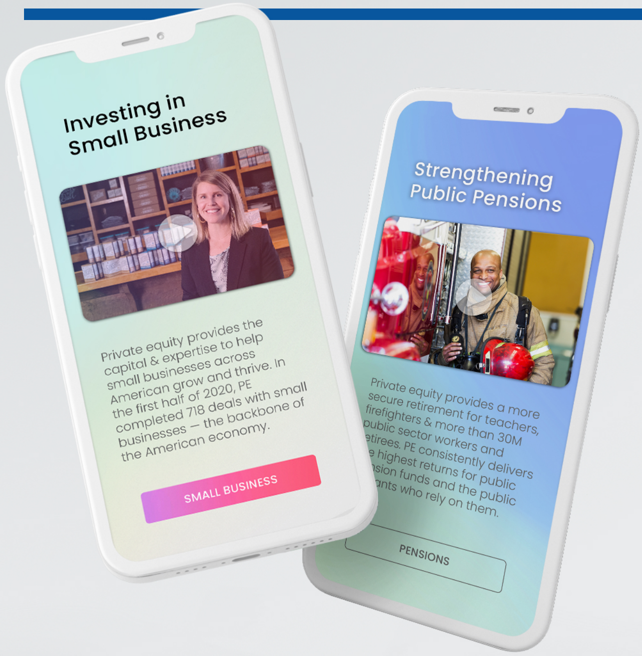
- Support good-paying jobs
- Boost the American economy
- Strengthen public pensions



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