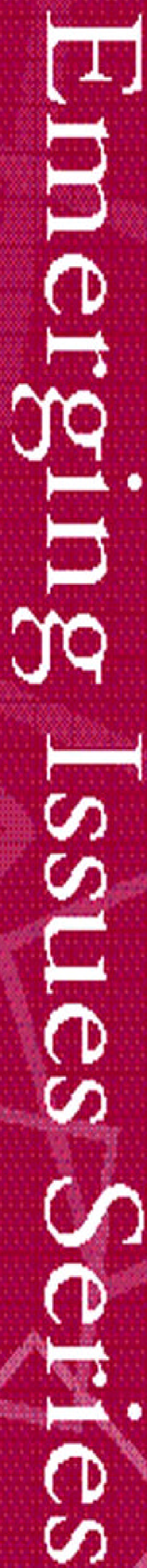

A Regulatory Perspective on Roll-Ups: Big Business for Small Formerly Private Companies

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Emerging Issues Series
Supervision and Regulation Department
Federal Reserve Bank of Chicago
March 1999 (S&R-99-4)

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A Regulatory Perspective on Roll-Ups: Big Business for Small Formerly Private Companies

by Michael Atz*

Currently, there are several avenues to finance mergers and acquisitions. One method, known as "roll-up" or "consolidator" financing, has recently emerged as a vehicle for consolidating smaller firms. The description of a roll-up and its associated advantages and disadvantages can be found in the Appendix at the end of this paper. Banks are finding ways to garner some of the returns as well as some of the risk that would normally go to venture capitalists. This article looks at the roll- up's risks and rewards.

In recent years, roll-up financing has become a multi-billion dollar business. Since 1994, more than 100 roll-ups reportedly have gone public, including 50 in 1997, primarily because of the continuation of a strong bull market during most of the year. The IPO of U.S. Delivery Systems, Inc. in 1994 is considered by many as the start of the roll-up process. Others attribute its beginning to the 1970's, when entrepreneur Wayne Huizenga (one time owner of the prior World Champion Florida Marlins baseball team and Blockbuster Video) combined several small companies in the highly fragmented waste management business to form Waste Management Inc.

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* The views expressed are the author's and do not necessarily reflect the views of management of the Federal Reserve Bank of Chicago or the Federal Reserve System.

Bank Debt Associated with an IPO

The strategy of nearly all roll-ups is to grow aggressively through acquisitions. Most of the growth is financed through the issuance of an IPO and then from secondary equity offerings. However, the new firm may also be able to grow by using financial leverage. A successful IPO often allows a company to obtain debt financing. Bank credit facilities and debt offerings are favorites when market conditions are favorable.

Bank credit facilities are customarily seen as either short-term lines of credit, usually for one year and used for working capital, or term loans, greater than one year and used to finance capital equipment. If deal size warrants, bank lines may be underwritten by a syndicated group of financial institutions. Syndication of the debt allows the pooling of risks, assures better distribution, and generally allows for large financing amounts. It is not uncommon to have a syndicate group both underwrite the new equity and issue debt. The risk comes to those firms that hold their portion of the debt or equity in their pipeline in anticipation of higher prices later. For several of these underwriters, it is possible to allocate a portion of their final holdings to their secondary trading portfolios in order to enhance returns derived from these transactions. Market conditions for these new issues can turn negative very quickly and the window of opportunity for favorable prices frequently is short.

Frequently, proceeds from debt offerings are then are used to reduce bank borrowings. Management of these roll-up firms must decide the amount of financial leverage to undertake to optimize shareholder returns. Most roll-up companies are so new they have never had a public market for their debt. As such, financial leverage begins with what is known as SEC Rule 144 borrowing. This borrowing allows the

holder to make a public sale of unregistered securities without filing a formal registration statement. The registration statement details the purpose of the proposed public offering and a detailed description of the company's operations, management, and financial condition. Rule 144 securities generally can't be sold for some period of time, usually a minimum of two years from the purchase date. Most of these investments made without SEC registration are private placements made to institutional investors. However, it is entirely possible that individuals may also hold these shares as participant venture capitalists.

Bank Involvement

Banks desire to enter this market because of the high reward-to-risk-ratio. Banks earn fees for their services. The largest fees generally accrue to the lead manager or underwriter of the roll-up. It is also possible for banks to earn additional fees if they also actively manage these equities. Several of these equities could be in a proprietary mutual fund portfolio or among the bank's trust client accounts. Compensation may also accrue to those underwriters that seek to retain shares for their own account in anticipation of rising prices. Moreover, fees can be earned if the bank is part of the lending syndication. Several of these structures have attractive fee revenues but no balance sheet impact.

Interestingly, many of these deals are brought to market by the investment banking affiliates of U.S. banks. A review of several recent roll-ups reveal some of the biggest lead managers (stock underwriters) to be BT Alex Brown Incorporated (now owned by Bankers Trust) and NationsBanc Montgomery (owned by NationsBank). Fees generated from these activities can be substantial for investment banking firms.

Risks

There are many risks posed to the bank by roll-up financing.

Credit risk. There can be credit risk posed to a bank by IPO underwriting. As noted in Figure 1, roll-ups are characterized by highly variable returns. Credit risk arises because most roll-ups also receive a bank credit line at the culmination of a successful IPO, and some of these lines are quite substantial. As an example, one roll-up firm recently sold 28 million shares at $19, bringing in fresh capital of over $500 million. On the basis of this successful IPO, the company obtained a $1.7 billion syndicated credit facility. Less than four months later, the stock price dropped to less than one-fourth of its original price. As a result, participating banks would find it difficult to sell a portion of their positions to other financial institutions without a discount. It is possible in this situation for a bank to incur a loss not only as an underwriter but also as a lender. This is especially true when the line is drawn down immediately, the roll-up fails to meet earning projections, and the ability to repay becomes strained.

Pricing risk. Failure to properly price the risk in these loans represents another risk to bankers. This situation can easily occur when there is insufficient financial information about the financial performance and the quality of management. Most of the founding companies are not large enough to be publicly traded or audited by major accounting firms. As a result, the pro forma financial statements created by the roll-up usually contain adjustments, many of which may be complex and difficult to understand. In addition, often several new acquisitions are made over time that further complicate the accounting process.

The key to the long-term success of this product is that the consolidated companies must have effective, strong management that can address all the complex accounting and financial issues. These newly formed entities often initially lack a strong management team. Founding companies each have their own management style and culture. Unfortunately, after consolidation, these individual styles and cultures might sometimes fail to work together effectively. How those styles meld is an extremely important factor in the organization's future success. Any underlying credit analysis must carefully assess the ability of the management team to succeed.

Another aspect of pricing risk is the risk that the new firm will not continue to grow earnings. The true test of consolidators and roll-ups lies in the ability to use a combination of cash and stock as currency to make additional acquisitions that will be accretive to current earnings. The successful integration of newly acquired businesses and the ability to manage profitability are critical to the continued success of the roll-up trend. Since a strong equity market is the driver behind roll-ups, a weak market could

have a material adverse effect on the roll-up process. In deteriorating market conditions, there is usually a flight to quality that reduces the capital available for IPO's.

There has been an unfortunate history of roll-ups acquiring additional companies at excessive prices. Lenders should monitor the newly formed roll-up entity closely to ensure that it is carefully assessing market value as their appetite to acquire more companies increases. If the capital markets perceive that they are paying excessive purchase prices, the result is a decline in the suitor's stock price. This will make it more difficult to do additional deals in the future.

Client suitability & reputation risk. Client suitability becomes an issue when any of the underwritten securities become part of an individual client's portfolio. Financial information often is unavailable because most of the consolidating firms were closely held. Therefore, underwriters should only offer these securities to those clients that have the ability to readily understand the speculative risks associated with these securities. Should the securities immediately fall in price, the client may ask the bank to made them whole or, in rare instances, try to tarnish the reputation of the bank claiming they did not understand the risks of these securities.

Conclusions

There is clear evidence that roll-ups have been able to withstand significant adverse capital market events and still survive. Roll-ups are here to stay and will continue to proliferate if they add value. Most roll-ups to date consist of companies in the same line of business, but it is possible that roll-ups could combine entities in different industries if there are strong financial and management synergies.

Banks are involved in roll-ups as both underwriters and lenders. The potential return on this activity is quite high but not without risk.

Are roll-ups a passing fad? The answer will be evident only after roll-ups have endured a full equity investment cycle (boom to recession). Preliminary evidence suggests the strong equity market is capable of supporting the ever-increasing number of public offerings that fundamentally drive roll-up financing. Given the exponential growth of offerings in 1997 and 1998, this financing vehicle is likely to become more popular as more fragmented industries consolidate.

APPENDIX

WHAT IS A ROLL-UP?

Roll-up financing enables a group of small companies to consolidate their businesses into one entity for the purpose of offering publicly traded stock. Roll-ups are most prevalent in industries that are highly fragmented. These industries are characterized by numerous businesses, none of which are dominant within the given industry. To date, roll-ups have consolidated companies in such industries as funeral homes, landscapers, metal processors, dry cleaners, flower wholesalers, bus lines, home builders, franchised automobile dealers and leasing companies. Industry observers note that the use of roll-ups has been stimulated by the large number of firms in which a family management structure has been in place for several generations. Descendants often do not wish to continue to run a family-owned business and are happy to see the business sold or consolidated with a larger competitor.

A simple roll-up starts with an investment banker or entrepreneur identifying several privately owned companies operating in the same industry that wish to sell their businesses for some combination of stock and cash. A deal is put together under which the owners of the founding companies (companies being acquired) agree to sell and be paid from the proceeds of the Initial Public Offering of the newly created entity. A new company is formed to acquire each founding company and initiate the IPO. Under typical buyout agreements, the founding companies' owners receive a combination of cash and stock in the newly formed company. Typically, the pay-off of a portion of high-interest debt is also made at this time. IPO proceeds may also be used to pay the venture capital firm or entrepreneur that helped form the company.

At times, little or no IPO proceeds remain after funding companies' owners are paid and the existing debt repaid. In such cases, the venture capital firm or other parties may opt to retain a percentage of the new company shares in lieu of cash as partial payment of their fees. These shares normally are not sold in the public offering but are part of the new entity's outstanding shares. It is not uncommon to have the new company's management file a shelf registration statement with the SEC and offer these shares in a registered secondary offering. The registration of these additional shares allows the founding shareholders to sell their shares in an orderly manner while simultaneously enhancing the stocks' liquidity in the market. However, selling these shares will have a dilution effect on current shareholders.

It is not uncommon for IPO investors to end up holding a minority interest in the consolidated companies. This can occur for several different reasons:

- The former owners of the founding companies or the venture capital firm desire to maintain majority control.
- The company or companies underwriting the offering may want to retain shares for their own account in anticipation of rising prices. The prices paid for these shares are usually a small fraction of the initial offering price. If the offering is successful, the former owners can sell their shares for an instant profit.
- Some founding company shareholders want to receive their compensation in the form of stock for tax reasons. Usually the cash portion of the purchase price is taxable, whereas stock in the combined company is frequently received on a tax-free basis.

- There may be a future issuance of common stock to stockholders of the founding companies pursuant to certain earn-out arrangements.
- Options to purchase shares by prior owners (entrepreneurs), including some that may be exercised immediately, may be offered, further diluting current shareholders' interests.

Roll-Up Advantages

There are clearly some benefits to roll-ups, including the following:

- Firms that have consolidated appear better able to withstand periods of poor economic conditions than a number of smaller privately held firms.
- Roll-ups can take advantage of various economies of scale and increased purchasing power.
- Roll-up companies should enjoy enhanced liquidity and increased access to varied sources of capital, thus lowering their funding costs.
- Operating efficiencies accrue as administrative overlap is eliminated.
- Roll-ups can afford to attract management talent with greater management experience and depth than individual companies.
- Roll-ups can also be used to acquire suppliers and other ancillary businesses that provide synergies for future growth.

Acquisition roll-ups that provide higher margins, enhance purchasing power, strengthen management talent, or reduce cyclical risk should benefit society by enhancing the long run value of the company.

Roll-Up Disadvantages

The other side of the coin shows the following disadvantages:

- The track record for roll-up IPO's is mixed. While some continue to trade at prices well beyond their initial offering price, others have suffered dramatic price declines with several showing losses greater than 50% from their initial offering price less than six months after issuance. (See Figure 1). In general, companies that went public in 1996 are presently showing large declines, whereas those that went to market late in 1997 when the market was higher are still performing well above their IPO price. The lesson to be drawn here is that even a bull market cannot always guarantee continued price increases.
- To pick a winner, roll-up investors must still do their homework on the fundamentals of each offering. There is no simple formula to identify which roll-ups will be successful. Several roll-ups were successful because they are in strong industries, while others may have been successful because of promotion and backing from an influential Wall Street firm. Still others' success can be attributed to good financial fundamentals, increasing cash flow, and earnings.
- Roll-up firms are volatile and trade thinly, especially during periods of market dislocation. During the period between July 17, 1998 and August 31, 1998, the Dow Jones Industrial Average fell nearly 2,000 points from a high of 9337 to a low of 7539, or 19.3%. During the same time period, the sample of roll-up stocks included in Figure 1 fell on aggregate from 278 to 170, or 36.7%. In the above example, the roll-up sample universe has a beta coefficient of nearly 2, indicating that it is approximately twice as volatile as a portfolio made up of large industrial

companies.[1] This indicates that roll-up firms are more likely to be harmed during times of market dislocation. Most roll-ups are smaller firms with thinly traded stock. Further research using a larger sample of roll-up firms is needed to determine if the results are similar, relative to the same Dow Benchmark, over a longer time interval.

- Consolidations of firms in a highly fragmented industry can alter the competitive landscape. While roll-ups provide benefits to participants, industry competitive conditions may be permanently altered once a successful roll-up takes place. Often, roll-up firms continue to expand by aggressively acquiring competitors, providing intense competition for those firms that remain independent.
- Few options are available to companies caught in the pipeline with pending offerings. When public capital markets sour, venture-capital firms step up but at a price. Venture-capital firms and other leveraged-buyout firms want a bigger share.

[1] For reference, a beta coefficient is a measure of a stock's or group of stocks' relative volatility. The beta is the covariance of a stock in relation to the rest of the stock market. The Standard & Poor's 500 Stock Index has a beta coefficient of 1. For purposes of illustration, the DJIA is assumed to also have a beta of 1, which is realistic as a benchmark comparison against my roll-up universe.

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FIGURE 1
SAMPLE ROLL-UP SUB-GROUP

COMPANY NAME & STOCK SYMBOL (SEE NOTE BELOW)	IPO EFFECTIVE DATE & PRICE	SHARES SOLD (P& S*)	CURRENT SHARES OUTSTANDING (IN MILLIONS)	% SOLD IN IPO (P & S*)	LEAD MANAGER	HIGH**	LOW**	DJIA-high as of 7/17/98 9337.97	DJIA-low as of 8/31/98 7539.07
COACH USA INC (CUI)	5/14/96 @ $14	10.7	26.8	40%	BT ALEX BROWN	52	25	50 3/16	26 5/16
COMFORT SYSTEMS (FIX)	6/27/97 @ $13	6.1	30.3	20%	NATIONSBANC MONTGOMERY	26 5/8	15	24 3/4	17 7/8
FINE HOST CORP (FINE)	6/20/96 @ $12	6.5	11.3	58%	NATIONSBANC MONTGOMERY	43	13/16	1 3/4	1 1/32
F.Y.I. INC (FYII)	1/23/96 @ $13	4.3	11.8	36%	BT ALEX BROWN	37	21	33 7/8	25
HOME USA (HSH)	11/21/97 @ $8	5	15.4	32%	BT ALEX BROWN	10 1/4	7 1/8	MERGED	
INNOVATIVE VALVE (IVTC)	10/23/97 @ $13	3.3	8.7	38%	NATIONSBANC MONTGOMERY	20 1/4	2 3/4	6 5/8	4 1/4
LANDCARE USA INC (GRW)	6/4/98 @ $8	5	16.2	31%	BT ALEX BROWN	10 1/8	5 3/4	9 3/16	5 3/4
METALS USA INC (MUI)	7/11/97 @ $10	9	35.4	25%	BT ALEX BROWN	20 1/8	10 1/16	17 11/16	11 9/16
PALEX INC (PALX)	3/20/97 @ $7.50	3	18.4	16%	BT ALEX BROWN	15 7/8	6 13/16	8 7/8	6 13/16
PHYSICIANS RESOURCE GRP (PRG)	6/23/95 @ $13	8.1	29.9	27%	SMITH BARNEY	11 11/16	1 5/8	4 1/8	1 5/8
SERVICE EXPERTS INC (SVE)	8/16/96 @ $13	4.5	13.9	32%	EQUITABLE SECURITIES	38	24 5/8	35 3/4	26 7/8
TRANSCONTINENTAL MARINE (TCMS)	10/30/97 @ $18	5	8.9	56%	JEFFERIES & CO.	28 7/8	4 1/4	5 13/16	4 1/4
UNICAPITAL GROUP (UCP)	5/15/98 @ $19	28	48.1	58%	MORGAN STANLEY	19 5/8	10 3/8	18 7/16	10 3/8
UNITED AUTO GROUP INC (UAG)	10/23/96 @ $30	5.5	19.6	28%	J.P. MORGAN SECURITIES	27 7/8	10 1/2	24 7/16	13 5/16
U.S.A. FLORAL PRODUCTS (ROSI)	10/10/97 @ $13	5	14.3	35%	MORGAN STANLEY	19 5/8	7	17 5/8	7 1/16
U.S. OFFICE PRODUCTS CO (OFIS)	2/15/95 @ $10	22.7	36.5	62%	MABON	17 1/4	7 1/2	17.25***	7 1/2***
WEST COAST ENTERTAINMENT (WCEC)	5/14/96 @ $13	5.4	14	39%	JEFFERIES & CO.	3 1/2	3/4	1 11/16	3/4

SOURCE OF DATA: BLOOMBERG FINANCIAL MARKETS

NOTE: Selected securities represent a sub-group of roll-up firms that operate in several diverse industries that are highly fragmented. The selection of Dow Jones Industrial Average (DJIA) merely demonstrates how this sub-group performed relative to the benchmark's highest and lowest level in 1998.