HIGHPOINT ASSOCIATES: INSIGHTS

EXTENSION MERGERS

Part 1: Why Roll-Ups Succeed or Fail

Part 2: Secrets to Success in Industry Roll-Ups

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HighPoint Associates

Extension Mergers

Part 1: Why Roll-Ups Succeed or Fail

Alex Nesbitt

Extension mergers, often referred to as roll-ups, have historically been one of the most successful business growth models. Whether pursued to extend geography, markets, products, or some combination of these, such mergers focus primarily on revenue synergies. They have fueled impressive growth for companies like Cisco and IBM, who have used their extensive sales and distribution networks to, in turn, drive sales of products from hundreds of small acquisitions. In addition to their effectiveness in the tech sector, extension mergers have a strong track record of success in the banking, telecommunications, and cable industries through the roll-up of regional players into national entities.

While these mergers have combined non-overlapping products and geographies to generate revenue growth, they have also taken place in industries with high economies of scale at the national level, such as those on the right side of the Value Creation Matrix (below). As a result, they have delivered significant cost synergies from increases in volume on scale-sensitive parts of the cost structure.

VALUE CREATION MATRIX*

Opportunities for creating value in extension mergers

National Sources of Differentiation	Local	National
High	**Franchising** • Restaurants • Car Dealers • Video Rental	**Specialization** • Software • Retail Banking • Consumer Brands
Low	**Local Commodities** • Courier Services • Janitorial Services • Security Services • Local Construction Services	**Volume** • Telecomm. • Oil & Gas • Industrial Commodities

Primary Economies of Scale

*The Value Creation Matrix was inspired by The Boston Consulting Group's Advantage Matrix

We have also seen the formation of national companies–including fast food, video rental stores, and auto dealers (see the upper left-hand corner of Value Creation Matrix)–through franchising. National franchises carve up the cost structure into national and local components. The national franchise consolidates the national scale-sensitive portions of the cost structure and relies on local franchise owners to provide the hustle and hands-on management that local operations require.

Over the past couple of decades, we have seen a noticeable increase in extension merger activity of local commodity businesses, such as couriers, janitorial services, and security services (reference lower left-hand side of Value Creation Matrix). These local commodity sectors have few sources of scale-sensitive costs at the national level and have traditionally been dominated by local players who can outhustle their competition.

Extension mergers that roll up local operating companies.

Roll-ups have a pattern. In the beginning, they create value by increasing liquidity. Small companies have limited access to capital and the company's stock is usually very difficult to buy or sell, making it illiquid. This depresses the earnings multiple that the company can expect to receive from investors. When a few small companies are rolled up into a bigger company, the bigger company's stock becomes attractive to more investors. This expands the company's access to capital and its liquidity. Increased liquidity translates into a higher earnings multiple and greater valuation.

The net net? The bigger company can create financial value by consolidating small companies with low earnings multiples into the larger company that has a higher earnings multiple.

Other roll-ups follow suit and it becomes a race for size. As companies consolidate, this liquidity arbitrage loses its power and the acquirer must find new sources of value to make the consolidation work.

In the early days of this kind of roll-up, investors can make large financial returns. However, the long-term financial results are mixed, with some doing well and others experiencing some type of financial failure or blow-up that destroys shareholder value.

A couple of case studies to illustrate:

Velocity Express, a roll-up of local courier businesses, grew to over 200 locations in the United States before it collapsed from poor financial performance due to failed integration.

Service Corporation International, a funeral home roll-up, matched the S&P performance for its first twelve years, then suffered a stock collapse when its efforts to expand the roll-up internationally failed. The scaled-back company still lags far behind the S&P for total returns.

But it's not all bleak.

On the positive side, Quest Diagnostics, a roll-up of diagnostic laboratories, has had a much better track record. Since its spin-off from Corning in 1997, Quest has grown from $1.5 billion in revenue to $7.5 billion today. Quest's stock has also done well, rising by over 2,200% compared to the S&P's gain of 290%. While Quest likely has more opportunities for regional economies of scale than many local commodity roll-ups, there is something to be learned from Quest's approach to managing its portfolio of roll-ups for value.

Various companies are now pursuing extension-based roll-ups in other highly fragmented and labor-intensive sectors: Brookdale (assisted living), Kellermeyer Bergensons Services (janitorial services), and Securitas (security services) are a few examples of firms working to crack the code on the lower-left side of the Value Creation Matrix.

There may be rough waters ahead for these companies and others like them, as many of them are singularly focused on getting big *fast* through aggregation. Questions around how to create operating value, drive profitability, standardize processes, and achieve competitive advantage have likely been deferred. The problem is that these are the questions whose answers determine the long-term viability of the post-roll-up company.

The billion-dollar question.

And the overarching question—the billion-dollar question, in fact—is *how to transform a group of aggregated local companies into one national or regional enterprise with competitive differentiation and advantage.*

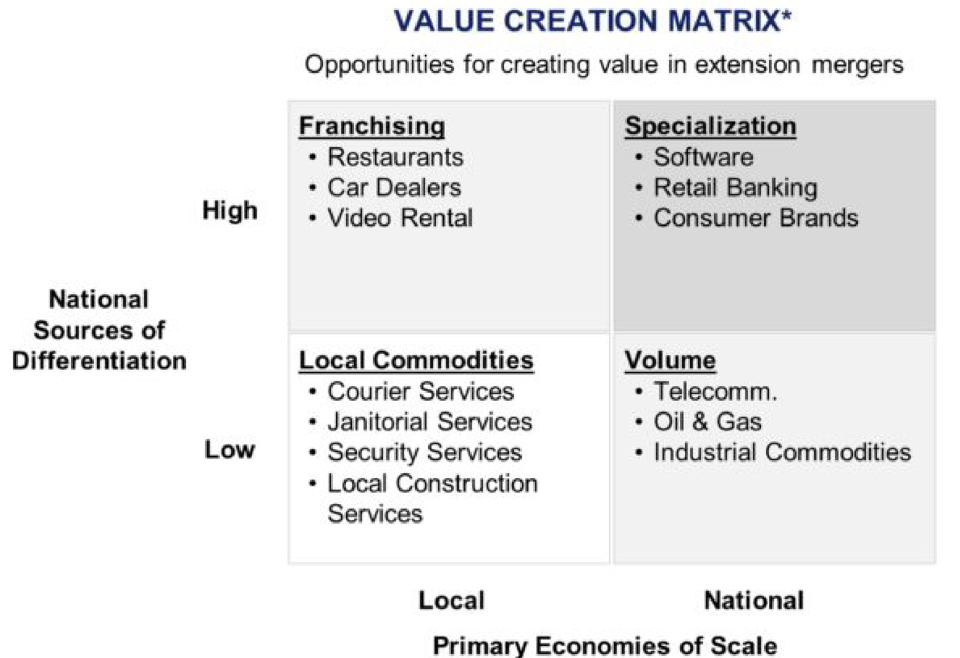
Each local entity will likely have its own primary operating constraint that limits performance, and though the constraint may not be unique, it will be different from many other local entities. The company that aggregates, say, 100 local businesses may end up with a portfolio of 20 or 30 operating constraints, each applying to a percentage of the total and each differing by factors like historical practices, location (e.g., different state/local regulatory environments), and market.

There will be winners and losers in every one of these sectors. The winners will be those that get big *and* create competitive advantage from their growing portfolio of operations. Those who cannot shift from a growth-only focus and find a solution to the disparate constraints of the units that make up the whole will very likely not last.

Extension Mergers

Part 2: Secrets to Success in Industry Roll-Ups

The first article of this series, *Extension Mergers: Why Roll-ups Succeed or Fail*, discussed the ups and downs of these types of mergers. It also introduced the Value Creation Matrix (below), a useful tool in identifying opportunities for value creation.



This is a hard, multi-dimensional problem; a tangled web of micro-economics, people, culture, processes, systems, and local market dynamics.

One popular approach is to identify best practices à la *In Search of Excellence* or *Good to Great*, and then try to standardize other operations to these best practices.

While this method seems scientific, it is flawed: The first problem is statistical. Separating the impact of best practices from random luck is difficult. Flip a coin enough times, and you will find long streaks of heads. Similarly, in any collection of local companies, you will find high performers who used best practices and others who were simply lucky.

A second, more troubling problem is survivor bias. We do the analysis and find best practices that seem to explain winning performance. However, it is impossible to know how many others tried those same practices and failed.

Industries on the right side of the Matrix are among the earliest industry roll-ups and have considerable national economies of scale. These economies of scale make value creation straightforward: Merge companies into national platforms and realize huge cost efficiencies from higher volume. Since many of these types of roll-ups have been completed, investors turned their attention to industries on the left side of the Matrix in search of new opportunities.

Industries on the left side of the Matrix have few sources of national scale. Local operations drive most of the cost structure. This is, even more, the case for local commodity industries in the lower-left quadrant of the Matrix. In industries like couriers, janitorial services, and security services competition can be fierce. Hustle and street smarts–combined with local scale–separate the winners and losers. This article focuses on the billion-dollar question that is the core issue for extension mergers in the lower-left quadrant:

How can a company transform a group of aggregated local companies into one national or regional enterprise with competitive differentiation and advantage?

Another common approach is to centralize work into lower-cost environments. Centralization can appear to yield major cost savings on part of the cost structure due to lower labor costs and economies of scale. However, it does not always lead to better results.

For example, centralizing phone calls has been tried in health care, telecommunications, cable, home repair, and numerous other industries. As anyone who has waited all day for a repair person only to find out they are not coming can attest, disconnecting the work from the local operations can cause unexpected customer service problems and increased costs. While local monopolies like phone and cable companies may be able to get away with terrible service, local commodities like doctors, vets, plumbers, and other local service providers cannot.

So, how do we untangle this web of issues to unlock value?

The secret lies in understanding there are two levers for improving local operational performance. The first is local scale and the second is local operating competence.

Take a large sample of car dealers and plot their operating costs per unit vs. sales and you will see a pattern. Operating costs per unit drop by 5-10% with every doubling of sales. That's economy of scale at work.

You would also see a huge amount of variance from the pattern. Swings of plus or minus 15-20% would not be surprising. That's the impact of local factors like operational competency and location.

1. Driving local scale

A larger scale operation allows for better staff utilization, more specialized skills, and increased amortization of overhead costs. The downside to greater scale can be increased distance from the customer and risks to customer intimacy. Finding the right balance is critical.

The first way to drive local scale is to identify overlaps and adjacencies in service territories. Some opportunities for consolidation will be obvious and should be pursued. Other opportunities will require judgment calls as to whether the economic benefits of consolidation are greater than the potential increase in management complexity or disruption to customer intimacy.

The second way to drive scale is by focusing and prioritizing business development activities within existing service territories. A client within the service territory that increases scale and density is much more valuable than a client outside the service territory that dilutes scale. Some of this increased value should be channeled into sales incentives to focus the business development team on these higher value accounts. Pricing and service level tactics should also be pursued to help drive conversion and retention for these higher value accounts.

2. Improving local operating competency

Every local operation will have its own operating constraint that limits its performance. It might be a market constraint such as limited demand; a resource constraint like recruiting or retaining skilled employees; or a process constraint as in a decision-making bottleneck. And while that constraint may not be unique, it will be different from many other local entities.

A further complication is that the local operating constraint is likely to move around over time. As an example, at some point in time sales levels may be lower than expected and you have staff surplus. At other times, the business might be booming and create a shortage of staff.

When we aggregate lots of location operations, it creates a portfolio of operating constraints that limit the performance of the whole. The variety and movement of these constraints make it very difficult for any centralized process improvement effort to gain traction and show progress.

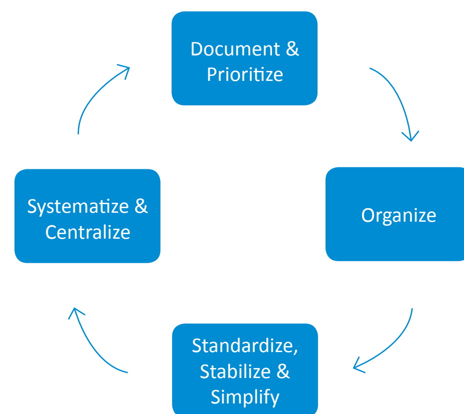
The person in the best position to address these local constraints is the local operations manager. However, this person is frequently too busy and may not have the requisite skills to address operating constraints systematically. Urgent problems consume their time, and they get hired because they are good at fighting fires, not because they are wizards of continuous improvement.

One way to tackle this is to treat local managers as the universal resource constraint that's limiting overall performance. We organize the business to make these local managers as effective as possible with a goal of shifting most of their efforts from working "in" the business to working "on" the business.

Focusing on making these front-line managers more operationally competent can be a game changer. In one example from the banking industry, front-line managers were able to increase the amount of time they spent analyzing the business, coaching, and giving feedback from about 15% of the daily work to 69% of their daily work, yielding improvements in throughput, cost, and quality.

To help a local manager make this shift, a skilled business coach can walk them through a standard process to become more effective. The four major process steps, as shown in the graphic below, are:

1. Document and Prioritize
2. Organize
3. Standardize, Stabilize, and Simplify
4. Systematize and Centralize



2.1 Document and Prioritize

Before deciding on the methods to get local managers working on the right things, we need to help them take an inventory of the "as-is" operations and performance versus the desired

outcomes. This "as-is" documentation includes:

- Quantification of how local managers spend their time
- Staff assessment of frequently occurring problem areas
- Assessment of staff training, skill sets, and areas for improvement
- Current target outcomes and performance measures in use (Note: These may differ from the outcomes and measures they should be using.)
- Comparison of currently used outcome and performance measures vs. recommended outcome and performance measures
- Quantification of performance vs. targets

Once the manager has documented the "as is," it will likely be clear where they spend most of their time: fighting fires. These are the areas that need to be prioritized for further investigation to identify root cause problems that impact the constraint. The business coach can help managers and local staff use analytic methods, such as asking why something happens and then repeating it until you identify root causes of problems (often referred to as the "5 Whys").

The priority is the root cause issue whose solution is most likely to improve the productivity of the constraint on business performance, i.e., have the biggest impact on freeing the local manager from low value-added work to give them time to focus on being more effective. That single improvement opportunity becomes the focus of the next phase of work. The other root cause issues should be placed in a parking lot for the future. Once the priority has been addressed, repeat the process to identify the next area of focus.

2.2 Organize

Before focusing on making things better, take steps to organize the work environment for maximum focus and productivity. The goal is twofold: First, reduce the amount of time and energy that goes into maintaining order in the work environment; second, lay the foundation for continuous improvement.

Start by organizing the work environment to make it conducive to productive work. Get rid of paper and other clutter that clogs up the work environment.

Purge or archive documents no longer in use. Remove unnecessary equipment. Clean and organize everything, both in physical space and on computers used by staff. Classify all working papers and tools by their frequency. Define and label a home location, organized by frequency of use, for everything you keep.

Define a clear process for where new work will enter and completed work will exit. Also, assign a staff member to audit the work environment every week and initiate corrective action to ensure it stays organized.

The second step in getting organized is to create visual controls. We want to make it easy to see performance versus plan and corrective action underway. Ideally, these visual controls will be readable at ten feet away. Be patient and don't overwhelm managers with too many visual controls, starting with a minimum core set they will find immediately useful then add more visual controls over time.

In service environments, work quality, safety performance, a work schedule/attendance plan and performance vs. plan, and the current priority and action steps associated with it will often form the centerpiece to visual controls. Other visual controls may include plans for new or changing customer requirements, an hour-by-hour choreography of what staff should be working on, the parking lot of future issues to work on, and other key activities you want staff focused on.

2.3 Standardize, Stabilize, and Simplify

This is the heart of the continuous improvement process. Given the prioritized area of focus, we want to standardize, stabilize, and simplify to bring order to the work and make it repeatable and effective.

The business coach, the local manager, and other key staff take time out from regular work and engage in a continuous improvement event. These are often called "Kaizen" (a Japanese word meaning 'change for the better') events. The focus of the event is on mapping, measuring, and identifying actionable improvements to the process.

Finding early wins that free up the local manager's time is essential. One way to do this is to develop standard work for the process. Standard work is a document that breaks the process down into repeatable work steps, work roles, and sequence. We can then examine the manager's role within the standard work to eliminate, delegate, or simplify to free up management attention.

Once we have freed up some of the manager's time, we can then redirect that time into repeating the process with a focus on the next constraint.

2.4 Systematize and Centralize

Once we have standardized and simplified the work, workflow automation and centralized support organizations start to become much more useful. The focus is on improving local outcomes by making work in the local operation flow faster and with less variance. These changes, done well, will support

much more advanced process improvement techniques, such as process mining and data analytics. These tools will allow the organization to take performance up to an entirely new level of operational excellence by constantly monitoring performance, process variability, performance problems, and time traps.

Implementation Considerations

The front-line managers will be the heroes of this journey. When effective, their mindset will go from a focus on fighting fires to one of building the business. Some will find this the most exciting work they have ever done, while others will not be able to make the transition. To be successful, they will need significant coaching, help, and support.

The success of this group and how they are treated will determine whether other staff see your company as a great place to work. Regardless if a manager can make the transition or not, treat them well.

Patience, persistence, and repetition are the recipe for success. The goal is continuous improvement that compounds over time and not one-time performance improvements. This aspect can be difficult for many leadership teams to accept and embrace. Leadership teams are often impatient for change and like to see home runs, i.e., big changes that have big results.

This is not a game of swinging for the fences; it's a game of continuous singles and doubles where the goal is to win every day. Those who win every day will build a different kind of company with a durable competitive advantage.

More on Mergers
You can read more about successful mergers in Alex's white paper, *Why Do Intentions Matter in Making Mergers Work?*

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