INVESTCORP

INSIGHTS

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Platform Investments
Buy-and-Build
Comes of Age

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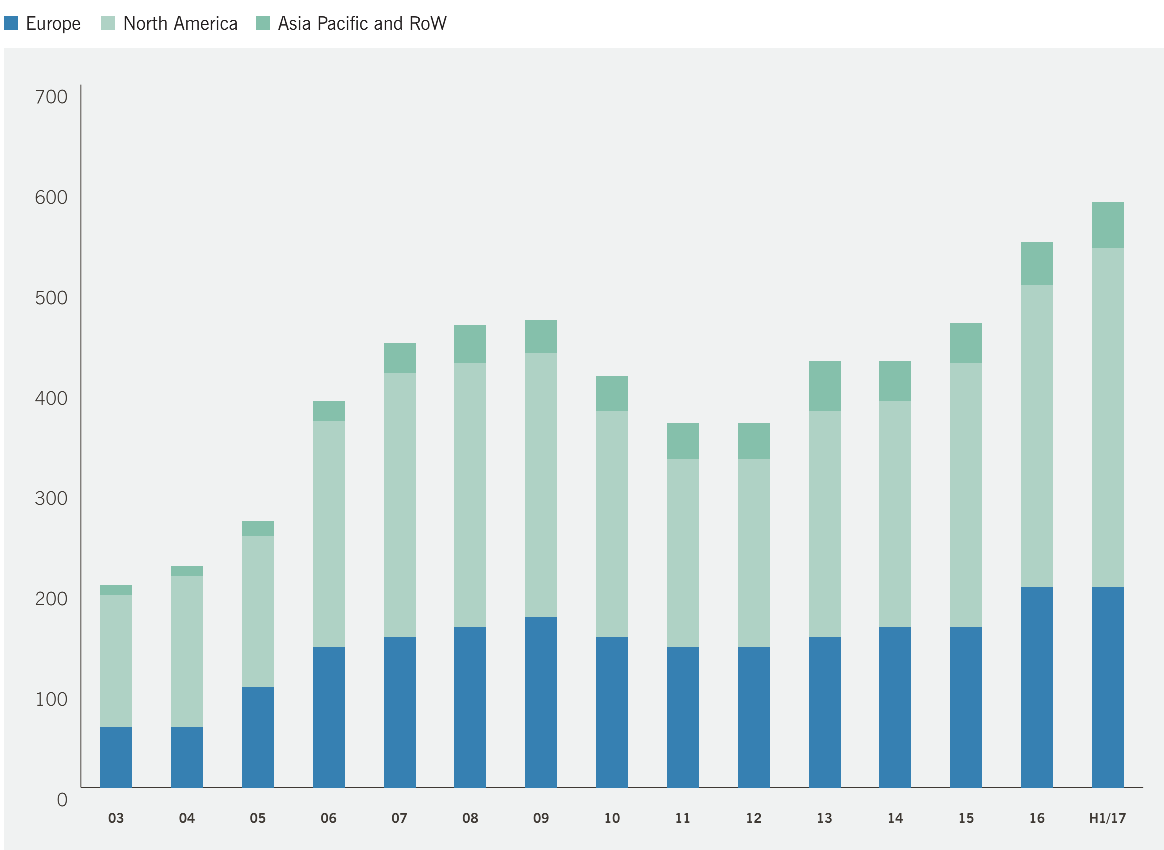
European buy-and-build activity reached an all-time high by volume in the first half of 2017.[1]

With dry powder in private equity ("PE") funds reaching almost $600 billion[2] and valuations testing new highs (global average acquisition multiple amounted to ~13.0x EBITDA for PE deals and ~11.5x for M&A overall in H1/2017[3]), PE funds have started to take far more hands-on and active roles in their investments. As highlighted by Boston Consulting Group (BCG): *"The relatively passive, monitor-only approaches of yesteryear are no longer enough [. . .] today's portfolio businesses require constant interaction, exposure, and insights from experts [. . .] as well as constant recalibration of the growth assumptions behind the investments themselves."*[4]

Figure 1. **Dry Powder by Region ($bn)**

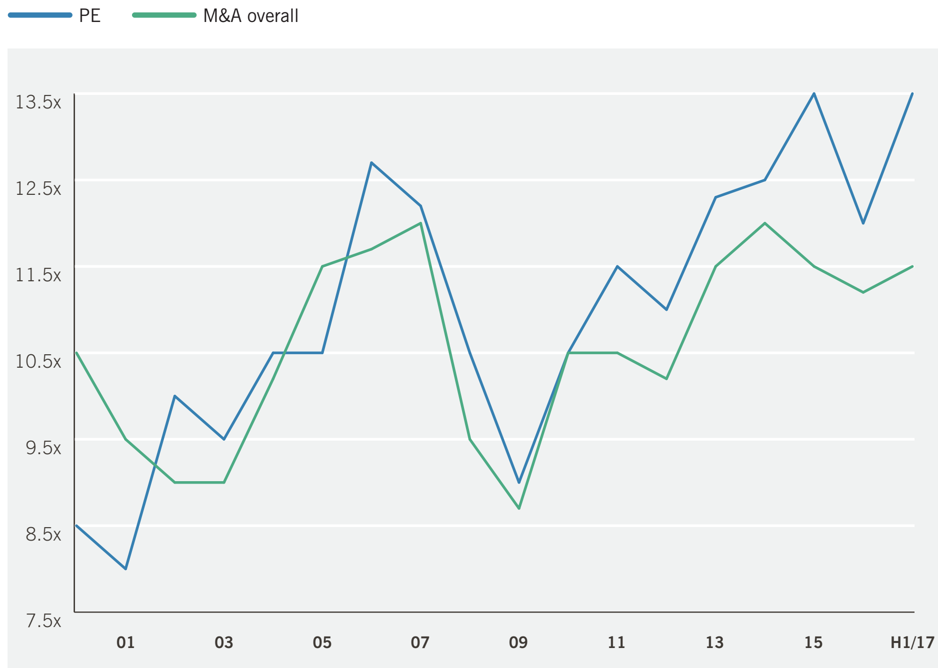


Source: Preqin

[1] Source: Mergermarket
[2] Source: Dealogic
[3] Source: Preqin
[4] "Capitalizing on the New Golden Age in Private Equity", BCG, 2017

Market conditions are requiring more creative deal structuring – creativity that is seeing large, more established firms adopt buy-and-build strategies.

Figure 2. **Global Average Acquisition Multiples EV/EBITDA**



Source: Dealogic

A SHIFT IN BEHAVIOUR

Today there are around 4,200 PE firms managing more than $2.5 trillion of capital, compared to 1,600 PE firms and $600 billion of assets under management in 2000.[5] Every PE investor continues to expect impressive absolute returns and is ever-demanding of the PE investment managers to whom they have allocated capital. Such market conditions are requiring more creative deal structuring — creativity that is seeing large, more established PE firms adopt buy-and-build strategies historically the bread and butter of small to mid-market investors. Financial engineering and leverage alone are no longer enough: PE funds have shifted their focus to operational value creation. An Ernst & Young private equity survey revealed that it does not stop at a firm shifting to an operational focus; many private equity firms have established dedicated operational teams, sometimes also labelled “post-acquisition teams.”[6]

Value creation strategies can be identified on two levels: (i) by driving operational improvements in the acquired target company itself and (ii) by transforming the target company through further M&A, i.e. buy-and-build. If done the right way, the acquired company is leveraged as a platform for M&A, and two potential routes for value creation emerge: (i) reaping synergies and (ii) creating a larger and more attractive company typically valued at higher earnings multiples than the original or subsequent add-on acquisitions. The latter is not automatically the case, but can be achieved if the company either becomes more attractive for liquid capital markets, e.g. IPO, or if its scale becomes a significant competitive advantage and/or barrier to entry. The appeal of platform investments is that, by merging enterprises in adjacent markets and industries, PE firms can create larger targets that become attractive for strategic acquirers and sponsors whose appetite would have ignored smaller players.

[5] Source: Preqin
[6] Ernst & Young Private Equity Survey 2016

Over the years, we have seen specialist investors emerge who solely focus on buy-and-build, and it is these models that in a tumultuous economy have stabilised the lower end of the private equity market. However, many of those small funds have grown up and matured, and the success of the platform/buy-and-build model hasn't gone unnoticed by large buyout funds.

One example of this might be the rapid consolidation that is being witnessed in the global payments processing industry: consolidation which has been driven by both private equity and strategic acquirers, such as Vantiv Inc.'s recent agreement to acquire Worldpay Group PLC, a business originally backed by private equity and created through the integration of RBS Global Merchant Services and further multiple add-on acquisitions.

Going back a number of years, one could point to Investcorp's own investment in Skrill in 2007 and subsequent add-on acquisition of paysafecard.com as an early example of such a buy-and-build consolidation process.

Almost
$600B
of dry powder in private equity funds

COMPANIES DESTINED TO GROW

In parallel to the described developments in the sponsor sphere, companies face rapid changes and complex challenges, many of which they struggle to master alone. In a single generation, businesses have had to adapt to entirely new marketing channels (Web and social), decide how to invest in and utilise new technologies and ensure they are adequately tooled-up to serve their clients across international markets. Due to global competition and increasing transparency, ongoing optimisation of supply chains and operations has become a sine qua non in order to drive profit growth. Likewise, many companies struggle to anticipate the impact of digitalisation on their businesses, overlooking the need to proactively assess, adapt and future-proof their offering and go-to-market strategies.

As a response, companies are forced to grow and achieve scale — fast, through organic growth and/or inorganic actions. Focusing on organic growth, either the company benefits from market growth or the company must gain market share. The latter often has to be "acquired" by spending significant amounts on capex,

Pursuing a platform strategy and combining it with operational excellence can drive true sector outperformance, creating a win-win situation.

R&D, marketing and/or sales. However, quite often companies are inadequately resourced to independently respond to the challenges, as they lack scale, financial resources and human capital. Inorganic growth does not have to be more cost-efficient than "acquiring" organic growth, but results materialise much faster; and it is not only that the big eat the small, but according to Jason Jennings' *New York Times* bestseller, it is especially that *"the fast eat the slow."*[7]

PLATFORM INVESTMENTS AS WIN-WIN

Platform investments are generally understood to be companies that a private equity house views as a starting point for follow-on acquisitions when investing through acquisition in a new industry or market space — in the same area. Hence, they are particularly relevant in fragmented industries in which there is considerable opportunity to drive consolidation through a buy-and-build and/or roll-up strategy.

According to BCG's article "The Power of Buy and Build: How Private Equity Firms Fuel Next-Level Value Creation": *"As value creation has moved beyond financial engineering, operational improvement is the most frequently used lever. In particular, many PE firms are enhancing the value of their portfolio companies through add-on acquisitions."* According to the same study, buy-and-build deals outperform stand-alone PE deals, generating an average of 8.5% of extra return (IRR) per annum from entry to exit compared to stand-alone deals.

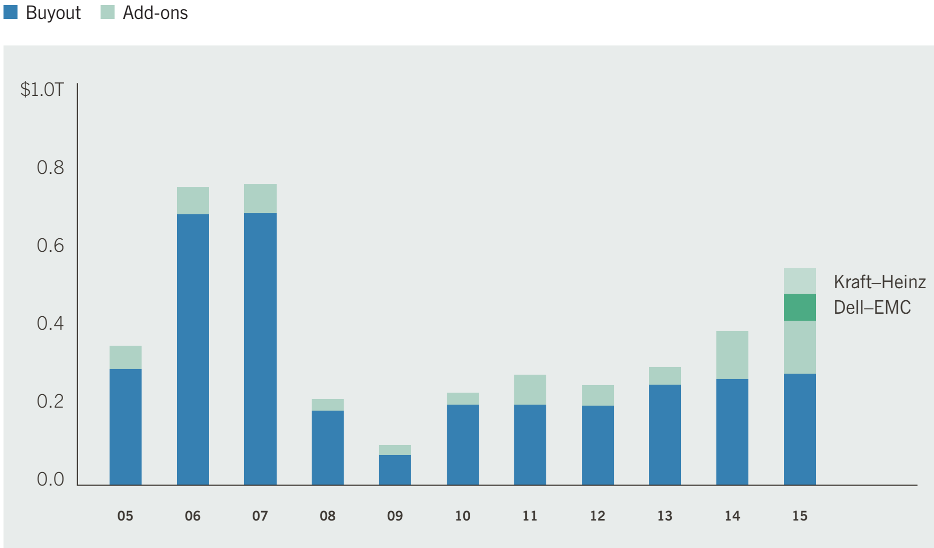
Nearly 50%
of equity in 2015 was deployed for add-on acquisitions vs. new buyouts

Against this backdrop, the desire to consolidate a sector has become a regular component of a PE house's investment thesis, no longer confined to the lower end of the market.

According to Bain, nearly 50% of private equity investment in 2015 was deployed for add-on acquisitions vs. new buyouts — a trend we very much expect to continue as firms look to overcome identified challenges, notably: (i) relatively light primary deal flow vs. an overhang of available capital, and (ii) companies benefitting from increased scale, providing them with incremental resources to win in a fast-paced and highly competitive environment.

[7] Jason Jennings, 2002, *It's Not the Big That Eat the Small…It's the Fast That Eat the Slow*

Figure 3. **Global Buyout vs. Add-on Value**



Source: Bain

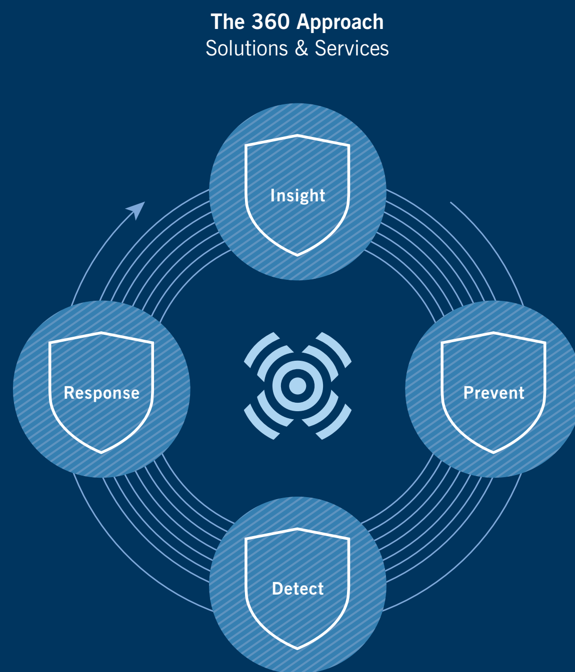
Pursuing a platform strategy and combining it with operational excellence can drive true sector outperformance, creating a win-win situation for both the PE owner and the company itself. However, only a few PE houses successfully master such an approach today, and there are many pitfalls along the way that one needs to be aware of which we explore in more detail below.

PLATFORM INVESTING: VALUE DRIVERS AND SUCCESS FACTORS

From a company's perspective, serving as a platform to consolidate an industry *or* being the firm acquired by a platform can have several benefits:

First, the platform company can achieve critical mass and economies of scale much faster. This can create a significant competitive advantage, drive further growth and profitability and discourage new players from entering the market. Although economies of scale are often associated with capital-intensive industries, marketing spend can often also be classified as a fixed cost. Bringing together many small companies under one brand umbrella can benefit all with the platform's marketing spend and leverage its brand equity. Besides attracting customers, the brand awareness of the platform can also be leveraged to attract and retain top talent. Additionally, the professionalisation and de facto centralisation of recruitment and HR tasks at the platform should further enhance the group companies' administrative processes and, ultimately, margins.

Second, a platform together with its add-on acquisitions can benefit from building a joint professional infrastructure, for instance allowing different group companies to access other group companies' client networks and establishing a global reach. By combining R&D resources, the entire group can achieve an innovative edge. In the era of digitalisation, significant investments in IT software, systems and training are required to adapt companies' offerings and go-to-market strategies. Anticipating the



CASE STUDY

SECURELINK

The market-leading provider of cybersecurity in Europe

Through a targeted buy-and-build strategy, Investcorp is successfully establishing Europe's leading independent cybersecurity solutions and managed security services (MSS) provider

TRACK RECORD

Investcorp has a long investment track record of investing in IT security companies on both sides of the Atlantic, having previously backed FishNet Security (merged with Accuvant to form Optiv Security), identity fraud detection and prevention business CSID, cyber security software company Sophos, anti-counterfeiting technologies specialist OpSec and data encryption and security company Utimaco.

STRATEGY

Recognising the need for more advanced services within a rapidly evolving threat landscape, Investcorp set out in late 2015 to form a leading pan-European cybersecurity specialist. SecureLink, until then purely focused on the Netherlands and Belgium and with a turnover of c. €75 million, served as the platform. In short order, it expanded into Scandinavia through the acquisition of Coresec, added UK specialist Nebulas to the portfolio and entered the German-speaking region through bolting on iT-Cube.

RESULTS

The combination of forces provided the newly formed group with significant resources and talent to further its services, which include the provision of Managed Security Services out of five Cyber Defense Centers. Today, SecureLink generates some €250 million in revenue, with more than 650 cyber security specialists safely enabling the business of SecureLink's more than 1,300 customers.

impact on business models and making companies future-proof in a new world require investments which can often be better absorbed if a company is larger. Managing the shift to a more digital-oriented business model and culture is already highly challenging; doing this amid a buy-and-build strategy can add further complexity. However, the merger of companies can also serve as a trigger event to migrate the systems and processes of all group companies to a state-of-the-art level, rather than forcing one company's system onto the others.

From a shareholders' perspective, the above listed aspects are equally relevant, as they increase shareholder value. In addition, the shareholder can benefit from the following two options to create further value:

First, a more sizeable group has more exit options. For a company with an enterprise value of €500 million or more — depending on many factors such as industry, country, etc. — an IPO can become a realistic exit route. Alternatively, a secondary buyout by a larger private equity firm can be attractive as the selling sponsor can benefit from peak valuation levels for well-established businesses. For once, ever-increasing competition between PE firms does not seem that bad.

Platform Investments generate an average of **31.6%** from entry to exit, compared to an IRR of **23.1%** on stand-alone deals

Second, if done correctly the shareholding sponsor can benefit from so-called multiple arbitrage. As typically lower entry multiples are paid for add-on acquisitions, and the larger platform enterprise is valued at a premium, the profit from "buy low, sell high" falls entirely into the shareholder's pocket. The most prominent research study on this difference in valuation levels, focusing on public markets, has been published by Fama and French and resulted in the three-factor model — this uses size as one factor to explain returns of companies, with small-cap companies often trading at lower valuation levels than their larger competitors and therefore generating higher returns over time.[8] However, a size premium can also be found in private markets. The main reason is the liquidity in the market, i.e. the number of potential acquirers and their buying power in the respective market segment. Whereas larger companies attract more buyers with plenty of liquidity or even public market investors, the market for smaller companies tends to be less liquid. By bulking together many smaller companies and thereby creating a larger company, PE firms can successfully bring those smaller companies into the more liquid capital markets which is, in itself, creating value.

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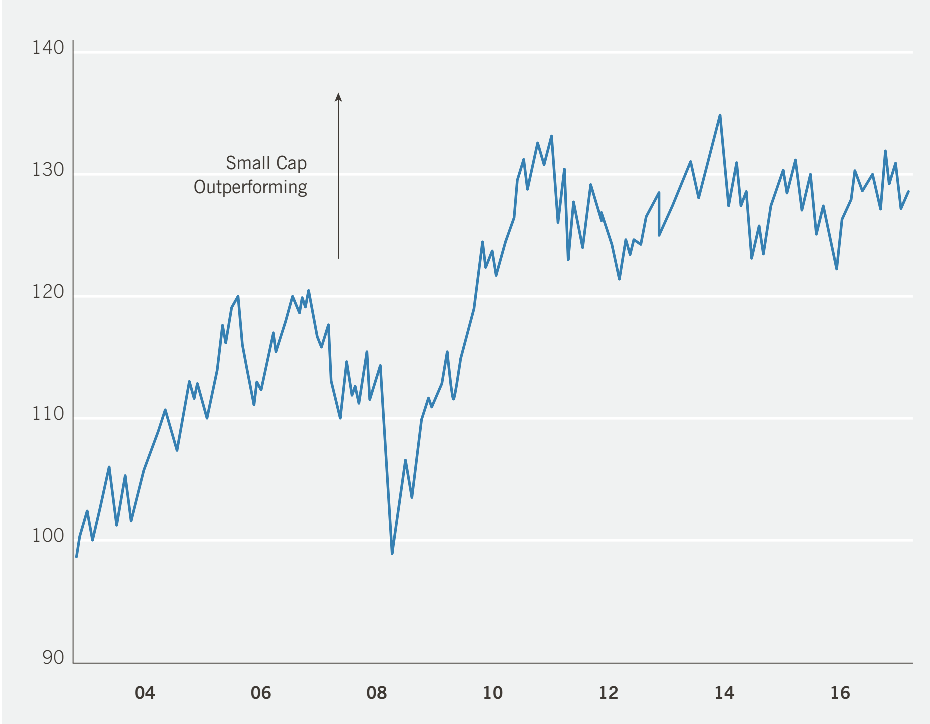
[8] E.F. Fama and K.R. French, 1993, "Common risk factors in the returns on stocks and bonds"

Creative operational value creation strategies cannot be overlooked. Platform investments and subsequent buy-and-build strategies form a critical element of this.

Figure 4. **Global Small vs. Large Equities**



Source: Thomson Reuters Datastream, FTSE and BlackRock Investment Institute. April 04, 2017
Notes: The line shows the FTSE Global Small Cap Index versus FTSE Large Cap Index. An increase in the index level means small-cap equities are outperforming large-cap equities. The index is rebased to 100.

HOW PE CAN SUPPORT

Having described the value drivers and success factors of platform investing, we will now look at how an operational PE owner can support a company and its management team to realise this value:

First, while the private equity investor might have drawn up a list of preferred acquisition targets as part of his/her due diligence prior to making the platform investment, it is not uncommon for further add-ons to be lined up early on in the hold period. Rather, the financial sponsor works in close collaboration with the platform's senior management, external bankers and consultants to identify and approach priority targets. Further, as private equity professionals are often experienced M&A professionals, the sponsor can actively support management to execute the acquisitions.

Second, in the pursuit of a targeted buy-and-build strategy, add-on acquisitions must subsequently be integrated into the platform company. As mentioned above, PE firms are broadening their operational teams and centralising expertise within fields such as post-merger integration, IT process standardisation and digitalisation. Having a close shareholder-company hands-on working relationship and being able to draw on in-house expertise and resources can help a company to gain an edge against its competitors.

Third, PE investors can help to establish effective organisation and corporate governance structures. This is especially critical and requires high levels of sensitivity in the context of a buy-and-build strategy, in which companies have been merged and certain management positions might be double staffed. Assessing the talent within the companies and making decisions about whom to promote and potentially externally hire require a lot of experience and expertise. A strong corporate governance structure is essential in preparation for a potential IPO.

CONCLUSION

As the industry matures, the ability to access debt and structure deals is no longer considered a core differentiator. For any private equity firm, regardless of size, looking to deliver top-quartile returns, creative operational value creation strategies cannot be overlooked. Platform investments and subsequent buy-and-build strategies form a critical element of this. However, it comes with significant work and the need for an ever-closer shareholder-management relationship. If done correctly, the combination of financial resources, expertise and entrepreneurship can add significant value, result in strong and synergetic teamwork between sponsors and management teams and generate high returns for investors: a true win-win situation for all.

ABOUT INVESTCORP

Investcorp is a leading global provider and manager of alternative investments, offering such investments to its high-net-worth private and institutional clients on a global basis. Led by a new vision, Investcorp has embarked on an ambitious, albeit prudent, growth strategy. The Firm continues to focus on generating investor and shareholder value through a disciplined investment approach in four lines of business: corporate investment, real estate, alternative investment solutions and credit management.

As at June 30, 2017, the Investcorp Group had $21.3 billion in total AUM, including assets managed by third-party managers and assets subject to a non-discretionary advisory mandate where Investcorp receives fees calculated on the basis of AUM.

Since its inception in 1982, Investcorp has made more than 170 corporate investments in the US, Europe and the Middle East and North Africa region, including Turkey, across a range of sectors, including retail and consumer products, technology, business services and industrials, and more than 450 commercial and residential real estate investments in the US, in excess of $55 billion in transaction value.

Investcorp employs approximately 390 people across its offices in Bahrain, New York, London, Abu Dhabi, Riyadh, Doha and Singapore. It is publicly traded on the Bahrain Bourse (INVCORP). For further information, including our most recent periodic financial statements, which detail our assets under management, please visit: www.investcorp.com.

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