Shorey Consulting, Inc.

Revisiting Roll-Ups
Value Creation through eCommerce

Situation

The concept of consolidating an industry by acquiring many small companies and "rolling them up" into a larger firm remains an intriguing path for creating equity value. In theory, the resulting larger company will have greater market presence, larger scale, more cash flow and, thus, more shareholder value. In practice, multiple acquisitions have not lived up to investor expectations. The process is often successful in building a larger company but usually fails to produce commensurate increases in profits and operating cash flows. The acquiring firms need to uncover new operating approaches for the acquired companies in order to produce the necessary profits and cash flow that will yield increased shareholder value.

The basic requirement for creating shareholder value is to increase operating cash flow. In the case of multiple acquisition programs designed to consolidate an industry ("roll-ups"), the acquiring company invariably adds new costs that tend to reduce rather than increase operating cash flow. At very least, there is an additional level of management carrying out the acquisition process and overseeing the acquired companies. Often the new corporate management imposes business standards in reporting, operating practices, benefits, and similar functions that drive up day-to-day operating costs. The challenge is to offset the increased costs and to earn a return on invested capital.

In order to overcome added administrative costs, the acquired businesses must increase their absolute dollar margins. The individual operating units must generate more contribution after overhead expenses than they did as stand alone units. Increasing margin percentages may not be sufficient if the percentage increases are gained by reducing revenues. The total costs are increasing and they must be covered by more total operating profit.

There are four ways to an acquirer in a roll-up can increase total profits before interest and taxes (EBIT) and operating cash flow:

- Reducing overhead costs
- Reducing operating costs without forcing reductions in prices or volumes
- Increasing prices without suffering disproportionate losses in volume
- Increasing volumes without increasing unit costs

The challenge for a successful roll-up is to implement some combination of these four elements in a way that more than covers any additional overhead costs and that is sustainable overtime. Most roll-ups have not accomplished this because they do not sufficiently change the operations of the individual acquired business units.

Acquiring companies undertaking roll-ups have tried many approaches, such as national branding or re-focusing to larger, national account customers to make the necessary improvements. The history of roll-ups has shown that these approaches have not been enough. Recent developments in eCommerce may now offer opportunities to change the business operations and to leverage the greater scale and in the consolidated company to the degree necessary for acceptable returns. Depending on the specifics of a business and industry, eCommerce has the potential to influence each of the four elements: reducing operating and overhead costs and providing opportunities to improve customer satisfaction leading to increased prices or volumes.

Roll-Up Business Concept

In a typical roll-up, the acquirer purchases many smaller, entrepreneurially managed companies with the intent of building a larger and more profitable entity. Often the founding entrepreneurs have close personal relationships with a strong base of local customers. These entrepreneurs usually have weaknesses in some, though not necessarily all, management skills and are sub-optimally sized to support modern business systems. Therefore, the theory is that the acquirer will add management capabilities and free the acquired entrepreneurs to cultivate and expand their customer bases.

The implementation problems in the traditional approach to roll-ups are exemplified by the experiences in office products and waste disposal (such as U.S. Office Products, Corporate Express and USA Waste, now Waste Management). In each instance the acquirer built a national business by acquiring many local and regional operators. The intent was first to retain the local customer base while expanding capabilities to serve larger, national customers and, second, to improve operations. All three of these companies started with strong investor support but, in the end, none has earned acceptable returns on invested capital.

In the case of the office products companies, one of the principal causes of failure was an inability to extract cost savings either in operations or in overhead. In addition, the consolidators attempted to build a new revenue stream from national and larger regional accounts to complement the local or regional focus of the acquired companies. These new customers could only be attracted at low gross margins that did not offset additional corporate and other costs.

USA Waste - Waste Management also had difficulty with operations and cost control when integrating acquired companies. These problems were augmented when USA Waste merged with Waste Management to create an even larger waste disposal company. Again, the consolidator could not extract enough cost savings to cover added overhead and, in this instance, the loss of direct, visual, local operating control.

Failure in the roll-up business concept, thus, can result from insufficient cost savings, unsuccessful refocusing on new customers and loss of operating control. Creating successful roll-ups will require paths to overcome these failings. Indeed, the original business plan should include a clear path to cost reductions and operating control before the roll-up process even begins.

Using Scale to Improve Returns

A company built up through multiple acquisitions develops a potential advantage in size and scale relative to the remaining smaller competitors in the industry. Achieving success as a roll-up requires tapping that scale advantage to offset additional costs. Traditional concepts of scale advantage focused on manufacturing processes or on extracting lower prices from suppliers. Many of these opportunities have become available to mid-sized companies and may not help change the competitive patterns in the types of industries often under consideration for roll-ups. Scale can also be used to change the customer mix, to improve sales force effectiveness, to simplify internal processes or to support capital investments that reduce operating costs. Unless the roll-up can take some advantage from scale, it will have difficulty creating value.

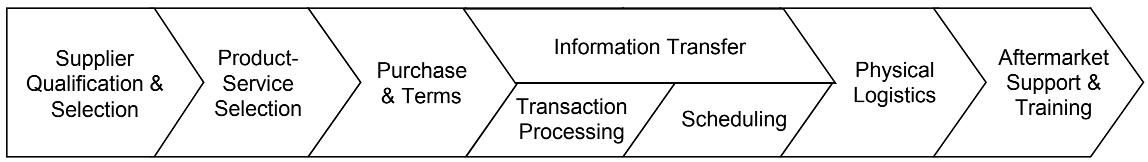
Past experience has shown that scale is hard to use as a basis for increasing sales. One alternative explored by consolidators in the office supplies, food service distribution and similar industries was adding larger regional and national accounts to the customer base since the consolidated company now has the size and geographic presence to be a single source supplier for these larger accounts. Unfortunately, these customers have the size and bargaining power to demand low prices, lowering gross margins by several percentage points more than any associated savings in sales and service costs. Therefore, the large accounts contribute significantly less in additional margin dollars than initially anticipated. One food service supply company found that its largest customers operated at a loss under any set of cost allocations. The problem is compounded if the local units are distracted away from their traditional high margin customer base.

Targeting revenue or price improvements may be a useful part of any program to improve profits and cash flow. However, revenue related approaches have not been successful in the past and there are no new reasons why they are likely to be more successful in the future. In order to change the economics and profitability of the total company, the acquirer will need to reduce costs. Fortunately, there are now opportunities in eCommerce to bring about those changes.

New Opportunities Through eCommerce

The evolution of eCommerce provides an opportunity for industry consolidators to bring scale advantages to operating cost reduction in ways not previously possible. Leveraging eCommerce capabilities may provide a new and more potent foundation for value creation in roll-ups and other industry consolidation efforts. Many of the operating cost reductions will be available in the sales and distribution process, where the local acquired business units interact directly with its customers. The relationship between eCommerce and the sales and distribution process is discussed in an earlier Shorey Consulting, Inc., article that describes the supplier/customer interaction in terms of six key activities.[1]

Figure 1: Purchasing Activities



Depending on the specific industry situation, there will be opportunities to bring scale advantages through eCommerce to each of these activities. Other business processes, for example, supply chain management, may also offer analogous opportunities.

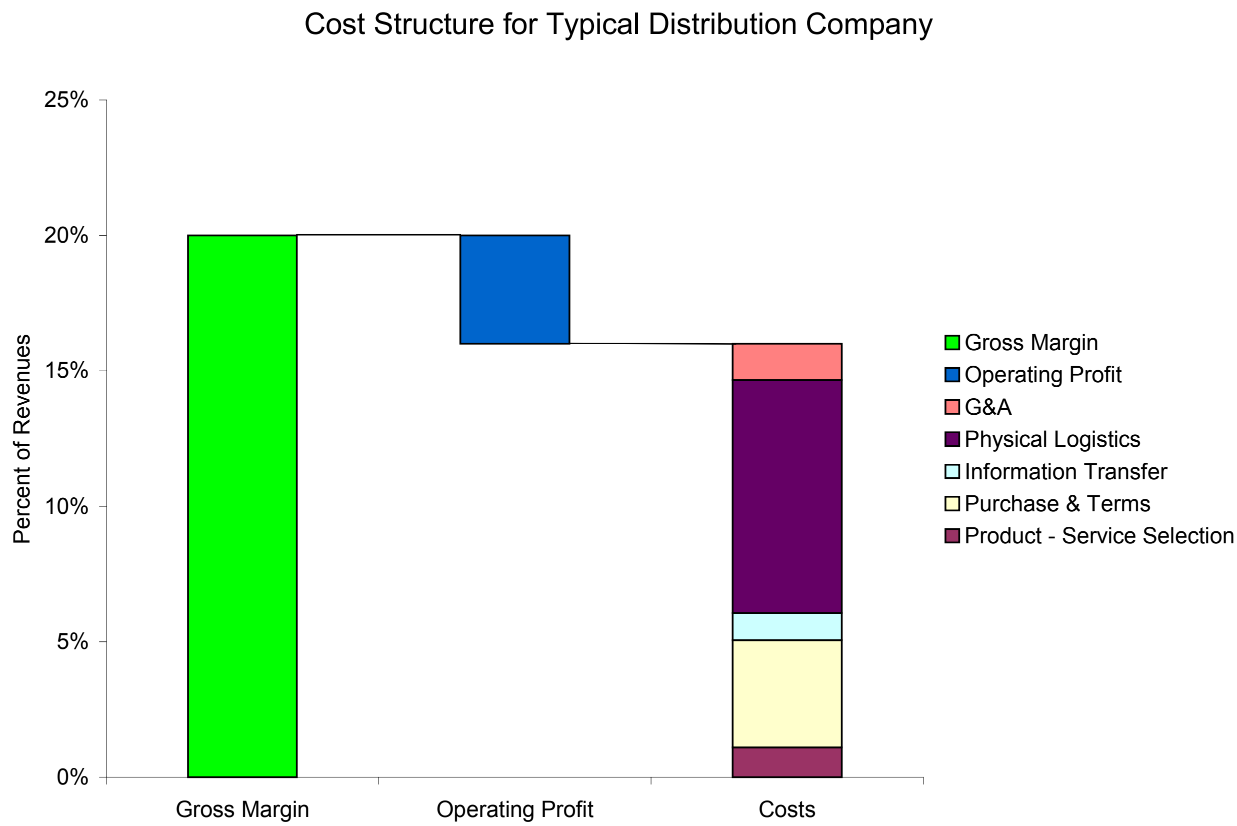
eCommerce Opportunities in a Distribution Industry

Distribution industries such as office supplies, maintenance and repair items, restaurant supplies, or health care products have been the source for many attempts at industry consolidations. These companies typically have low gross margin percentages accompanied by high *Physical Logistics* costs (order fulfillment and physical distribution) and low operating profits. The challenge in crafting a successful industry consolidation is to use scale as a source of competitive leverage.

A pre-consolidation distribution company has one or more local branches, each of which has a typical cost structure with a 20% Gross Margin and a 4% Operating Income before parent company charges (Figure 2). *Physical Logistics* make up the bulk of the operating costs with other costs in the sales force (focusing on order taking in *Purchase & Terms* and some *Product-Service Selection*). This structure leaves very little room for any costs above the local level or for any profit.

[1] Shorey Consulting, Inc., *Identifying Successful Business-to-Businesses eCommerce Models,* November 2000, available at www.shoreyconsulting.com/eCommerce_Article.

Figure 2: Margin, Profit and Costs



A successful roll-up starting with these margins and costs must change the underlying economic structure of the local operating units to reduce costs and increase profits. Logistics are the major cost item but are mostly actual delivery costs (trucks and drivers) and, thus, impervious to major change. The selling process, amounting to 5% or more of revenues or nearly one-third of operating costs, is the next largest cost item and one where opportunities for new business approaches are possible. Restructuring the sales process can generate 2 percentage points of cost reduction, yielding a 50% increase in operating profits. Alternatively, a restructured sales process can free up sales representative capacity that could be dedicated to identifying new customers to expand the business and to working with existing customers to sell them a more profitable mix of products.

Several distribution companies have responded to this challenge by creating eCommerce, web-based order entry systems that allow the customer to place orders directly over the Internet, typically with a customized "market basket" of frequently ordered items and other special offers. By using the web-based systems, the customer no longer needs to rely on the sales representative to visit and take the order, eliminating the time sales reps currently spend on order entry. Removing the extra individual and customizing the order form simplifies the process and reduces both ordering and fulfillment errors.

In effect, the web-based order entry system shifts activities from the sales rep to the customer. While the cost reduction benefits to the distribution company are clear, the customers must also perceive benefits or they will not take on the added tasks. For many customers, the convenience of ordering whenever they choose and the customization of the order forms is a sufficient motivation; distribution companies rarely need to add other incentives to encourage customer usage of web ordering.

The sales reps, not surprisingly, are often major pockets of resistance to a new web ordering system. First there is a natural fear of change. Second, many sales reps are comfortable as order takers and are not experienced in other sales activities such as new customer identification and acquisition. Finally, the order taking process provided a natural reason for sales reps to visit with customers. Any web-based order system will need to incorporate strategic marketing practices coupled with retraining to encourage new, higher value interaction between the sales force and customers. Despite these potential obstacles, eCommerce provides a path for restructuring activities, lowering costs, obtaining new customers and, thus, changing the economics and competitive structure of the industry.

Smaller competitors will need to respond and will be at competitive disadvantages in terms of costs and sales rep retention when larger ones begin offering web-enabled ordering. The smaller companies will have higher operating costs relative to the larger roll-up because they will not have the revenue base to absorb the eCommerce development costs. Furthermore, their sales forces will no longer be as productive as those in the larger firms so that the larger firms will be in a position to recruit and reward the better sales reps. Finally, and most significantly, to the extent that customers value the automated ordering process or other features of eCommerce such as remote managing of order timing to reduce customer inventories, the customers will begin to demand it of smaller suppliers. If those suppliers can not respond competitively, the customers will begin to migrate to the larger firms. In any of these circumstances, the larger firms will be using scale advantages and will be in a position to restructure the industry – the necessary support for successful roll-ups.

Other eCommerce Approaches

Other types of companies can also benefit from eCommerce initiatives and use them to change their industry's economic equilibrium. The areas of greatest eCommerce potential will depend on the underlying cost structure in the industry and on the features of high interest to customers. The actual ideas will need to emerge from within the industries and survive reality testing on workability and practicality. Some potential options for industries that have been of interest to roll-up investors might include:

- *Contractors:* repair diagnostic systems to reduce time on the job and required experience level of technicians, project estimating and bidding systems to increase accuracy of quotes and bids

- *Custom manufacturers:* product configuration systems to reduce time and skills necessary to specify a product and to shorten lead times between ordering and manufacturing
- *Retailers:* inventory tracking and management systems to reduce total inventory levels and to reduce the cost of returned/unsold goods, integrated supply chain systems to shorten the product cycle and allow restocking within a season.

Ingenuity and close contact with customers will produce opportunities in many different industries. Any resulting change in profit economics will create new opportunities for consolidation and, thus, make these industries more fertile candidates for roll-ups.

Future Opportunities

Roll-ups or industry consolidation efforts may no longer deserve the poor reputation they have gained with private equity investors. Many past efforts have shown that a bigger company is, in the end, not necessarily a better one. There needs to be a clearly defined basis for competitive advantage following the roll-up and eCommerce now provides one path for using the new size and scale of the roll-up as a basis for such an advantage. Successful sponsors of roll-ups will target opportunities where they can:

- Analyze the underlying cost structure of the individual operating units and identify significant activities where costs can be changed
- Understand the needs of customers and target new initiatives that use scale to enhance customer satisfaction in areas of high priority to the customer
- Use eCommerce initiatives to change costs and enhance customer satisfaction
- Follow through with implementation to ensure that the cost reductions and customer benefits actually occur
- Resist the temptation to add unnecessary overhead and create an insuperably high overhead penalty

A good idea and skills in making multiple acquisitions were always necessary but never sufficient for a successful roll-up. Follow through to use newly acquired scale remains critical to success and eCommerce is providing one path to use that scale effectively.

Shorey Consulting, Inc., is a strategy consulting practice dedicated to working interactively with clients in order to develop approaches for profitable growth in the face of change. It encourages thoughts, comments and additional examples of sales and distribution approaches as key elements in successful business models.
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