BDO

PRIVATE EQUITY
PERSPECTIVES
PODCAST

EPISODE 22:
EXPLORING ADD-ON ACQUISITIONS & CO-INVESTMENTS

INSIGHTS FROM THE BDO PRIVATE EQUITY PRACTICE

INTRODUCTION

Todd: Hello, and welcome to another episode of BDO's Private Equity PErspectives Podcast. I'm Todd Kinney, National Relationship Director in BDO's Private Equity practice here in New York City. Today, I'm excited to welcome two special guests to talk about private equity trends and strategies. First up, I'd like to welcome Alice Birnbaum, who is Head of Business Development at BBH Capital Partners. It's wonderful to have you on the podcast, Alice.

Alice: Thanks, Todd. Great to be here.

Todd: Next, I'd like to welcome Andy Cook, who is a Partner with Southfield Capital. It's great to have you on the show as well, Andy.

Andy: Good morning, Todd. Great to be here.

INTRODUCTORY QUESTIONS

Todd: All right. Let's kick things off. Andy, you've been with Southfield Capital since 2002, if my fact-checkers have it correctly. So, perhaps you can tell our listeners a bit about your role and how the company has evolved since then.

Andy: Sure. I'm a Partner with the firm, so I get involved in substantially, all the firm's external activities, deal sourcing, transaction negotiation, due diligence, debt placement, portfolio company management, board level involvement, and fundraising. In terms of the evolution of Southfield, as you mentioned, we were founded 18 years ago in 2002, and it was Andy Levison and myself working, essentially, on a deal-by-deal basis with more of a generalist approach. Today, we have 18 employees supporting both an equity fund and a mezzanine fund. I spend all of my time on the equity fund where we're focused on

TOPICS DISCUSSED INCLUDE:

INTRODUCTION

INTRODUCTORY QUESTIONS

INDUSTRY SECTOR OUTLOOK

ADD-ON ACQUISITION & OTHER STRATEGIES

COFFEE BREAK WITH VERENDA GRAHAM, BDO

COINVESTMENT TRENDS

partnering with growth-oriented, lower middle market business services companies with $4 million to $12 million of EBITDA.

Todd: I'm sure you'll have a lot of excellent insights to share and I appreciate that. So, turning to you, Alice, as Head of Business Development for BBH Capital Partners, again, it would be great if you could share a bit of background about your firm and perhaps your role there.

Alice: Absolutely. So, BBH Capital Partners is the private equity business within Brown Brothers Harriman. We've been in private equity for over 30 years. We've raised almost $4 billion in capital across 10 different funds. Our focus is in partnering with founder-owned or owner-managed middle market companies across a pretty broad range of industries including healthcare, technology and telecom, and business or industrial services. We're a pretty flexible partner. We can be a control or non-control investor and can invest anywhere from $10 million up to $130 million, or more with co-investment, across our funds. I've been at Brown Brothers for 13 years and, as you said, I lead our investment sourcing and origination efforts for our funds. So, my job is finding companies that we might want to invest in.

INDUSTRY SECTOR OUTLOOK

Todd: Awesome. Oh, you both certainly have a wealth of experience to bring to this discussion. So, Andy, I'll turn to you. I understand that Southfield Capital focuses on companies and outsourced business services. So, I'm just curious what you're seeing and if these sectors are currently experiencing headwinds, tailwinds, or somewhat of a mix?

Andy: Sure. Well, it's all relative in today's environment, but I would say, in general, outsourced business services are performing relatively well. Unlike manufacturing or distribution models, the companies that we're focused on are typically asset light nature and didn't have any supply chain disruptions due to COVID offshore sourcing problems. And I would say, by definition, outsourced business services, it's not consumer-facing. So, there's no direct exposure to certain areas that were mandated to be shut down or severely altered due to COVID laws or regulations, such as restaurants, gym franchises, travel and leisure, etc. Many of the deals we're looking at are non-discretionary spend in nature. So, one example I can give you is in our portfolio, we have a tech-enabled security services firm focused on managing, monitoring and direct security guard work. And in that case, we've been a huge value-add for our customers in the grocery and drugstore channels, where in addition to traditional loss prevention and security services, we're now offering services such as access control, limiting the number of patrons based on square footage and the enforcement of mask wearing, which is a new and unique challenge and our customers have chosen to outsource to us, which has driven a material increase in our business. So, again, a challenging environment in general, but we are seeing certain areas where there are opportunities and tailwinds.

Todd: That certainly makes sense. Appreciate that insight. So, Alice, your firm, invests across healthcare, TMT, and business services. I guess, just focusing on healthcare for the moment, where are you seeing opportunities?

Alice: Yeah. So, for the past few months, we've all been sitting at home and our team has been closely monitoring the impact of COVID on the healthcare industry. We've been thinking a lot about compelling themes that are emerging that we'd like to try to get behind and how we can invest in them. Our investment activity in healthcare dates back 30 years to our very first investment which was in a business called Columbia Hospital Corporation, whose strategy was to acquire and manage hospital systems throughout the country. Columbia merged with Hospital Corporation of America or HCA, which today is one of the largest hospital businesses in the U.S. So, that early investment gave us some initial credibility as healthcare investors. Since then, we've been very active in the space. We tend to look for businesses that both improve patient outcomes and reduce costs to pairs. So, to that end, we've owned businesses in homecare including a business called All Metro and one called Coordinated Homecare. Veterinary health, we own a vet hospital called Ethos. Behavioral health, we own an acute care behavioral hospital called Haven. Outsourced services to hospitals, we've partnered with a business called American Physician Partners, which staffs and manages emergency rooms for hospitals. And HCIT, we owned a business called Best Doctors, which we sold to Teladoc in 2017. So, this doesn't cover all of our healthcare investments, but it does give you a flavor for where we've been active and seen opportunities. Historically, we have been more heavily weighted toward investing across the healthcare provider services landscape. We're thinking about broadening that opportunity set and thinking a lot about some compelling themes that we'd like to try to get behind. Some of those might include the shift from traditional fee-for-service care to fee-for-value-based care, where reimbursement models are focused more on patient outcomes rather than services rendered. Cost containment is a big one. Costs are continuing to rise for everyone, so anything that focuses on cost containment including alternative models of care or sites of care, so moving care from a higher-cost setting to a lower-cost setting. Consumerism of healthcare is another theme that we're really interested in. So, for example, any healthcare IT tool that could better enable consumers to make their own health decisions. So, tools that could better enable patient engagement, tracking, something like a technology interface that could help get a consumer to the right provider or drug or site of care. Those are some of the areas that we're excited about finding opportunities.

ADD-ON ACQUISITION & OTHER STRATEGIES

Todd: Great. I appreciate that intel. Pretty comprehensive answers, so thank you. Andy, I see that Southfield is collaborating with the owners and managers to drive organic and add-on acquisition growth. So, I guess it's a two-part question: how has that strategy shifted due to the pandemic, and have you seen an increase in add-on deals?

Andy: Sure. So, a little bit of context here. In almost all cases at Southfield, we're the first institutional capital into a business. And that particular portfolio company has never done an acquisition before due to a number of factors. It could be lack of capital, lack of systems, or they may just flat-out not know how to do an acquisition even though they've contemplated it in the past. So, Fund II is seven platforms, and we've done 17 add-ons. If you look at the growth profile of an average portfolio company over time, it's usually 50/50 between organic growth and growth driven through acquisitions. Today, we're definitely still playing offense as it relates to add-ons. We have four add-ons for the portfolio under LOI today. We were, again, as you mentioned before, around since 2002 during and through the Great Recession. And we're seeing some similarities today where there are good companies with attractive entry points in terms of valuations. If you look numerically at our add-on activity, kind of first half of 2020 versus first half of 2019, it's actually almost the same. Deal flow has held up very well, and I think that's because entrepreneurs realized that there's value in being part of a larger, more diverse enterprise with an institutional funding source to back it up. And they may have either been impacted, or are hearing stories about people that are impacted. When you have, usually, most of your wealth tied up in this one asset, to think about some diversification, especially when it's tough-sailing out there, can be a comforting thing. So, in general, I would say it's a challenging time for obvious reasons—the pandemic, the debt markets have been unsettled, etc.—but we're still seeing plenty of interesting areas to deploy capital in what we think is an attractive risk/reward profile.

Todd: Makes sense. I'm going to stay with you, Andy, for this next question. So, Southfield Capital is primarily a control investor, but the firm is shown that it's open to minority investments, given the right circumstances. Perhaps you could expand on the scenario where a minority position may be an attractive option.

Andy: Yeah, we are. I mean, look, I think there's really two perspectives here, right? It's the owner's perspective, and then it's Southfield's perspective. From the owner's perspective, it's someone who looking to take chips off the table, or bring in capital for growth, but isn't ready to formally sell control. In many cases, we see folks who it's almost like a badge of honor, where they haven't had to incur any debt at their enterprise. For them to bring in equity instead of debt may satisfy what they're looking to accomplish. Also, again, because we're, typically first institutional capital into transaction, many cases, these entrepreneurs are looking to partner with an institution who can bring in operating expertise to help professionalize the business as it relates to ERP and accounting systems, personnel, in many cases we see under-investment in the finance department or the sales effort to give you a few examples. From a Southfield perspective, what would work for us as an investor is, we're not a passive minority investor. We like to be hands-on and add value, and our bias is always towards growth. We like to see a pathway to triple the business during our hold period. Now, obviously, in a downside scenario, we would need some guardrails set up to help manage the business if performance isn't where it needs to be, no different than a lender having covenants, but we would seek to deploy capital there where there are very viable growth opportunities, either through add-on acquisitions, or organic growth. Look, maybe down the road, that once the owner/entrepreneur gets comfortable with us, he or she may look to sell a control position to us at a later date, which will be open to that as well. So, those are a few kind of areas where I think it's important to have perspective and we'd be open to doing a minority transaction.

COFFEE BREAK WITH VERENDA GRAHAM, BDO

Todd: All right. Lots of insightful observations there, Andy, so thank you. Next, I'd like to turn to our Coffee Break guest, Verenda Graham, who is BDO's National Private Equity Tax leader, and also a Partner in the firm's Tax practice. Verenda is based in BDO's Nashville office. Let's hear what she has to say.

Verenda Graham: Thanks Todd. I thought I'd use a few moments today to talk about tax strategies we're seeing within private equity that you may want to consider to potentially help offset some of the financial impacts of the global pandemic. Preserving cash is top of mind for nearly everyone who runs a business. The CARES Act made some headway in providing loans and tax benefits to that end; the PPP Program, extending the net operating loss carry back period and changing the interest expense limitation are just a few of those examples.

However, there are other non-income tax opportunities that funds and portfolio companies may want to consider as additional ways to maximize cash flow or mitigate tax liabilities sufficiently. And these are above-the line-actions you can take now.

The first is important for businesses that are fixed-asset intensive, and that's a property tax assessment review. For many businesses, property tax is the largest state and local obligation and one of the principal regular operating expenses incurred. Unlike other taxes, property tax assessments are an ad valorem tax, meaning they are based on the estimated value of the property and are subject to varying opinions. Due to shutdowns that have occurred, either because governments had to mandate them or because companies have had to shutter their doors for lack of customer demand, property values are decreasing. However, it's important to note that assessed property values by governments tend to lag true market values in an economic recession. So one strategy to unlock the financial liquidity is by taking a fresh look at current property values with a specialist who deals with property taxes. Property tax appeals generate cash savings by challenging assessed values and reducing property tax bills.

Another area to evaluate relates to customs and duties. As you're likely aware, on July 1, 2020, the United States-Mexico-Canada Agreement, USMCA, replaced the 26-year-old North American Free Trade Agreement, NAFTA. While USMCA retains most of NAFTA's rules, several changes to the specific rules of origin are notable. There's specific information that manufacturers, importers, and exporters need to understand about USMCA, including the requirements to take advantage of duty-free treatment when shipping across the territory borders, new certification procedures, minimum data requirements and more. Many companies involved in mergers and acquisition transactions often neglect to consider the cost and the complexity of customs and duties. Determining what is and isn't subject to customs can be a complex process, which should be performed by someone intimately familiar with the tariff code and the changes that have resulted from the shift to USMCA. Customs and duties are above-the-line expenses and care should be taken to apply the USMCA guidance to obtain duty-free exchanges.

Speaking of M&A, I mentioned some of the tax benefits of the CARES Act, such as the net operating loss carrybacks. Those making deals and negotiating contracts should also consider the impact of the CARES Act on those acquisitions, and make sure that they have the correct language in their stock purchase agreement so that the buyer receives the future benefits of any NOL carrybacks. Unless it's explicit in the stock purchase agreement, the funds may go back to the seller.

And finally, there may be some areas such as credits and incentives that can be employed to offset above-the-line taxes like franchise taxes. If a business is operating in a state that assesses a franchise tax based on the equity value, often that tax can be substantial because of the premium paid for portfolio companies. Many people think that if they are in a taxable loss, they won't need or use credits and incentives. But what they are forgetting is that there's often another potential above-the-line tax that can be offset, such as franchise taxes or payroll taxes. For portfolio companies and funds looking to manage their cash outlay, these above-the-line options can do just that, while reducing the total tax liability.

And now back to you, Todd.

Todd: Thanks, Verenda. Now, let's return to our conversation with Alice Birnbaum and Andy Cook. So, before the break, we were discussing add-on acquisitions and other strategies. Alice, I know at BBH Capital, you're an experienced control and non-control investor. Just curious how that flexibility has helped you, particularly this year with the pandemic and everything else going on.

Alice: Sure. So, Todd, as you said, BBH Capital Partners, we have the flexibility to deploy equity and debt capital in both control and non-control transactions. This flexibility allows us to focus our efforts on finding the best businesses and the best management teams and then tailoring our investment to meet the objectives of that particular situation, rather than having a prescribed investment structure for which we need to find suitable opportunities. So, the playbook that BBH has been running for the past couple decades is what we continue to run today. It's to partner with owner-managers of businesses who want to maybe take some chips off the table, pursue aggressive growth which requires outside capital, or some combination of the two. So, over the past couple decades, most of our investments have been significant non-control investments. That flexibility allows us to deploy capital through all types of M&A cycles without having to change what we're doing and change our playbook. We can just continue to focus on finding the best businesses, the best management teams. I also think that when you partner with founders of companies, you need the flexibility to be a non-control investor because quite often, founders are looking for a partner who can provide them with liquidity, help them achieve their growth and the vision that they have for their business, and they don't want to give up control over their business. And those are great situations for us.

COINVESTMENT TRENDS

Todd: Sure, makes a lot of sense. Thank you. I guess let's stay with Alice on the next topic to start, and then we'll have a follow-up from Andy. So, again, BBH Capital Partners teams up with strategic co-investors as well as through co-investments with the firm's limited partners. Alice, perhaps you can describe for our audience a bit about that strategy and how it's worked for BBH.

Alice: Sure. So, there are a couple things we like about co-investing. We love co-investing with strategics or executives who can help influence the outcome of an opportunity and help bring expertise into our syndicate. We have these types of co-investment relationships in about half of our investments. The other thing we like regarding co-investments has to do with our LPs. We really like being flexible, which is sort of a theme today for us, and one of the ways that we pursue larger opportunities without having to raise a larger pool of capital is to offer co-investment opportunities to a subset of our LPs. That subset would include some of our larger institutional partners, and also high-net-worth families and family offices who do business with Brown Brothers. We want to have the flexibility to write a $200 million equity commitment like we did for EdgeConneX, our data center business, or Westrock Coffee, which we closed on in February of this year without having to make all of our investments that size. We still want to be able to have the flexibility to write a $50 million check in certain situations.

Todd: All right, good points. Good points, Alice. Andy, care to share your thoughts on co-investment trends?

Andy: Sure, I guess the first thing I'd note is for us management typically owns 20% of NewCo. Those are already significant a management rollover, which is strategic in nature. As it relates to co-invest specifically, we definitely do it. So, roughly one-third of the capital we deployed in Fund II was through co-investment from our current LPs. Our general viewpoint is we view LPs as our customers. Certain LPs have a model where they don't want to co-invest, are not equipped for it, and that's fine. And certain LPs have a model where co-invest is something they clearly want to do and it's very clear upfront at the start of the relationship and in that case, we do certainly seek to accommodate that. As it relates to true kind of third-party co-invest, we haven't done much of that. We kind of prefer our management and our current LPs to get that allocation, but we would be open to it in the case where it is a strategic co-investor who can add value. That would justify making that investment. So, it's something we're certainly open to and I've had discussions in that regard in the past.

Todd: Gotcha. Well, we've come to the end. It's really been a pleasure talking with both of you today. As I said, several times here, I know our audience will truly value your insights. I have to say, as part of the Private Equity practice at BDO, both of your firms, BBH Capital Partners and Southfield Capital, have been very good to BDO over the years with your transaction and portfolio needs, and we truly value the relationship. So, thanks for joining us today.

To our listeners, thanks so much for tuning in. If you haven't already, we'd love for you to subscribe, rate, and leave a review of the show on iTunes. Until next time, this is BDO's Private Equity PErspectives.

CONTACT:

SCOTT HENDON
Private Equity Practice Leader
214-665-0750 / shendon@bdo.com

TODD KINNEY
Director, Private Equity Industry
212-885-7485 / tkinney@bdo.com

BDO PRIVATE EQUITY PRACTICE

Strategically focused and remarkably responsive, the experienced, multidisciplinary partners and directors of BDO's Private Equity practice provide value-added assurance, tax, and advisory services for all aspects of a fund's cycle, wherever private equity firms are investing.

ABOUT BDO USA

BDO is the brand name for BDO USA, LLP, a U.S. professional services firm providing assurance, tax, and advisory services to a wide range of publicly traded and privately held companies. For more than 100 years, BDO has provided quality service through the active involvement of experienced and committed professionals. The firm serves clients through more than 65 offices and over 700 independent alliance firm locations nationwide. As an independent Member Firm of BDO International Limited, BDO serves multi-national clients through a global network of more than 88,000 people working out of more than 1,600 offices across 167 countries and territories.

BDO USA, LLP, a Delaware limited liability partnership, is the U.S. member of BDO International Limited, a UK company limited by guarantee, and forms part of the international BDO network of independent member firms. BDO is the brand name for the BDO network and for each of the BDO Member Firms. For more information please visit: www.bdo.com.

Material discussed is meant to provide general information and should not be acted on without professional advice tailored to your needs.

© 2020 BDO USA, LLP. All rights reserved.

People who know Private Equity, know BDO.
www.bdo.com/**privateequity**