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AN ABSOLUTE PRIORITY FOR BANKRUPTCY PROFESSIONALS

Bad roll

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Logic has it that in highly fragmented industries, economies of scale are desirable. What's so seductive is that this scale often seems so relatively easy to pick up. Take on debt to roll up five, 10 or 20 mom-and-pop businesses in a given sector, integrate them, then take the whole thing public.

In the 1990s, such rollups became a craze. For example, **U.S. Office Products Inc.** collected 206 or so companies in the mid-1990s, with 97 in 1997 alone. The company reached nearly \$1.5 billion in sales by 2001 and had diversified beyond office products to printing services and airline ticket sales.

Other industries appeared ripe for rollups as well. Auto-parts companies (**Tower Automotive Inc.**, **Oxford Automotive Inc.**, **Johnson Controls Inc.**) became platforms for consolidators. **Alderwoods Group Inc.** (formerly Loewen Group) collected funeral homes. Archibald Candy Corp. swept up candy retailers.

"There was a lot of money available in 1998," says Rhys T. Wilson, a partner at Atlanta law firm **Robins, Kaplan, Miller & Ciresi LLP**, who conducted a study of rollups. "If I was in the right industry, I could get a ton of money just based on loose projections."

Now many of those rollups have crashed. Wilbur Ross' success consolidating the steel industry notwithstanding, platform companies currently litter the bankruptcy court or have ceased to exist. "A lot of people got burned during the '90s," says Wilson. "There were hundreds of millions of dollars lost in bad rollups."

The Chapter 11 wave started with Alderwoods on June 1, 1999, but it really gained momentum as the bubble was bursting in 2001. **Railworks Corp.** (a consolidator of railroad construction and support services companies), **USA Floral Products Inc.** (flower distributorships), **Waste Systems International Inc.** (landfills and waste remediation companies), **Excite@Home Corp.** (Internet service providers) and U.S. Office Products all filed then. In 2002 came Archibald, **Metals USA Inc.** (metal processors) and **Encompass Services Corp.**, a specialty contractor consolidator that actually merged with another rollup company, Group Maintenance America Corp., in 1999, overloading the combined entity with debt. Archibald would file for bankruptcy again in 2004. (Oxford, too, filed in 2002 and then again in 2004.)

Nor have the filings ended. **Omni Facility Services Inc.**, which started consolidating the landscaping business in 1998, filed for Chapter 11 last June. Tower Automotive made its bankruptcy petition on Feb. 2.

It's a situation far removed from what consolidators experienced before 2000. According to Wilson, consolidators were paying an average of 6 times pretax earnings for private companies, bundling them, then selling out via initial public offerings at multiples of 13.5 or so. Some companies that had sales of \$50 million or so a few years earlier found themselves becoming national brands through rollups. Venture Economics Information Services, a research firm, in 1998 claimed that between 1996 and 1997, rollups provided investors with an average return of 63.5%.

Small wonder that the money so easily flowed to consolidators. About \$30 billion was invested in rollups in the late 1990s. Companies snatched up laundromats, auto dealerships and nursing homes in bunches.

Warnings bells rang. "Strategic errors made by the consolidators will not show up for at least one or two more years," predicted Adam J. Fein, now president of **Pembroke Consulting**, in 1999.

And they did, in big ways. U.S. Office Products, for example, suffered a net loss of \$804.1 million at the same time its sales hit \$1.5 billion.

Nearly every expert cites a trinity of interlocking factors for why rollups didn't work: poor senior management; lack of integration; poor deal structure. Some see them all as the same thing. "Management uber Alles," says Tower Automotive's debtor counsel, James Sprayregen of **Kirkland & Ellis LLP**. "Integration and consolidation problems are just proxies for bad management."

Often, a platform company would retain the same management as it made add-on acquisitions, putting executives who knew how to run an organization with tens of millions of sales in the position of running one with billions. As one professional close to the bankruptcy case of construction equipment rental consolidator **National Equipment Services Inc.** says, "You can't put someone used to \$30 million in debt in charge of a company with \$900 million and expect the same success."

Over time, integration becomes more difficult. "If you acquire the old management, those owner-operators will likely have a lot of trouble in the new structure," says Craig S. Dean, a principal at **AEG Partners**.

Successful consolidations often emerged only after outside professionals were brought in to manage the company. That's something Ross' private equity firm, **WL Ross & Co.**, did when he bought five steelmakers out of bankruptcy and bundled them into one, International Steel Group, managed by nonspecialists accustomed to running public companies.

"The nuts-and-bolts operations guys are absolutely essential, but you need the administrator to put the big pieces together," says Joseph Cioffi, a partner at New York law firm **Davis & Gilbert LLP**.

Even that's no guarantee of success. Sometimes businesses such as car dealerships thrive on an individual's personality and don't fit into a larger, more corporate structure. Also, the nuts-and-bolters who remain still have to be given incentives, especially if they were bought out for cash during the rollup.

"Incentives have to be driven by strong results," says Bernard Katz, partner-in-charge of **J.H. Cohn LLP**'s business investigation services group. "There needs to be a way of giving a backend piece of the business to the sellers,"

Katz points to the failure of **FPA Medical Management**, a rollup of private physician practices, as an example. FPA structured payments in a manner that didn't account for patient load, so there

was no incentive for doctors to perform as they did before the deal, he says. The result: FPA, which had a market value of \$1.37 billion in 1997, filed for Chapter 11 the next year and sold its assets for only about \$110 million.

Even if personalities mesh, systems might not. Witness National Equipment Services, which consolidated in the construction-equipment rental sector. Prior to filing for Chapter 11, National Equipment had more 30 different systems to process orders, somehow avoiding the most obvious economy of scale for a rollup. "Companies were too busy buying and didn't spend enough time running themselves," Pembroke's Fein says.

Another distraction was planning a quick exit for a fat payday. In fact, companies started doing rollups as they went public. These "poof IPOs" took advantage of pooling-of-interest accounting, Wilson says. Consolidators could buy companies without worrying about the effect goodwill would have on earnings, and thus, their newly issued shares.

But the Securities and Exchange Commission in 1996 required companies that were attempting to make acquisitions while going public to use purchase accounting, which required that goodwill charges be taken against earnings. This forced consolidators to stay with the company for a longer period before it could launch the IPO, something many of them found too difficult. And when the Financial Accounting Standards Board eliminated the pooling method altogether in June 2001, "poofs" literally vanished into thin air.

Buyers then started offering sellers earnouts, or a stream of future profits. But that incentive method soured when earnings often failed to reach projections. "It's a classic story of acquisitions," says J.H. Cohn's Katz. "People want to believe that two and two can make five, but oftentimes the deal doesn't even make it to four," he says.

So companies would just keep on growing and taking on debt until they couldn't sustain themselves, and eventually fall apart.

Rollups continue, but they aren't anywhere as widespread as they used to be. **Quest Diagnostics Inc.**, for instance, has acquired \$10 billion worth of laboratories and patient service centers in add-on deals.

Indeed, there are successful consolidators. Private equity firm **GTCR Golder Rauner LLC** has acquired more than 60 companies in healthcare, brand products and other niche industries. And while GTCR looks like it's engaging in rollups, it draws a distinction. "We consider what we do to be industry consolidation, not rolling up," says Vincent J. Hemmer a principal at GTCR. "First and foremost, we only back a strong management team. We start almost three-quarters of our acquisitions by forming a team [and] then acquiring the platform company."

One of GTCR's platform companies is **Prestige Brands Inc.**, which last year bought four over-the-counter pharmaceutical and household goods companies, integrated them and generated \$13 million in synergies. Prestige launched an IPO in February.

Another GTCR consolidation success has been **Coinmach Service Corp.**, which started out as a single laundry facility. With GTCR's patient backing over the past 10 years, it's bought up others in the industry and has grown into one of the largest laundry machine providers in the U.S. with more than 660,000 machines.

Then there's Ross. Starting in 2002, he began picking up steel assets through bankruptcy court auctions, even in the face of union, trade, and legacy pension and healthcare cost issues plaguing the industry. First he bought LTV Corp., then he rolled up four other bankrupt steelmakers — Bethlehem Steel Corp., Acme Metals Inc., Weirton Steel Corp. and Georgetown Steel Co. — to form platform company International Steel Group, or ISG. Buying those assets via

Section 363 of the federal bankruptcy code enabled Ross not only to get them cheaply, but also largely free from many of the liabilities and legacy costs that led to the steelmakers' downfall.

In October came the payoff. Ross agreed to sell 90% of ISG to London-based **LNM Group** for \$4.5 billion, giving him an 11-fold profit.

Ross is now rolling up the textile and coal sectors, again buying distressed or bankrupt assets. His International Textile Group has made deals for **Cone Mills Inc.** and **WestPoint Stevens Inc.**, though neither has gone smoothly. Meanwhile, in April, his International Coal Group, or IGC, announced it was buying the remaining interests in AnkerCoal Group Inc. and CoalQuest Development LLC, distressed coal companies in which IGC already had significant investment. IGC had already bought the assets of **Horizon Natural Resources** out of bankruptcy in October. IGC, the fourth-largest coal producer in the world with annual sales expected to reach \$1 billion, is hoping to launch its IPO by June.

But Ross' success wasn't just in buying assets on the cheap. In the steel industry, he took steps to clean up management and inspire rank and file. At LTV, he rehired old staff to run the company. At Bethlehem, he cut management levels in half and provided performance incentives for workers. Combined, he was able to realize significant economies of scale from consolidation of the five steelmakers by finding lower cost sources of base materials.

There's evidence of a rollup renaissance in the rural telecom market, where **Citizens Communications Co.**, **Alltel Communications** and **CenturyTel Inc.** are all picking up local telephone lines and companies. "When entering into a local market, the best way to get customers is to buy a company already there," Fein says.

And as large defense contractors jettison assets, it seems as if **L-3 Communications Holdings Inc.**, a New York-based communications and surveillance product manufacturer, is always there to pick them up.

But as far as a rebirth of the rollup movement of five years ago, forget it. For one thing, says Katz, money isn't as accessible as it was then. For another, the horror stories of recent years are too fresh in everyone's minds.

That's especially since plenty of platform companies are still trying to find their way out of bankruptcy. Omni Facility sold off its operating arms and is looking to liquidate. Oxford recently exited from its second Chapter 11 stay after liquidating its U.S. assets; it's rebuilding around its European assets. As for Tower, says Jim Gillette, automotive analyst at **CSM Worldwide**, the next likely move is to centralize management. The company has already announced that it's closing plants and laying off workers.

Indeed, consolidators have found that oversight can't be too diffuse. Customer quality is the first thing to suffer if it does. "You can't be big just for the sake of being big," Fein says. "You have to pass on something to the customer."

Even for those tempted to roll up a fragmented sector, the economics don't favor it. "Consolidation is harder now because it's hard to find quality companies that are willing to sell at attractive prices," Wilson says.

And even when you can, the end game — going public — isn't as easy as it used to be.

"You can't consolidate, then go public like you could," Fein says. "But there are still plenty of niches around that a savvy investor can find and take advantage of."