



High Rollers

A new generation of financial hot-shots are making their fortunes on roll-ups -- risky consolidations of IPOs. The risks are even greater for the CFO in the middle.

[Joseph McCafferty](#), CFO Magazine

April 1, 1998

The day before last Thanksgiving, then-39-year-old financial whiz Jonathan Ledecy pulled off a bold deal. He went to the public equity markets and raised half a billion dollars for his company, Consolidation Capital Corp., in an initial public offering. What made this deal so brazen was not just that Consolidation had yet to earn a dime. In fact it had no revenues, no assets, no operating history, and no identity. Ledecy hadn't even settled on an industry for his new venture. He raised the capital in a blind pool on the strength of his reputation alone.

That reputation rests on his ability to build so-called roll-ups. These are companies created to consolidate fragmented industries by gobbling up small mom-and-pop businesses. But unlike regular consolidations, in which strong industry leaders buy up weaker rivals, roll-ups are started from scratch.

Here's how it works: A promoter like Ledecy finds between 5 and 10 private companies in the same industry that agree to sell their businesses for cash and stock from the proceeds of an IPO that has yet to occur. The IPO and the merger of the founding companies occur simultaneously. Using its stock as currency, the new company continues the acquisition binge in the hope of eventually creating a national power-house that will dominate the industry.

Roll-ups are red hot on Wall Street. At last count, about 90 roll-ups had gone public since one of the first, U.S. Delivery Systems Inc., debuted in 1994, including 50 in 1997 alone. And the frenzy continues, with an average of 5 coming to market each week.

Also called "poof" companies because of the way they seem to materialize out of thin air, roll-ups are consolidating such industries as funeral homes, dry cleaners, flower wholesalers, bus lines, home builders, and air-conditioning repair services. In fact, roll-ups have popped up in every fragmented industry.

But the risks in these deals are as great as the rewards. "There are so many hurdles to overcome that it is very difficult to pull these deals off," says Patrick Sullivan, partner in charge of acquisition advisory services for Coopers & Lybrand LLP in Los Angeles.

That hasn't stopped Ledecy and those like him from trying. They are financial cowboys, '90s style. But unlike 1980s' corporate raiders T. Boone Pickens and Carl Icahn, who made a killing preying on conglomerates and selling off their pieces, these cowboys make money by putting the pieces together. In that sense, roll-ups are the reverse of the leveraged buyouts of the '80s. Sullivan calls them "leveraged buildups," because they leverage equity to build the company.

The king of consolidators is H. Wayne Huizenga, owner of the Florida Marlins baseball team. Huizenga pioneered the technique by rolling up garbage-truck businesses to create Waste Management Inc., the nation's largest waste company. He went on to create the largest video chain, Blockbuster Video, and is trying to work his magic on the auto retail industry through Republic Industries Inc.

Now promoters have taken the concept to the next level, with roll-up IPOs. Ledecy, who created one of the earliest and now largest roll-ups, U.S. Office Products Co. (USOP), has since created three more--USA Floral Products Inc., a flower distributor; Consolidation Capital; and UniCapital Corp., a consolidator of commercial leasing firms that filed to go public in February. These three were all done in the past year, while Huizenga took 25 years to get to his third.

The man with the most notches on his belt, though, is Steve Harter, chairman of Notre Capital Ventures II, a Houston-based investment bank. Harter has six bronze bulls, awarded by the New York Stock Exchange when a company is listed there, to prove it. He sharpened his skills doing M&A work for Arthur Andersen LLP and, later, analyzing acquisition candidates for Allwaste Inc., a Houston environmental-waste company. After orchestrating the U.S. Delivery roll-up, he completed five more, including some of the most successful yet. Coach USA Inc., a roll-up in the motor coach industry, went public in May 1996 at \$14 a share and has more than doubled to a recent close of \$38. Another of Harter's creations, Metals USA, is up 60 percent, to a recent high of \$16 since its initial offering last July.

Harter also started Comfort Systems USA Inc., which is out to consolidate the air conditioning and heating industry; Physicians Resource Group Inc., a consolidator of ophthalmology practices; and his most recent IPO, Home USA Inc., a consolidator of mobile-home retailers that went public last November.

FEES THAT MATCH THE P/Es

Clearly, the success stories are alluring. But roll-ups have their critics. Among them, oddly enough, are the stronger players, who take aim at less-scrupulous copycats. "There is a tremendous amount of financial alchemy going on," says Harter. What concerns them is that roll-ups can be a house of cards. After the IPO, the roll-up continues to acquire companies, using equity it raised at high P/E ratios to buy smaller private companies that trade at lower multiples. This arbitrage helps maintain the roll-up's high ratio and the acquisition binge; it's a machine that feeds itself.

But P/Es are as much about investors' perceptions as about earnings. If investors come to doubt that earnings can be sustained, the multiple will come down, throwing sand into the gears. And it's virtually a foregone conclusion that every industry will ultimately run out of suitable acquisition candidates. Yet consolidators almost always cite the arbitrage as the key to their strategy. "It is the concept," says Leducky. "It's a gerbil wheel." At that point, investors in roll-ups will have to worry whether their company can effectively manage what it owns.

Trouble is, roll-ups often lack experienced management teams. "Roll-ups tend to be headed by executives who have experience in roll-ups, but not in the industry," says Samuel Hayes, a finance professor at Harvard Business School. That, he says, can be a recipe for disaster. Indeed, some observers contend that once traditional measures of performance are applied, like comparison of same-store sales or other measures of operational growth, lofty P/E ratios will fall back to earth even before a roll-up runs out of potential targets.

"Fueling growth by buying companies with lower P/E ratios has long been discredited as a strategy that has no rationale," says Geoffrey Brooks, an assistant professor at the University of Pennsylvania's Wharton School. He cites the failure of diversification in the 1960s as a prime example. Jeffrey Evans, vice president of research at Credit Lyonnais Securities (U.S.A.) Inc., agrees. "It's the greater-fool theory. At some point it has to stop, and someone is left holding the bag." Often that includes the CFO.

Consider Fine Host Corp. The Greenwich, Connecticut-based food-service firm set out to consolidate small players that run concessions and cafeterias at universities, corporations, and sports arenas. It went public in the summer of 1996 at \$12 a share and shot up to \$43 by the fall, buoyed by a flurry of acquisitions. But in April 1997, the CFO, Nelson A. Barber, was suddenly demoted to treasurer, and by October analysts were complaining about a lack of information. In December, the stock fell 64 percent when the company removed Barber and its CEO, Richard E. Kerley. The company later admitted it had recognized some income before it was earned and incorrectly capitalized certain expenses, and restated earnings back to 1994, incurring losses instead of profits. The Securities and Exchange Commission is conducting an informal investigation.

In many cases, though, the promoters and underwriters make a killing whether the roll-ups bear fruit or not. "The people who financially engineer these deals make an enormous amount of money," says Patrick Hurley, partner and M&A director at Howard, Lawson & Co., a Philadelphia investment bank. He says that the promoters get a large equity stake for a very small up-front investment. "If they have been able to sell stock, they've made money whether the roll-up succeeded or not." (Often they are locked into agreements that prevent them from selling for 12 to 18 months.) Up-front fees for underwriting, accounting, and legal services are also high due to the complexity of the deals. Hurley estimates that total managers' fees related to completed roll-ups, including the management fee, underwriting fee, and selling concession, are about 50 percent higher than for normal IPOs.

When roll-ups do go wrong, the underlying problem is most often a focus on the financial engineering at the expense of improving operating efficiencies. "The biggest risk in this whole phenomenon is that acquirers lose sight of the nuts and bolts," says Evans. "They just buy things to buy them." Perhaps this point is best illustrated by the title of the keynote presentation, "It's Easier to Buy 'Em Than to Run 'Em," at the upcoming second annual Industry Roll-Ups Conference, a how-to course on the strategy.

CONFLICT-RIDDEN?

Some roll-up cowboys seem to have problems handling the conflicts of interest that can arise. Consider Leducky. One of the companies he merged into USOP as it went public was Sharp Pencil, of which he himself was majority owner. Although he used \$17.6 million of the February 1995 IPO proceeds to, in effect, buy himself out, Leducky did not think it necessary to get an independent appraisal of Sharp's value, according to USOP's prospectus. Leducky, who denies any conflict of interest, says he got the same multiple for Sharp Pencil as the other founding companies. "They were all valued in the same way. Everyone negotiated the deal

together." Still, investors had little way of knowing whether the price was fair, because none of the financial information about Sharp in USOP's prospectus was audited, according to the filing.

Ledecky's conflicts of interest didn't end once he paid himself for Sharp. He took Consolidation Capital public even while serving as chairman of USOP and USA Floral. That raised the risk that he would make acquisitions for Consolidation Capital that might have as easily served USOP's and USA Floral's interests. "[Management] may have conflicts of interest in determining to which entity a particular business opportunity should be presented," says Consolidation Capital's prospectus. And even if USOP, USA Floral, and Consolidation Capital weren't competing for the same businesses, Ledecy's time and attention could not be fully devoted to the interests of either or any of the companies, a factor that was also noted in the prospectus. Ledecy announced his resignation as chairman of USOP in January, effective this month.

MRI UNDER SIEGE

Ledecky isn't the only roll-up artist to have engaged in questionable self-dealing. Gary Siegler, chairman of Medical Resources Inc. (MRI), a consolidator of medical imaging centers that went public in 1993, is also accused of indiscretions. The company is facing lawsuits related to questionable payments it made to 712 Advisory Services, a company Siegler controlled. Former managers allege that the advisory firm didn't earn the \$1.5 million it was paid in cash and securities to advise on a number of MRI's acquisitions in 1997. Also, the ex-managers contend that Siegler arranged for MRI to take a \$3 million stake in a private plane, which they claim was unnecessary. They allege that Siegler, who earned his wings working for Carl Icahn in the 1980s, wanted the plane for private use.

In early November, CFO John O'Malley was fired, and two other executives, chief operating officer William Farrell and general counsel Gary Fields, resigned after they raised the matter with the board and called for Siegler's ouster. They have since filed whistle-blower lawsuits. The company disclosed the departure of its CFO in a press release that also warned of earnings shortfalls, causing the stock to tumble to 83/4 from a high of 205/8 just a month earlier.

The company has launched an internal investigation, and is also being investigated by the New Jersey Attorney General's office, according to company filings.

WHY STOP AT OFFICE SUPPLIES?

If Ledecy and Harter are the two founding fathers of roll-ups, their strategies couldn't be more different. Ledecy is a hands-on manager, often taking the position of chairman, while Harter builds the roll-ups and lets others with more experience in the industry run them. Harter likes to move slowly, focusing on integration of the acquired companies; Ledecy moves fast to build up a big organization as quickly as possible. Perhaps nowhere is that more evident than at USOP.

Sharp Pencil was one of six privately owned office-supply companies that Ledecy put together. But he didn't stop there. Two years and 220 acquisitions later, USOP was a member of the Fortune 500, with \$3.8 billion in revenues. The stock had gone from \$7.50 at the offering to a high of \$27 in the summer of 1996. "It was crazy," says Donald Platt, senior vice president and CFO of the Washington, D.C., company. Of course, Platt relied heavily on outside resources, including a team of lawyers and accountants, to get the deals done.

Within these 220 acquisitions, are there no bad apples? "Not yet," says Platt. "We restricted them to well-managed, profitable companies. At worst, we would still be making money."

The trouble was, after grabbing that many companies, USOP had a patchwork of firms in six different businesses, including office supplies, travel, coffee sales, printing, and even educational supplies. The idea was to focus on the customer and provide one-stop shopping for corporate purchasers, rather than a tight industry niche.

At the pace Ledecy was moving, however, it was nearly impossible to attain significant economies of scale. Little integration was accomplished. Once purchased, in fact, a company was pretty much left alone. Ledecy not only kept existing management teams intact; he insisted they remain, locking them in with long-term agreements. Even the names of the companies were unchanged. And in only a few cases were warehouses and other overhead shared. "If you start to consolidate too quickly, you make the wrong decisions," says Platt. And buying well-run businesses left little room for improvement. Any integration they did do failed to increase margins. As a percentage of revenues, gross profit actually decreased from 28.1 percent for the nine months ended January 25, 1997, to 27.9 percent for the nine months ended January 24, 1998.

Without improving efficiency, USOP needed to keep up the acquisition pace to continue growing and keep the P/E ratio high. "Stock value is important. If you don't trade at a healthy multiple, using your stock as currency has less value," says Platt. "It absolutely feeds on itself. Success breeds success."

Until something finally gives. Without enough acquisitions or internal growth to drive earnings, USOP started to stumble. The stock fell to \$16 at the end of 1997 from a high of \$27.

In January, the company conceded that it could no longer sustain the current strategy, and reversed course. It decided to spin off four of the units--travel services, printing, educational supplies, and technology--and focus on its core businesses of office supplies, furniture, and beverages. And the executive who replaced Ledecy at the helm, Thomas Morgan, plans to do exactly what his predecessor couldn't: integrate with the aim of increasing efficiency through economies of scale. Just to be safe, the company also tapped the debt market for an additional \$800 million to help fund a \$1 billion stock buyback.

HELP WANTED

Harter has taken a different approach. In contrast to Ledecy, he intensely scrutinizes each acquisition and integrates each purchase completely into the organization. And he focuses on industries that have much to gain from better management, increased purchasing power, and increased efficiency. "If the customer doesn't benefit at the end of the day, you haven't created value," says Harter.

But he, too, has stumbled on occasion. Take, for instance, Physicians Resource Group (PRG), which Harter established as a roll-up in June 1995 to consolidate ophthalmology practices nationwide. It quickly grew from 10 practices at the outset to 177 by the fall of 1997. But costs grew even more rapidly. In the third quarter of 1997, the company reported a loss of \$18.4 million, even though revenues grew to more than \$100 million from \$60 million a year earlier. Harter refused to comment on PRG's problems, but Richard D'Amico, PRG's chief administrative officer, admitted to the Dallas Morning News, "We grew too fast." Last November the company, now the largest eye-care group of practices in the nation, announced it was holding off on any more acquisitions, closing 14 of its troubled practices.

It is a common occurrence in roll-ups, says George Koo, an analyst with Burnham Securities Inc., in New York. "They move too quickly, projections aren't conservative enough, and costs get out of control." That's created plenty of opportunities for acquisition-minded CFOs. "In a roll-up, each of the things a CFO focuses on--raising capital, making acquisitions, improving operations, and talking to Wall Street--is at a fever pitch all the time," says Mike Kirksey, senior vice president and CFO at Metals USA, a Houston-based consolidator of metals processing firms. Perhaps the consolidation trail wouldn't have been so rough for PRG if it had had a strong CFO. For the two and a half years the company has been public, there have been no less than three finance chiefs.

"The CFO is crucial to the success of a roll-up," adds Kirksey. "The complexity requires someone with the skill to do the deals, but also to make them work, operationally."

Harter turned to Kirksey, former vice president of strategic planning at Keystone International Inc., a publicly traded valves and controls manufacturer in Houston, when he wanted to consolidate the metals-processing industry. Along with CEO Arthur French, also from Keystone, they created Metals USA. In any roll-up he starts, Harter has used professionals from the industry to run the business, though he has sat on four of his six companies' boards. "My ego doesn't need to be called 'chairman,'" he says.

THE GOLDEN GOOSE

Harter at least has learned from his mistakes. Has Ledecy? He claims so. "One of the things I learned from U.S. Office Products is to focus," he says. But he already may be forgetting that lesson. In January, just days after USOP announced it was reversing its consolidation strategy and instead spinning off four separate roll-ups, Ledecy announced his plans for Consolidation Capital. The company will provide a variety of services to retail and office-building owners, including pest control, landscaping, and equipment maintenance. In February, it announced plans to acquire seven electrical contractors for \$138 million, half of which would come in Consolidation Capital stock. When the acquisition is completed, Consolidation will be the fourth-largest electrical contractor in the United States. In a time when focusing on a niche is the standard, that will be a hard sell on Wall Street.

Eventually, many roll-ups will go the way of the LBO. When the stock market turns down, they will have a harder time using equity for acquisitions no matter how profitable they are. The cowboys themselves fear that day will come even sooner, as their corporate cattle drives fall victim to their own success.

"I have seen guys try to put these things together with mass mailings and Internet sites," says Harter. Fair warning for CFOs tempted to saddle up.

Joseph McCafferty is an associate editor at CFO.

RAISING SEC EYEBROWS

Regulators aren't quite ready to roll over.

----- Roll-ups are also receiving their fair share of scrutiny from the SEC. Part of the commission's concern lies in the accounting for roll-ups. In August 1996, the commission dealt a blow to the structure with Staff Accounting Bulletin No. 97, which pertains to accounting for business combinations. Until then, many roll-up artists managed to avoid the need to write off goodwill, the premium over the book value that an acquirer pays for a company's assets. They took advantage of a loophole that let them carry the acquired assets at historical cost, rather than at fair-market value, or shifted the goodwill to one of the minority shareholders. With those options ruled out by SAB 97, roll-ups can avoid goodwill only by qualifying for pooling-of-interest accounting, and few can surmount all the hurdles involved.

At first, many thought the ruling would kill roll-ups, because amortization of goodwill would be an on-going drag on earnings. "Everyone was a little concerned when SAB 97 came out," says Patrick Hurley of investment bank Howard, Lawson & Co. But so far, roll-ups have managed to defy the doubters. "They rolled right over the goodwill hurdle" by convincing the investment community to look at cash flow instead of earnings per share, says Hurley.

Although the SEC has not publicly indicated any further concern about roll-ups, Hurley says it is taking a closer look and has invited his firm to make a presentation to the staff on the nuts and bolts. The SEC is particularly interested in disclosure, says George Moosburner, a senior vice president of investment banking at Howard, Lawson. "Are we appropriately disclosing in a manner that can be understood by the investing public?" he asks. "The accounting gets very complicated because you're trying to present pro-forma financial results for a company that doesn't exist. More things go wrong."

The frenzied acquisition pace adds to the complexity, according to Donald Platt, senior vice president and CFO of U.S. Office Products. "You don't know if you're buying your way into profitability or operating your way there," he says. "It's always a big problem with roll-ups." J.McC.

----- For more information:

Second Annual Industry Roll-ups Conference, April 20-21 The Grand Hyatt New York City Sponsored by IBC Group 1-508-481-6400 www.ibcusa.com/conf/rollup

© CFO Publishing Corporation 2007. All rights reserved.