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Service firms receiving multiple buyout offers from private equity investors

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Hope Plumbing's Austin Walker loads pipes during a supply pickup. The local company is receiving acquisition offers of eight to 12 times earnings. (IBJ photo/Eric Learned)

While glitzy tech companies get most of the attention when it comes to capital markets, one of the hottest investment targets might also be one of the least sexy.

Erwin

No matter. Private equity firms are simply head over heels for service firms such as plumbing and heating and air-conditioning companies.

The attraction to service companies has existed for some time, but it has ticked up over the last three to four years. Then, last spring—as the pandemic took hold—interest skyrocketed.

That's in part because the companies have continued to do well—even grow rapidly—as people hunkered down at home.

Indianapolis-based equity investment firm Monument MicroCap Partners LLC has invested in three service firms this year, the most recent a Florida roofing company.

"Service companies have always been of interest to us, but I think the pandemic has accelerated that interest for a lot of investors," said Bob Erwin, Monument CEO.

Foster

The red-hot market has even caught some in the service sector by surprise.

"Some people in our industry are calling this the gold rush," said Chad Peterman, president and co-owner of Indianapolis-based Peterman Heating, Cooling and Plumbing. "There are service companies out there being sold for previously unheard-of amounts—12 to 17 times earnings." That's at least twice the normal price, he said.

"Service companies don't have the sizzle that tech or software companies have, but these are typically companies that are consistent growers, that throw off a lot of cash and don't require a lot of investment," said Mark Foster, managing partner for Kirr Marbach & Co., a Columbus-based financial management firm. "And typically, they're recession-resistant. The pandemic and uncertain economic future has prompted a real emphasis on that."

Jack Hope, owner of Indianapolis-based Hope Plumbing, was accustomed to occasional approaches over the years from private-equity investors.


Hope

Hope, who started his service firm 13 years ago and has grown it to 70 employees, typically had one or two inquiries a year. But the last nine months have been like nothing he's ever seen.

"I'm getting approached at least once a month by equity investors," Hope said. "And they're more aggressive than ever. They're very, very aggressive."

Typically, he said, equity investors have offered him a price in the range of three to six times his company's annual earnings. This year, Hope is receiving offers of eight to 12 times earnings.

"I've been approached—and by serious parties—more this year than I have all other years combined," Hope said.

Peterman, who has no interest in selling, said he's getting calls from would-be buyers two to three times a week. "I think it has something to do with the pandemic and the fact we've been deemed essential."

Hope, 40, said the offers are tempting, but he and his 38-year-old business partner, Brad Persic, are too young to sell out.

"If we were closer to retirement, these offers would be very appealing," Hope said.

'Ripe to sell'

But Hope and Persic are somewhat unusual. The average age of service company owners is part of what's driving the trend, Foster said. And it's the reason many believe the heat will continue into 2021.


Scolnik

"So many of these companies are owned by baby boomers in their late 50s and 60s that investors think this is a sector that is ripe to sell," he said.

Sectors like plumbing, heating-cooling and roofing firms are prime consolidation targets because they're highly fragmented. The industry also contains some regional and national players, giving private-equity investors the opportunity to scoop up small and midsize firms, increase back-office efficiencies, expand the business, then sell for a tidy profit to industry behemoths in four to seven years—often a target turnaround timetable.

"Our revenue is up 25%-30% this year," Hope said. "We've been growing at a strong double-digit clip for a couple of years. That's another reason I don't want to sell. As our company grows, the offers will only get larger."

"The service these firms provide are absolutely necessary for people to live their ordinary, daily lives," said Glenn Scolnik, Monument MicroCap chairman and managing partner. "They've demonstrated this year that

Hot market

Private equity firms have become increasingly interested in service companies, including plumbing and HVAC operations, but demand this year is hotter than ever.

General appeal:

- A plethora of willing sellers, because many are owned by baby boomers looking to retire.
- Market is highly fragmented, providing lots of opportunities to increase back-office efficiencies through consolidation.
- Market has some regional and national operators, so investors can hope to profit from a resale in four to seven years.
- Revenue and profit projections are largely reliable.
- Service firms are somewhat recession-proof.

Standouts that catch an investor's eye:

- Experienced and stable management that will stay after the acquisition.
- 25% to 35% of revenue is maintenance and repairs, providing higher profit margins than installations.
- Customer base includes government, military, health care and education, all somewhat recession-proof.
- At least $10 million in annual revenue and $3 million in profit, with steady 25% to 30% gross profit projections.
- Revenue focuses on short-term, diversified projects with few change orders and quick payments.

Source: IBJ research

they're the dictionary definition of an essential business. We're definitely looking to buy controlling interest in more service firms."

'Specific characteristics'

But private equity investors are not just snapping up any company whose employees turn a wrench, patch a leak or wield a hammer.

Abbasi

"When investors look at service firms, there are a list of specific characteristics they're looking for to maximize the investment," said Faraz Abbasi, senior partner for Indianapolis-based Centerfield Capital Partners.

The No. 1 factor is a strong management team.

Monument's Erwin said that, while his firm is looking to take a controlling interest in service firms, it's also looking for an owner willing to stay after the acquisition.

"You need not only a strong owner," he said, "but a strong team below that. Having a management team that is strong, honest, hard-working and motivated is perfect for us."

Scolnik noted that the service industry is "a relationship business. And a strong management team can help maintain critical relationships essential for the company's continued growth."

Private-equity investors are looking for service firms with at least $10 million in annual revenue and $3 million in gross profit. But the makeup of that revenue also is key.

Investors want at least 25% to 30% of revenue to come from service contracts, maintenance and repairs. Maintenance and repairs have higher profit margins and are less cyclical than installations. Those sources of cash, along with service contracts, create a recurring revenue stream.

Investors also look for firms with customers in the government, military, health care and education sectors.

"Revenue in those sectors is even more recession-proof and less cyclical than residential and commercial," Abbasi said.

Private equity investors also favor service firms with short-term diversified projects where cash comes in quickly and change orders are rare.

Hunter or hunted

One ideal scenario, Abbasi said, is to buy smaller firms for smaller price tags—four to six times annual earnings—then combine them and sell at a price seven to nine times annual earnings.

But even relatively big fish are being targeted this year.

Peterman, which was founded in 1986 by Pete Peterman—Chad's father—has 190 full-time employees after adding 90 this year to keep up with demand. The company pulls in 40% of its revenue through service, so it's no wonder investors are interested.

Chad Peterman, a member of Nexstar Network, a national best practices organization consisting of more than 700 residential heating, plumbing, air conditioning and electrical firms, said the acquisitions activity has been the main topic of conversation among members the last nine months.

“Believe me, we’re not the only ones getting calls every week,” Peterman said. “I’ve never seen a time like this before. Everyone in the industry understands this is out there.”

Chad Peterman, 34, and his brother Tyler, 31—who recently took over the firm from their father—are more interested in being the hunter than the hunted.

“We’ve had very strong growth in 2020, and we’re looking to expand organically and through acquisitions,” Peterman said. “A lot of these service-firm owners are baby boomers like my dad and are ready to retire. We send letters out every month looking to acquire other firms.”

Peterman expects to close on one acquisition this month, and the company is “in [acquisition] talks with a couple more,” he said. “It’s a good time to be in that position to make acquisitions in this sector. We think there’s a bright future, not just for our company, but in the service sector overall.”