PE Follows Commercial HVAC Into Retrofit Era

HVAC heating and cooling ventilation air conditioning system. HacKLeR/Shutterstock

Private equity, which has long prized fixed-service contracts and break/fix businesses in the red-hot HVAC market, is seeing the benefits of backing businesses offering upgrades and replacement work as U.S. commercial buildings enter a retrofit cycle.

By Nikitha Sattiraju

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Private equity is expanding its horizons in commercial HVAC and plumbing services as the asset class looks beyond the words "recurring" and "break/fix."

A growing number of investors are showing interest in companies that, in addition to the prized maintenance and repair services, provide less frequent retrofit and replacement work as energy efficiency and aging equipment place system upgrades in the spotlight.

Sponsors are also not shying away from betting on businesses with exposure to new construction amid growth in domestic manufacturing.

Baltimore-based lower middle market firm Slate Capital Group LLC on June 21, for instance, made a growth investment in Vertical Mechanical Group, which installs HVAC and plumbing systems in new commercial constructions, retrofits existing infrastructure and provides maintenance and repair services. The company specializes in more energy-efficient variable refrigerant flow technology.

"They do quite a bit of new construction, but a large portion of their business is retrofit work," said Slate Capital managing partner Erik Ginsberg. "There's a huge push nationwide to install or retrofit HVAC systems with VRF technology, which is a not only a more efficient system, but also more environmentally friendly."

The Sterling, Va.-based platform, which has over 250 employees, caters to commercial building owners, general contractors and facility managers in the Washington D.C. region and the broader Mid-Atlantic.

"Vertical Mechanical Group has one of the largest installation and retrofit backlogs we've ever seen for a company in the sector, so there's plenty of business to be done," Ginsberg said. "They have a blue chip list of customers, and nobody in their service region has received the memo about impending recession because building continues at a tremendous pace."

Outdated Systems, New Regulations

About 65% of commercial buildings across the U.S. were built before 1990 and fall in the retrofit window, according to a 2023 facility services report from investment bank TM Capital Corp.

Once buildings reach the 20- to 25-year mark, systems such as HVAC require either replacement, retrofits or more intensive preventative maintenance and frequent break/fix repairs. Retrofitting, or adding new parts to a system to increase its efficiency, tends to be cheaper than replacing the entire system.

This expected uptick in demand has investors ascribing "re-occurring," or less fixed but predictable, value to retrofit work similar to repair services.

Witness OMERS Private Equity Inc.-backed commercial HVAC business [illegible]lo Mechanicals Inc., which is looking for add-ons with a high proportion of retrofit and service work for commercial buildings in the K-12, higher education, healthcare and government markets, managing director Eric Haley told The Deal in August.

Blackstone Inc. (BX) bought HVAC compressors and controls Emerson Climate Technologies Inc. from Emerson Electric Co. (EMR) in a $14 billion transaction in October. About 80% of the target's business involves replacing and upgrading existing units.

Meanwhile, founder-owned commercial HVAC services business Authority HVAC is in search of growth capital to ramp up replacement of aging HVAC equipment for its customers.

The Environmental Protection Agency's October rule phasing out hydrofluorocarbons could also shift more commercial customer spend toward replacement and retrofit from repair of HVAC and refrigeration systems over the next 18 to 24 months.

Kian Capital Partners LLC expects to see an uptick in demand for its new commercial HVAC distribution platform Team Air Distributing Inc. starting the second half of 2024 from the EPA rule mandating a 40% reduction in HFC use next year, the firm's principal Jordan Lee told The Deal in June.

"The contours of interest have broadened substantially as effective investment strategies emerge in each facility services sector, consensus builds around the value of "re-occurring" revenue and investors take stock of the upside potential for backlog-driven businesses," said TM Capital managing director Jarrad Zalkin.

On the residential side too, certain geographies, such as the Pacific Northwest, will see more homeowners installing and upgrading HVAC systems, Riverside principal Harrison Petts told The Deal.

"In the Pacific Northwest, for example, whether its climate change causing hotter peak summer temperatures or wildfires causing poor air quality—there are a lot of drivers that are influencing homeowners to install newer and better systems," Petts said.

Riverside, which frequently invests in facility services businesses, currently owns residential plumbing and HVAC services business Radiant Plumbing Services Inc.

Manufacturing Boom

Growth in high tech manufacturing on shore coupled with delayed upgrades and renovations in certain markets is also expected to boost new installation and upgrades in HVAC.

The Chips and Science Act provides close to $53 billion over five years to expand semiconductor manufacturing capacity as global shortages have spurred domestic production, while clean energy provisions in the Inflation Reduction Act is expected to double domestic wind and solar production through 2030.

Meanwhile, postponed repair and renovation projects during the pandemic in healthcare and education buildings, including improving HVAC systems, are likely to keep those sectors relatively busy.

On June 14, Ardian SA acquired a majority stake in Atlanta-based Tom Barrow Co., a commercial HVAC manufacturer representative whose business leans toward systems in new construction over existing infrastructure. Tailwinds in healthcare, education, government and industrial manufacturing work in the platform's favor, compared to offices, retail and hospitality, executives at the firm said.

...ject' work is no longer a dirty seven-letter word," Zalkin said.

Part of Slate Group's interest in VMG also had to do with the target's diverse new construction clients.

"One of the things we really liked about VMG is their broad historical exposure to a variety of construction end markets, including multi-family, hospitality, commercial and government segments," Ginsberg said. "When one area is hot, they can focus more there, and when it goes cold, they have other areas to target."

Services Still Rule

That said, recurring multi-year service contracts are still the top attraction for investors. On-demand repair services, too, have become more popular over the past few years given their high margins.

These types of businesses, particularly residential contractors, have clocked record valuations in the high-teens to low 20s range in the past couple of years.

Slate's VMG, too, plans to boost its fast-growing services division, in part through add-on acquisitions in existing markets and new contiguous markets on the East Coast. The platform will also look to add adjacent services such as electrical.

"VMG has an interest in growing the service side of the business to be a larger percentage of their work," Ginsberg said.

Slate, which typically invests in platform companies with $3 million to $15 million in Ebitda, will also help VMG set up shop in new locations organically.

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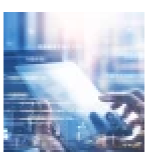

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PEOPLE MENTIONED

Mark D. Director | Erik Ginsberg | Jessica Ginsberg | Eric Haley | Jordan Lee | Harrison Petts | Paul Zalkin

Company Overview

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