23 Predictions for the Year Ahead

The Fails Management Institute presents its annual 'Memorandum' on building industry trends.

For the past three years, The Fails Management Institute (FMI) Mergers & Acquistions Group has generated a Memorandum outlining the trends we see impacting the construction industry.

Topic covered in this Memorandum include:

- The impact of tight surety credit on industry consolidation.
- Effects of anti-doublebreasting legislation.
- The rapid consolidation of the construction materials industry.
- An update on international activity in the U.S. construction market.
- The trend to Subchapter S status.
- Divestitures as an emerging trend.
- The absence of LBO activity in construction.
- Acquisitions in slow market areas accelerating.
- Tax code changes and their impact on ownership transfer.
- Increasing need for independent business appraisals.

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1. In 1988, there was a continued feeding frenzy in the construction materials industry—cement, aggregates, ready-mix, asphalt. There are new players in the market, large amounts of capital available, and ten buyers for every seller. We have identified approximately 40 foreign and domestic firms interested and capable of making a $20 million plus acquisition. Prices will continue to be very high by historical standards.

There will be an acceleration of the consolidation of the construction materials market. Many good sellers are still available. All significant resources in major metropolitan areas will be owned by a few major firms by the turn of the century.

2. Several points can be made relative to general building contractors.

a. Building contractors continue to become ever more mobile, expanding geographically to seek better opportunities. Margins continue to be held down by the resultant competition.

b. No boom in acquisition activity is expected in this sector. Acquisition remains, however, a viable expansion technique since market entry via start-up can be slow and expensive. If price is the only way to differentiate your product, success is unlikely.

C. Large regional and national firms are moving into secondary markets and not focusing on only the major metropolitan areas. Volume orientation continues to dominate industry thinking.

3. The mechanical/electrical markets remain in a state of disarray. In spite of significant acquisitions by MMR and JWP, the industry will likely remain fragmented. Profitability should increase due to the shake out in the early 1980s.

The service/ maintenance markets will receive a lot more attention.

4. Open shop activity continues to grow in California. Opposition to open shop has been minimal due to a strong marketplace and full union employment.

5. Expect to see more contrarian investing. Buying into a market at the bottom and waiting for a return to prosperity can return significant profits. The traditional approach of entering a strong market has usually resulted in a higher entry price, more competition, and greater risk. “Niche markets” will have to be anticipated to provide significant profits.

6. The impending labor shortage of the 1990s will further increase the pressure to expand via acquisition. The ability to significantly add to a firm’s work force can be enhanced by purchasing a sizeable, proven organization.

7. There is a general trend toward maintenance/service type markets in virtually all segments. Low risk, high margin, and repeat work for established customers has long been a part of the business in sections like industrial and mechanical. Other types of firms are now seeing the wisdom of this strategy. New construction will always have its appeal, but the service/ maintenance markets will receive a lot more attention. It is an easy diversification move.

8. There appears to be an ongoing disenchantment with the publicly held construction firm. They consistently under-perform the market and, in many cases, end up going private. Do not expect any surge of new public offerings for firms relying on contracting for the creation of a stable earnings stream.

9. A new section added to the Internal Revenue Code in 1987 (and expanded in 1988), IRC Section 2036(c), will

create havoc for the family owned construction industry firm. The provision effectively eliminates so-called "estate freeze" techniques and makes it infinitely more difficult and expensive to transfer the business from the older to the younger generation. The result will be more outside sales of family firms and the need to purchase more life insurance to fund estate taxes.

10. Expect the need for formal independent business appraisals to accelerate. Having a formal valuation by an independent third party to determine "fair market value" will be necessary in any of the following situations: gift of company stock to charity, any transfer of stock to a related party whether by gift or sale, any transaction impacted by Section 2036(c), divorce settlements, estate settlements, ESOP transactions, or any other transfer invalving potential tax consequences.

The impending labor shortage of the next decade will increase the pressure on contractors to expand through acquisition, thereby adding a sizeable pool of proven workers to the firm's labor force.

Repeat work from established customers is both low-risk and high margin. New construction will remain important, but contractors will look increasingly to the service and maintenance markets as an easy diversification move.

11. The proverbial "local" contractor will find his opportunities enhanced in the 1990s. With the increased dominance of the market by divisions and branches of large firms, owners will tend to favor the locally based firm where they can deal with the owner/ president. This will allow some smaller firms to grow faster than the market as a whole provided the financial resources exist to do so.

12. Aggregate companies which have historically been solely materials suppliers have entered both the asphalt paving and ready-mix concrete business via acquisition. The insistence by sellers that the purchaser acquire the-paving or ready-mix portions of the business along with the materials will force more materials-only firms to vertically integrate.

13. Bonding companies have stepped up their pressure on construction firms to develop business continuation plans. Many successful, well-capitalized firms have lost their bonding because they refuse to develop continuation plans

14. New construction companies or second generation firms tend to have a larger number of shareholders than in the past. Single owner companies are becoming much less common. Also expect to see more females in ownership

and in management positions. ESOPs will continue as a viable option for spreading ownership, but remain a "best choice" for a very small percentage of firms.

15. The age of many owners/managers of construction companies is providing tremendous opportunities for capable managers in their 30s and 40s. Owners who have failed to train a successor will find other companies, particularly larger ones, an excellent source of management talent.

16. A definite non-trend is the absence of LBO activity in the construction business. Given what is going on in the restructuring of corporate America, why has the activity not infiltrated the construction community?

a. There is nothing to leverage. Most firms in the industry are undercapitalized. The major assets are people, not fixed assets. Consequently, the ability to borrow against a firm's asset base is limited.

b. The volatility of earnings and cash flow is widely recognized in the industry. Without a dependable, steady stream of earnings, servicing debt is usually a problem.

c. Wherever bonding requirements exist, leveraged buyouts are precluded by definition. Given the current posture of the surety industry, suggesting an LBO is a waste of time.

d. There are very few public construction industry firms or firms that are large enough to attract the attention of the Wall Street LBO artists.

Having said all of that, there are hundreds of "LBOs" done every year in the form of a family transfer or sale of the business to a key employee group. Invariably, however, they are done slowly and without the benefit of outside capital.

17. The tightness in the surety markets continues to force a consolidation in the industry especially among general contractors. Some effects include:

a. Significant downsizing of firms whose capital base or recent performance will not support past levels of volume.

b. Reduced competition on the larger projects due to an inability to bond by some previously competitive firms.

c. Forced mergers/acquisitions/joint ventures to avoid significant downsizing or liquidations.

d. Continued tightness of margins, sophistication of owners, litigation, etc., cause returns to be unacceptably low.

There are no apparent changes in sight for improving the surety situation. Some would argue that the existing strict underwriting standards should be retained or even tightened further.

18. The anti-doublebreasting bill still stands like a cloud over the contractor segment. Plans are being made, acquisitions postponed, and divestitures contemplated based on a presumption of passage of the bill in some form. The disposition of that piece of legislation will have a large impact on the overall structure of the industry and how individual firms operate.

19. The HVAC sector is seeing an acceleration of the franchising of service operations. The next decade will see the virtual elimination of the independent residential/commercial mechanical service firm.

20. International activity continues unabated. In spite of some less than successful ventures in the U.S., the large

Consolidation of the construction materials market will accelerate.

international firm wants to be in the U.S. They are getting smarter, however.

a. There is more interest in joint ventures and minority investments than in the past. Becoming partners with a U.S. entrepreneur seems to be a better strategy than cashing him out.

b. Interest is increasing in the service oriented sectors, the building product manufacturing and distribution sectors, the construction materials sector and the other more asset intensive sectors of the industry. The classic hard dollar, public works, traveling contractor is of less appeal.

c. The "single Europe" movement and "Glasnost" have diverted attention away from the U.S. market to some degree. We expect considerable efforts aimed at the European market by the major international construction/

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engineering firm. Some U.S. firms may even decide to go to Europe for acquisitions or joint ventures. Joint ventures are more likely since acquisition candidates in the medium sized range are scarce. Those markets are much more consolidated than is the U.S. market.

21. The impact of tax reform in 1986, 1987 and 1988 ,will have a significant impact on the construction industry. Current tax payments are going up, cash flow is going down, and working capital will be impacted negatively. The changes will encourage financial combinations, but will make them more expensive to consummate. Conversion to Sub S status will continue but at a cautious level until some decisions about tax increases are made.

22. Divestitures became more common in 1988. The trend seems to be to focus on the firm's strengths, i.e., to "stick to your knitting." Things that do not fit are being sold. This is particularly true among the foreign investors who have accumulated diverse interests in some previous acquisitions.

23. The 1990s will see the culmination of the aging of the U.S. construction company owner. The post-WWII entrepreneurs will also pass "normal" retirement age. The number of firms changing hands will accelerate dramatically.