On the Block

The construction industry is for sale, as half the nation's contractors expect to be sold.

More than 50 percent of the nation's largest construction firms expect to be sold during the 1990's. The implication of this finding is that acquisition, as a method of implementing strategy, has become accepted in the construction industry and is here to stay.

This and other findings, as detailed below, were revealed in a recent survey conducted by the Fails Management Institute (FMI).

In ascertaining the level of aquisition activity in the U.S. construction market, it must be noted there is no central source of information on domestic construction industry aquisitions. Since most firms are privately held and transactions small, deals are not reported in the financial press and remain obscure.

The results of FMI's survey reveal a surprisingly high level of activity among the major industry players. Respondents stated that as a viable means of achieving corporate objectives:

- 92 percent would consider the acquisition of another company to achieve further growth.
- 80 percent received information on at least one acquisition candidate in the last year.
- 57 percent seriously considered at least one candidate in the last 12 months.
- 77 percent seriously considered an acquisition candidate in the last three years.
- 25 percent actually completed an acquisition or merger in the last 12 months.
- 50 percent has acquired another company in the last 10 years.

The percentage of firms participating in acquisitions was comparable to the number participating in joint ventures in the last 12 months (24.7 percent versus 25.7 percent). However, the actual number of joint ventures was higher, with many firms involved in more than one.

For an industry where acquisition activity virtually did not exist 15 years ago, contractors seem to have embraced the concept wholeheartedly. This would seem to indicate a continued high level of acquisition activity.

Of the firms involved in acquisitions in the last 10 years, approximately two-thirds rated their deals as generally successful. Though many may be surprised by this success level, it is important to recognize that unsuccessful deals receive far more attention than successful ones.

When asked why any aquisitions had been less successful than desired, respondents gave a variety of instructive answers including:

- Weak existing management, management's desire to be independent and loss of motivation.
- Market related problems, such as unforeseen market downturn and unanticipated competitive pressure.
- Inadequate due diligence and analysis.
- Lack of bonding capacity.
- Lack of knowledge of the acquired business.
- Paying too high a price.

Management and marketing problems were cited the most. But all the items noted above argue for more analysis and, perhaps, more healthy skepticism before buying another firm.

About half of the acquired companies still had the original management team intact. These statistics generally conform with U.S. industry at large for acquisitions.

There has been an increase in acquisition activity during the 1980s. Unfortunately, many of these transactions have not been successful and, consequently, many firms are divesting themselves of companies they have acquired. In the last 12 months, there have been 1.8 acquisitions for every divestiture, compared to 3.3 acquisitions for every divestiture over the past 10 years. This is a startling increase.

Why Do Construction Firms Make Acquisitions?

Geographical diversification was the reason most often cited for past acquisitions. Regarding future acquisition plans, 68 percent of respondents indicated interest in doing the same type of work they currently perform in a new market within the next five years. This suggests industry mobility and fierce competition will continue.

The second most frequently mentioned objective for acquisition was product/service diversification (50 percent in the next 5 years). If companies followed through on these plans it would be a significant departure from past practices in the industry. Only recently has it become seen as necessary to diversify services as a means of reducing market risk.

The next most cited reason for considering acquisitions was to gain an increased share of existing markets—presumably by buying competitors. This data indicates contractors instinctively understand "sticking to your knitting" is the safest and most profitable acquisition strategy.

Acquisition, as a method of implementing strategy, has become accepted.

For acquisitions in the past five years, the union/open shop issue was cited by 26 percent, dropping to 7.5 percent who plan such acquisitions in the next five years. This probably indicates expectations of anti-doublebreasting legislation, concerns about additional union complaints or, possibly, that firms who wanted double-breasted capabilities have already acquired them.

Another popular objective for buying companies was the acquisition of management talent. Construction labor markets are tightening and will continue to tighten. This, coupled with the fact that good people are the key to profitable growth, is leading many contractors to augment their human resource base via acquisition. The strategy of "buying people" can be very expensive, and care must be taken to retain those people after the acquisition.

The FMI survey also shows continued interest in, and movement to, the Sunbelt. In spite of a resurgence of the northern states' economies, entering those markets via acquisition is not viewed by most of the respondents as a desired strategy.

Types of Firms Acquired

The general construction firms (SIC 1500) responding show diversified interests in the types of firms they would acquire. Many were already active in other types of businesses. The top areas of interest were acquiring commercial construction and industrial construction firms (both 48 percent), reflecting the type of work the general contractors do now. Secondary interest was in various heavy construction such as highway, heavy industrial, utility, wastewater and construction aggregates. Many firms had already diversified into these areas.

Historically, general contractors have not been inclined to purchase subcontractors. The results of the survey confirmed this by showing an interest of only 5-8 percent of the respondents.

Like general contractors, the heavy and highway contractors who responded to the survey (SIC 1600) have diversified interests and many are already diversified to a large extent. Highway and quarrying operations topped the list of firms likely to be acquired, followed by industrial and wastewater work. Interest was also expressed in the ready-mix, commercial, power, engineering and utility markets. Interest in subcontracting was confined to electrical (9 percent) and mechanical (7 percent).

Subcontractors (excluding concrete and evacuation) indicated interest in acquiring within the same line of business.

It is generally accepted that the only person interested in buying a contractor is another contractor-and usually another contractor operating in the same markets. A move toward diversification is likely, especially among the very large firms, following the model of large international construction firms.

Sixty-five percent of the firms indicated the maximum annual volume for a target acquisition firm is $50 million. Also, 62 percent indicated they would invest no more than $5 million. These figures reflect the relative fragmentation of the industry and the absence of large, wellcapitalized firms. Many respondents volunteered that size was less important than other factors, especially the capability of key people.

Of firms involved in acquisitions, two-thirds rated their deals successful.

Determining the Price

Every construction acquisition is unique and all facts must be known before price is meaningful. However, all buyers intend to earn a return on their investment in the acquired firm. The survey revealed the average firm planned to earn a return on investment of 18.1 percent after taxes (respondents ranged from a low of 7 percent to a high of 40 percent).

A return of 18.1 percent would yield, with little or no growth in future earnings, an earnings multiple of approximately five. In other words, the typical buyer is willing to pay about five times the current after-tax earnings of the selling firm. This relatively low multiple reflects low growth prospects and high risk.

An asset purchase is the most popular type of transaction as indicated by 75 percent of the respondents who had completed deals in the past three years. Interestingly, only 12.3 percent had used joint venture or partial purchase with an option to acquire additional amounts, as a structure. Use of the asset purchase strategy should increase in future years—especially to foreign investors.

The majority of transactions have been cash deals, with only half as many being cash and notes. Only 12.3 percent indicated using stock as purchase vehicles. This certainly reflects the small number of public firms with stock that a seller would be interested in having.

Fixed price transactions are most prevalent, with 81 percent of the firms having used this structure. However, 37 percent indicated use of a contingent feature in the pricing, reflecting the risk of construction acquisitions and the desire to reflect that risk in the purchase price.

A majority of the firms (52 percent) indicated the sale of their own firm was a possibility in the next ten years. The primary reasons given for such sales were to resolve estate planning and management succession issues. Another 17 percent cited bonding capacity as the chief issue.

If 52 percent of the largest firms in the U.S. might be offered for sale in the next ten years, the percentage of small- to medium-size firms in similar situations will certainly be higher. The aging of the World War II generation of entrepreneurs will climax in the 1990's, with many good firms being sold.

New tax laws passed in the last few years (IRC Section 2036(c)) have made it much more difficult to retain businesses within families, the result being third-party sales.

Exhibit 1
Why Construction Firms Make Acquisitions

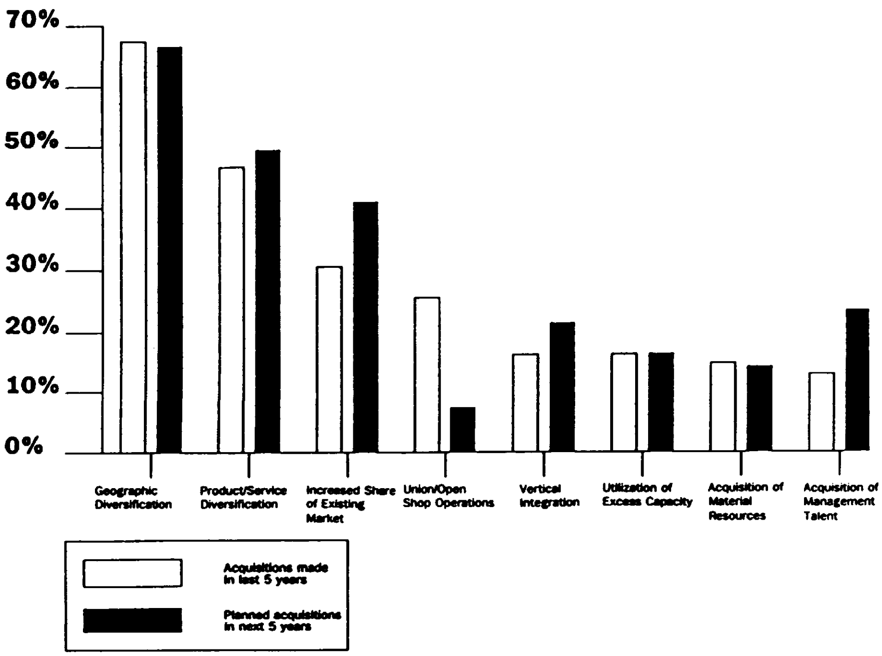
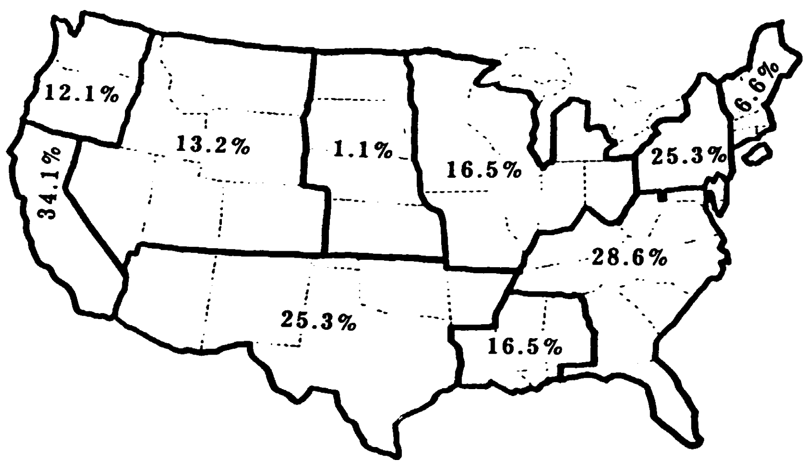


Exhibit 2
Acquisition Interest in the U.S.



About the Authors . . . Hugh Rice and Stephen Darnell are directors of the Fails Management Institute in Denver and Raleigh, NC, respectively. Both provide in-house consulting services in the areas of construction industry mergers, acquisitions, joint ventures, and valuation. A free copy of the FMI survey described in the above article can be obtained by writing Hugh Rice, FMI, 90 Madison Street, Suite 600, Denver, CO 80206.