Merger/Acquisition & Succession Planning

Trends for 1996-1997

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Aquisitions in Construction

General Trends

- The year 1995 was a watershed year for acquisition activity and interest in the U.S. construction market. The outlook for the industry has improved measurably since the early 1990s, and many companies are increasingly expansion minded. Acquisition has finally arrived as the growth vehicle of choice. Twenty years ago, internal growth would have been the choice every time. The next 10 years will see a flurry of activity in virtually every segment of the construction industry.

- The globalization of the world construction market will likely accelerate a trend that FMI identified 15 years ago: the development of a two-tiered market. The successful firms will be the national/ international companies that are well financed and on the leading edge of industry developments, or they will be the “small” specialized firms with state-of-the-art technology and productivity in their area. The more generic, medium-size firms will have difficulty competing. Consolidation of the industry is the inevitable result.

- Consolidation in the construction industry will accelerate over the next live to 10 years. Reasons: firms seeking geographic diversity, both domestic and foreign, to counteract cyclical; demand for sole-source responsibility by owners creating demand for full-service capability created via acquisition or strategic alliances; large, complex projects require large multidisciplined turns; large infrastructure projects demand large, well-financed firms to compete; breaking into a new industrial market segment is virtually impossible without an acquisition.

- Divestitures will continue to accelerate in the 1990s. The reasons include selling off unsuccessful acquisitions and a general restructuring of construction industry firms back to their core businesses or in a new strategic direction. These activities will include both foreign and domestic firms.

- For the next few years, the construction acquisition market will be primarily a buyer’s market with a few notable exceptions. Here are the trends by industry segment: Buyer’s Market—building, highway, heavy/civil, utility/pipeline, construction-management firms, subcontractors. Seller’s Market—heavy industrial, industrial maintenance, asphalt paving (with aggregates), EPC (engineer/procure/construct), environmental, niched companies in any segment, telecommunications, high technology.

- Many construction company buyers are realizing that traditional commercial/institutional/public markets are not going to become less competitive or more profitable. Consequently, acquisition criteria are changing to focus on highly specialized niches in the private sector where competitive advantages can...
be developed and greater returns can be earned. Examples include specialty companies in the gaming, hospitality, retail, entertainment, biotech, computer and telecommunications industries.

- More construction industry firms will be available for sale as firms are put on the market due to available buyers—without any of the normal seller motivations. Some of the activity will be driven by a desire to not be left behind by the consolidation and changes in the marketplace and in other cases to merely take some money off the table.
- There will be more acquisition activity driven by the need to gain qualified workers.
- The stock market and the private equity markets have generated abnormally high levels of capital looking for a place to be invested. Expect to see acquisition capital come into the construction industry at levels unprecedented in past years. Also, expect these investors to be disappointed with the returns achieved.
- Going public will come back into style for the construction industry in the last half of the 1990s. Very few contracting firms fit the profile for a successful initial public offering, but those that do will be motivated by the ability to raise capital, achieve rapid growth potential and pursue a viable exit strategy. “Public” characteristics include repeatable earnings stream; growing earnings/revenue, market sector leaders, customers in growth segment and barriers to competition.
- Construction firms committed to growth and diversification will continue to differentiate, add value to services and shift risk. This “decommoditization” of construction will be characterized by flexibility and creativity in delivery methods, “customized” services to owner’s needs/demands, more “front-end” preconstruction services, increase in the price of services and value from client’s perspective, provide services to corporate end users as they “outsource,” provide financing, equity, and build, own, transfer initiatives.

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Building Contractor Acquisitions

- Acquisitions of building contractors will accelerate in 1996 as buyers see the changing market as an opportunity to acquire market position and organizational talent at a realistic price. Firms with heavy industrial capability or a strong local presence will be in particular demand.
- Many building contractors will be available for sale in the last half of the 1990s. The primary motivating factors include the following: business continuity and management succession issues; bonding/banking constraints created by inadequate capital; heightened awareness of business risks compared to capital availability; need to take advantage of available markets, but lack of financial, technical or organizational resources.
- Acquisitions of 100 percent of a building construction firm and “cashing out” the owner will continue to fall out of favor. Becoming “partners” with a local entrepreneur is a much safer and saner way to go. The best acquisition structure to move into a local market is the per-
permanent or quasi-permanent joint venture. A firm that expands geographically must be a “local” contractor in each of its markets. Some buyers insist on purchasing 100 percent for tax or other reasons. They are instituting incentive compensation or phantom stock plans to keep local management’s interest.

- Expansion on a regional and national scale is more of a current issue with large general contractors. Many of these larger firms seek to differentiate themselves through geographical diversification, a broad customer base, a varied experience base, customer focus and financial strength. Specialization in niches continues, but diversification into a variety of niches also is necessary. Decentralized, entrepreneurial management is a key factor in making this niche strategy successful.

- Acquirers of general-contractor/construction-management firms are realizing that high returns can be earned even with mediocre profit margins since creative structuring can minimize the net investment by the buyer. Since most general contractors carry significant cash balances, the buyer must primarily provide bonding capacity. This fact allows significant returns on invested capital for those firms with excess bonding capacity. Expect to see more of this anomaly in the coming years.

- A new strategy is beginning to develop in the general contracting market focusing on local market penetration and diversification. As contrasted to geographic diversification with a narrow range of services, this strategy is to stay close to home and pursue a wide variety of general contracting markets. Examples would include building renovation, construction-management firms, utility, highway and/or industrial.

- There will be more efforts made to form design/build capability in the industry. Turnkey projects requiring bonding will fuel this movement. “Partnering” arrangements between architecture/engineering firms and general contractors will be one method of meeting
this need. Construction firms are also actively seeking design/construction-management acquisition targets, and design firms are attempting to acquire construction capability. Contractors of all types will be seeking ways to get closer to the customer. The customer will see design/build as a way to avoid costly disputes and litigation.

- Rehab, renovation, retrofit and remodel will be buzzwords of the last half of the 1990s in virtually all sectors. In the commercial market, reconstruction is now 40 percent to 50 percent larger in volume than new construction. Firms developing these kinds of specialties will find better profits resulting in higher business value. Acquisition is one path into this market.

- There will be continued foreign interest in the building sector due to the volume/purchase price ratio and the need to provide bonding capacity and very little capital. Interest coming from Japan and other Asian countries, Latin America, Canada and the Middle East, along with continued activity by the large European firms.

**Subcontractor Acquisitions**

- Demand for subcontracting firms as acquisition targets will continue to be slow. Very few buyers exist for firms in any particular specialty area. However, each industry segment has several prospective purchasers for particularly attractive firms or for capacity that can be acquired for a very small investment. Expect to see the emergence of one or more mechanical or electrical giants in the next three years to replace the well-publicized failures in this area. Lessons have been learned that will allow this multioffice, national strategy to work successfully.

- The mechanical contracting market is undergoing some significant restructuring. Everyone is discovering the service business and its profit potential. So-called performance contracting, with its ability to create and control projects in the private sector, is gaining momen-

**Acquisitions in Construction Materials**

- The second major wave of consolidation continues in the construction materials industry, as witnessed by many acquisition transactions.

- The second half of the 1990s will see the major players, both international and domestic, purchasing more and more independent operators. It is expected that most major markets will be dominated by a few players.

- Interest in the U.S. construction materials market is not driven by the market’s immediate outlook. In fact, many are predicting a downturn in construction markets beginning in 1997. What is fueling the continued demand for acquisitions is long-term strategic planning and the need
to employ underutilized corporate assets—cash—to satisfy shareholders.

- The construction materials business is being securitized. Martin Marietta Materials is still an 80 percent owned subsidiary of Lockheed Marietta; however, its stock now trades on the New York Stock Exchange. CAMAS plc demerged with English China Clays plc and is now separately listed on the London Stock Exchange. Centex Construction Products, Inc. was spun off by Centex Corporation and is now traded on the NYSE. MONROC, Inc., with sales of only $35 million, sold 600,000 shares to the public and is now listed on NASDAQ. The industry is seeking direct access to the financial markets in order to raise capital for growth through acquisition and provide a level playing field with multinational construction materials companies that are publicly traded.

- Large deals will be few and far between because most of the merchandise has been spoken for. Unless some of the foreign players decide to withdraw from the United States, deals will be add-ons to the larger players.

Medium-sized deals ($20 million to $50 million) are likely to dominate the market since there are some independent companies in that value range that, for various reasons, are likely to go on the market in the next few years. There will be much interest in these companies because the public companies need growth to drive stock price. Additionally, these companies provide enough critical mass for a stand-alone operation that can be grown via “add-on” acquisitions.

- The availability of sellers that meet the traditional criteria has dwindled. Many have been acquired, and most have been approached about selling. More buyers are chasing fewer deals. This is good news for prospective sellers, although traditional economics of supply and demand has not had its typical impact on price due to valuation mistakes of the last decade.
Overpaying for companies in the past has reawakened the buying community to the ups and downs of the business cycle. Earnings capacity is evaluated with the recognition that the U.S. construction industry runs in six- to lo-year cycles. Many prospective sellers are still conditioned by prices paid to their peers in years past and are not realistic relative to value. The days of making offers “too good to refuse” are over. Prices are much lower than in the 1980s—sometimes as much as 50 percent lower. Transactions now require motivated buyers and sellers.

Acquisitions will be influenced just as much by long-term relationships and compatibility of corporate cultures as by the price offered.

Buyers are continuing to target rural markets, where they have a better opportunity to control a market and influence pricing. Several small acquisitions yielding dominant market position can be more lucrative than one larger deal.

Some of the major buyers in the 1980s are now selling off certain assets that no longer fit current marketing strategies.

Buyers are more receptive to companies with activities outside their core business. This flexibility is a reaction to a market that has fewer and fewer “perfect fits.” Buyers are entertaining different aspects of the integrated aggregate/asphalt/ready mix/contracting process in an effort to broaden their list of targets.

Environmental regulations and the difficulties and costs involved in the permitting process have become true barriers to entry. This has helped perpetuate the advantage of acquiring versus start-up.

Aggregates Industry—Consolidation is continuing, with sellers motivated by continuity problems. U.S. public and private buyers are most aggressive, but some internationalists are still going strong. This is the most attractive segment for buyers, given their desire to “control the material.”

Ready Mix Concrete—Pricing has been tough in many markets. Some sellers will sell for continuity reasons, but others will look to change for competitive reasons. Expect cement companies and possibly aggregate firms to acquire ready-mix companies to secure their market. This will not happen in some markets where prices are high enough for the service-oriented producer to survive. Cement producers prefer a healthy, independent ready-mix producer, but market share is critical. Current antitrust investigations in the cement industry could change the market dynamics.

Prestressed Recast—Excess capacity continues in this industry. There will be further sales, consolidations and shutdowns. Vertical construction is down, with the exception of parking garages, and, as always, there is competition from alternative building systems.

The prestress/precast concrete products business has been in the doldrums for some time, primarily due to its commercial construction
orientation. Also, because of the low value-added nature of these products, most producers are only marginally profitable, even in the best of markets. The time has come for a whole new look at the prestressed/precast business in the United States.

With the number of European firms in the American building market today and their higher level of concrete products technology and construction application, the impetus for change will probably come from them. Mass production techniques and the use of precast concrete in a broader range of construction markets are characteristic of the European concrete industry. The international construction firms will try to duplicate these conditions in the United States. Many will do so by acquiring existing U.S. precast companies as a base of operations and subsequently introducing their methods over time.

**Management Succession/Ownership Transfer**

- The number of shareholders of individual construction firms will increase as employee ownership becomes more pervasive. For the privately held firm, an absence of buyers, the presence of Chapter 14 of the Internal Revenue Code (legislation prohibiting tax-free transfers of business interests to family members) and a general lack of capital in the hands of individuals will require multiple individual investors. This is in contrast to the sole owner of the past. Ownership by key management employees will be the movement of the next decade.

- Employee stock option plans continue to be popular in American industry but are infrequently used in the construction industry. ESOPs could increase due to Chapter 14 and the need for financing to buy out retiring shareholders. ESOPs are terminated by construction firms as frequently as they are created.

- “Family business” has been discovered by the business press. History would indicate that popularity leads to awareness, which leads to political recognition. Expect to see a glorification of family business and a strenuous effort made to keep businesses in the family. Frequently, this is an incorrect decision for a construction firm. Fortunately, many business owners recognize that the business must be managed independent of family issues.

- The absolute requirement for a strong leader in construction firms of all sizes is going to change the succession plans of many owners. Giving the business to the three children equally or selling out to three key employees equally frequently leads to disaster. If there is no leader, don’t do it. If there is a
leader, give him or her the power to manage the firm.

- The increasing sophistication and risk of the construction industry are combining to discourage the continuation of the family business where the next generation of owner/managers are not clearly qualified and motivated. Taking over the family construction business without the requisite skills, training, orientation, and desire is a formula for disaster.

- Conversion to Subchapter S status will continue to occur. The avoidance of double taxation on corporate earnings will continue to encourage Sub-S status in spite of the current tax disadvantage. Also, the ability to remove excess funds from the firm will continue to attract owners whose business is adequately capitalized. Limited liability companies will begin to replace Sub-S as this entity form becomes more accepted.

- The 1993 tax provision allowing investments in certain types of corporations to be taxed at 50 percent of the normal capital gains rate will cause creation of new structures to include employees in ownership under this favorable provision. Offering employees stock or stock options in lieu of cash compensation will become more prevalent.

- The independent appraised values of construction firms trended steadily upward in the 1980s. These appraisals were influenced by activity on Wall Street, leveraged buyouts, and ESOP transactions in other industries. Expect to see the values attributed to contracting businesses continue to decline to more realistic levels in the last half of the 1990s. This will prove to be especially true of ESOP appraisals due to the impending repurchase liability of these plans.

- 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 IRC Chapter 14, divorce settlements, estate settlements, ESOP transactions or any other transfer involving potential tax consequences.

- Many succession plans are being thwarted by the reluctance of new shareholders to sign personal indemnification agreements. More would-be entrepreneurs are evaluating the risk/reward relationship and seeking ways to limit their liability.

- The potential of a capital gains tax cut is causing some delaying of internal and external transactions. CD

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