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Investment Analysis: Building your Business through M&A

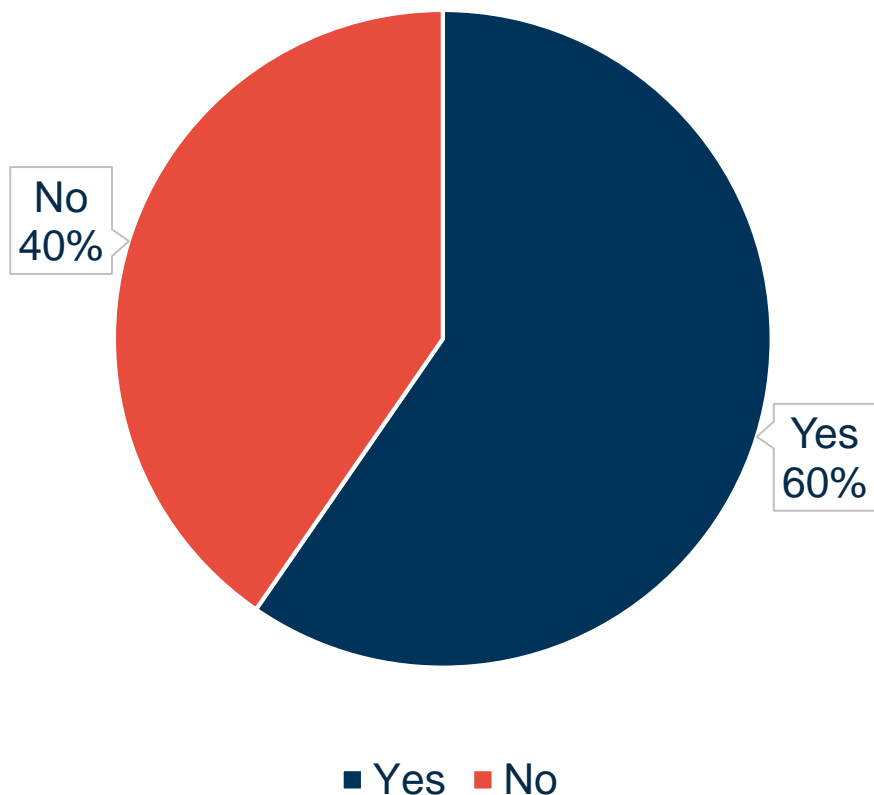


Key Contractor M&A Trends

- **M&A activity remains robust**
- **Continued bifurcation of the industry between very large and smaller niche firms drives M&A activity**
- **Self-performing contractors draw most interest**
- **Sustained international interest in the United States**
- **Speculation over potential increase in infrastructure spending**

FMI Survey:

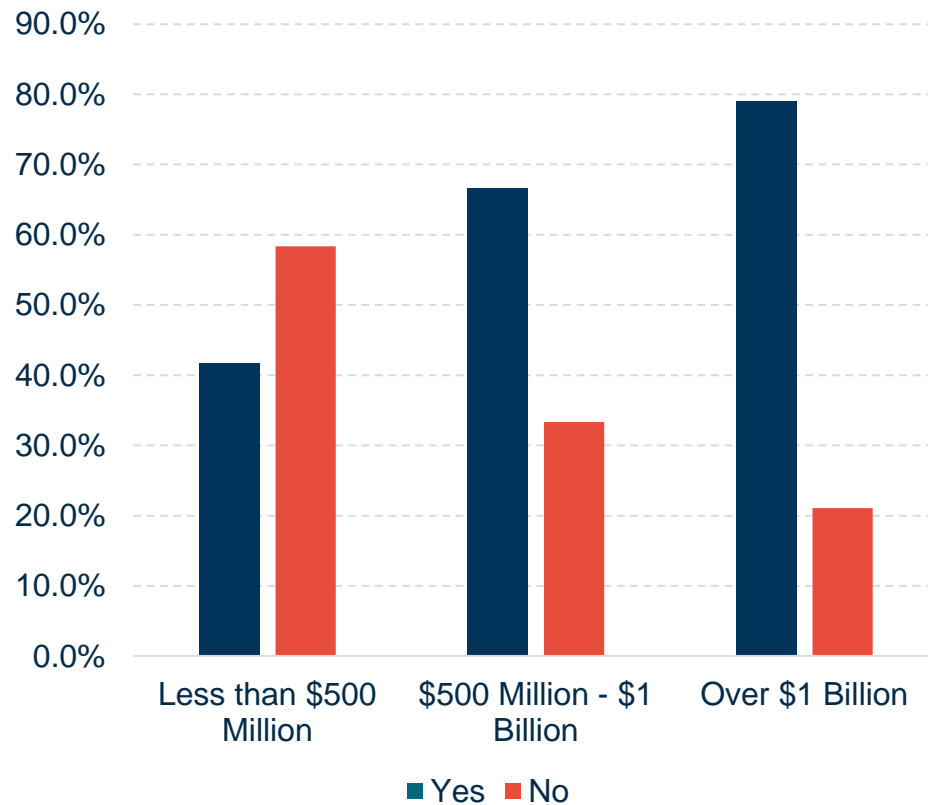
Are Acquisitions a part of your current strategy?



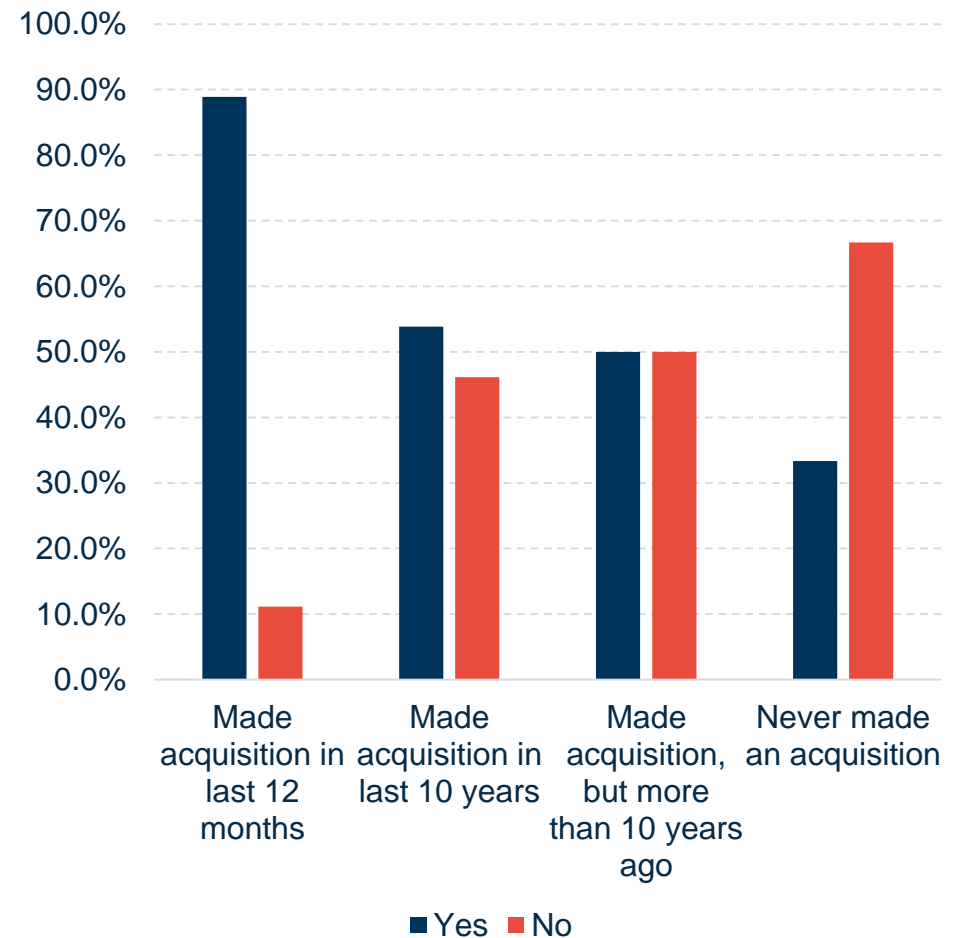
Source: FMI.

Key Contractor M&A Trends

Are acquisitions a part of your current strategy? (Revenue Size)



Are acquisitions a part of your current strategy? (Recent Activity)



Source: FMI.

Construction Market Trends

Current / Short Term: 1 -2 years

- ✓ Most markets have recovered, profits rebounded
- ✓ Tax reform is improving valuations; infrastructure spending hopes fuel continued optimism
- ✓ Contractors are strategically expanding their businesses through selective acquisitions
- ✓ Infrastructure, power and industrial maintenance/service remain the most attractive segments of the U.S. Construction market.
- ✓ Surety markets are loosening, which may attract new entrants

Construction Market Trends

Current / Mid-Term: 2 - 5 years

- ✓ Manufacturing renaissance in U.S. will continue to drive industrial construction
- ✓ State and local budgets will remain constrained
- ✓ Infrastructure spending will be driven primarily by states, with federal infrastructure spending a wild card
- ✓ Surety markets may tighten; return of personal guarantees and stricter ratios
- ✓ Recessionary forces will likely develop and affect company valuations and transaction activity

Construction Market Trends

Current / Long Term: 5 - 10 years

- ✓ More rigorous regulations and commercial demand for “green” infrastructure will foster revenue growth into the future
- ✓ Integrated project delivery (in its various forms) will continue to grow in popularity
- ✓ Labor will influence contractor strategy, project delivery, and M&A
- ✓ Long-term U.S. population trends will offer tremendous growth opportunities

Contractor Acquisitions

✓ What Drives Buyers?

- Diversify geographic risk
- Diversify capabilities or integrate
- Provide people
- Establish local “partner”
- Low profit + low investment = high returns
- Ongoing dilemma – hire or acquire?



Contractor Acquisitions

✓ What Drives Sellers?

- Financial constraints
- Opportunity for employees
- Right timing / right price
- Retirement / succession
- Personal risk



Contractor Acquisitions

✓ What Drives Activity?

- Motivated buyers and sellers
- Changing market conditions, abundant “catalysts”
- Low interest rates, strong stock market valuations



Building Contractor Acquisitions

✓ **Renovation/retrofit markets attractive**

✓ **Foreign interest due to:**

- Ratio of purchase price to volume is low
- With established bonding capacity, little capital is required
- Delivery mechanism for PPP



Industrial Contractor Acquisitions

- ✓ Industrial maintenance is attractive
 - Meaningful barriers to entry
 - Specialized work force
 - Valuable relationships
 - Good cash flow, recurring revenues
 - No bonding



Heavy Highway Contractor Acquisitions

- ✓ **State budget deficits have constrained spending**
- ✓ **Federal funding more certain, but diminished**
- ✓ **Most projects are being awarded below budget**
- ✓ **Valuations often not compelling for sellers**
 - Asset value often exceeds earnings value



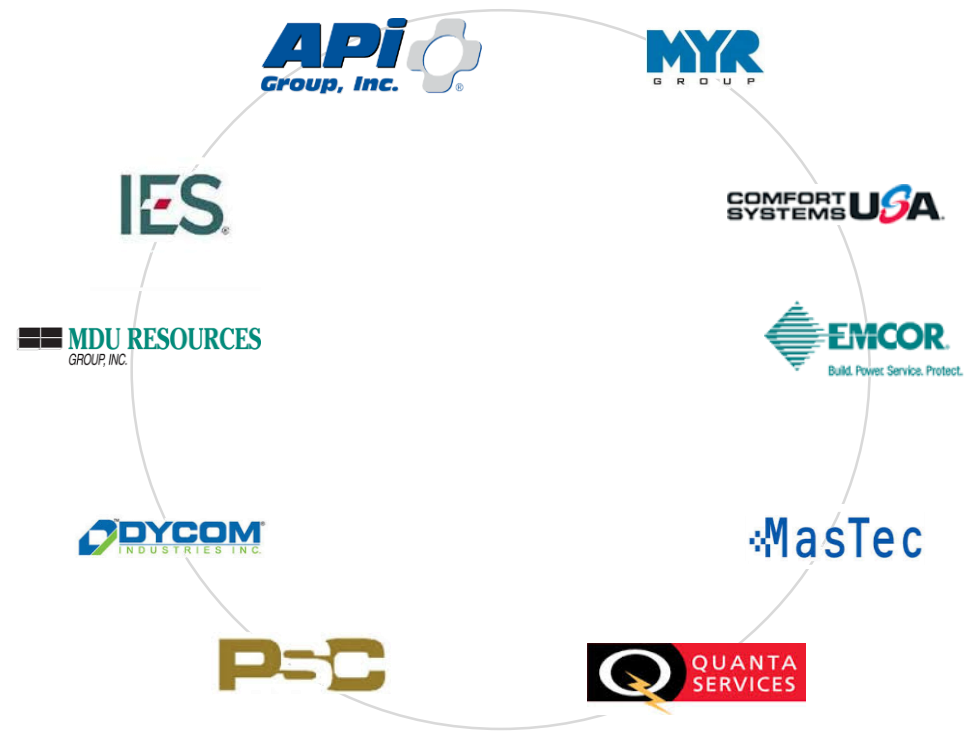
Specialty Contractors

History of Consolidation

- ✓ Began in 1980's with JWP and formation of EMCOR
- ✓ 1990's continued with roll-up trend (Quanta, Comfort Systems, Encompass, IES)
- ✓ Utilities (Exelon, First Energy, Xcelcom, PSEG, PP&L, Keyspan, MDU, Northeast Utilities)
- ✓ 2000's brought divestitures / bankruptcies / buybacks
- ✓ Survivors have diversified and flourished

Trend Continues Due To:

- ✓ Prime contracts / relationships
- ✓ Multiple arbitrage (public companies)
- ✓ Meaningful synergies
- ✓ Recurring revenue
- ✓ Specialized work force



Specialty Contractors

Investment Growth Drivers

- ✓ Foreign markets have slowed
- ✓ U.S. markets are highly fragmented
- ✓ U.S. infrastructure likely to turn to P3
- ✓ U.S. market is large, stable, and safe, with long-term growth prospects
- ✓ With established bonding capacity, capital requirements are limited



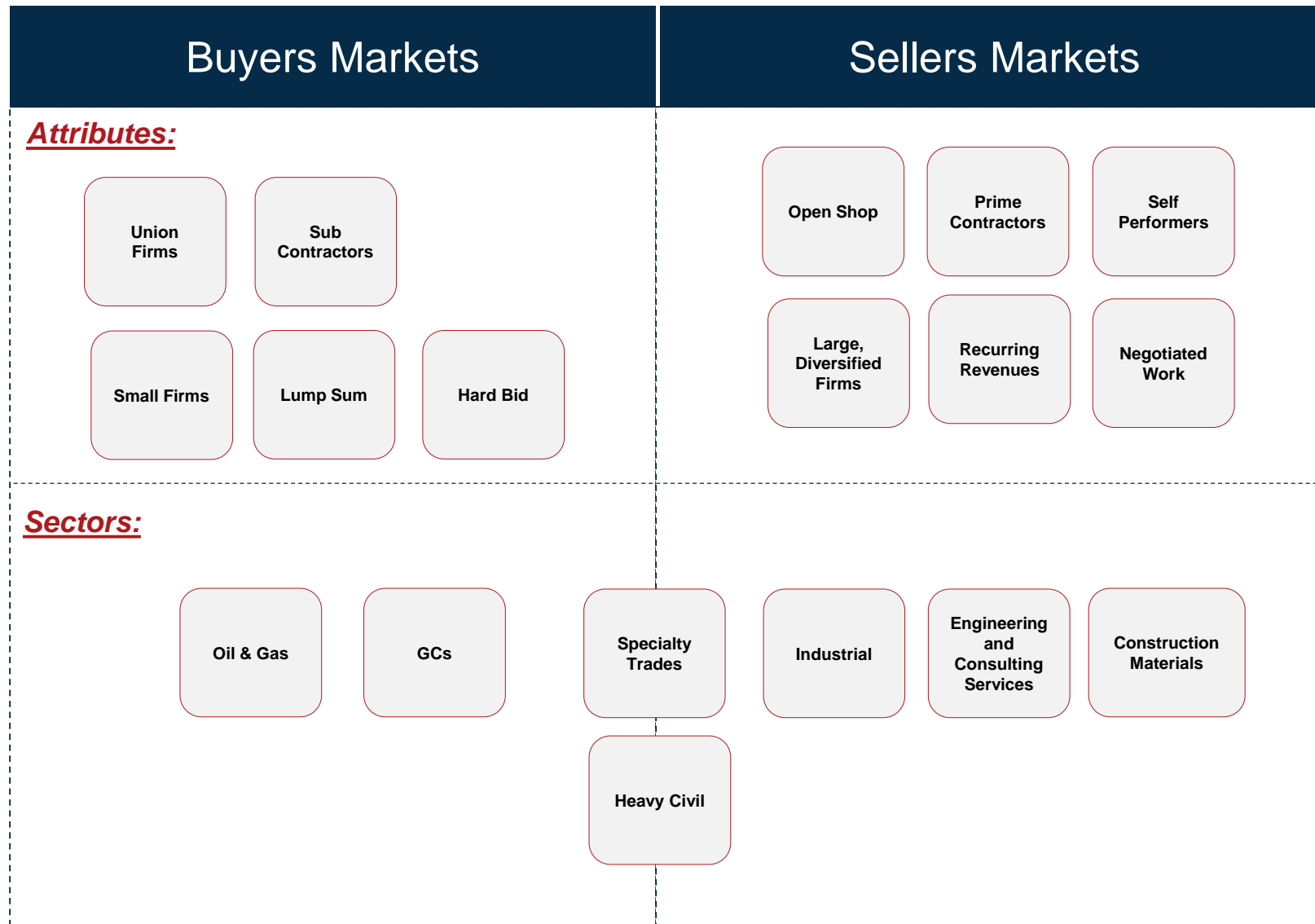
Foreign Interests

- ✓ Large contractors
- ✓ Specialty markets
 - Geotech
 - O&G
 - Construction Materials
- ✓ Heavy highway / civil
- ✓ Large GCs
- ✓ Substantial bonding requirements

Foreign Interest in U.S. Construction



Buyers and Sellers Markets



Private Equity a Key Player in M&A Markets

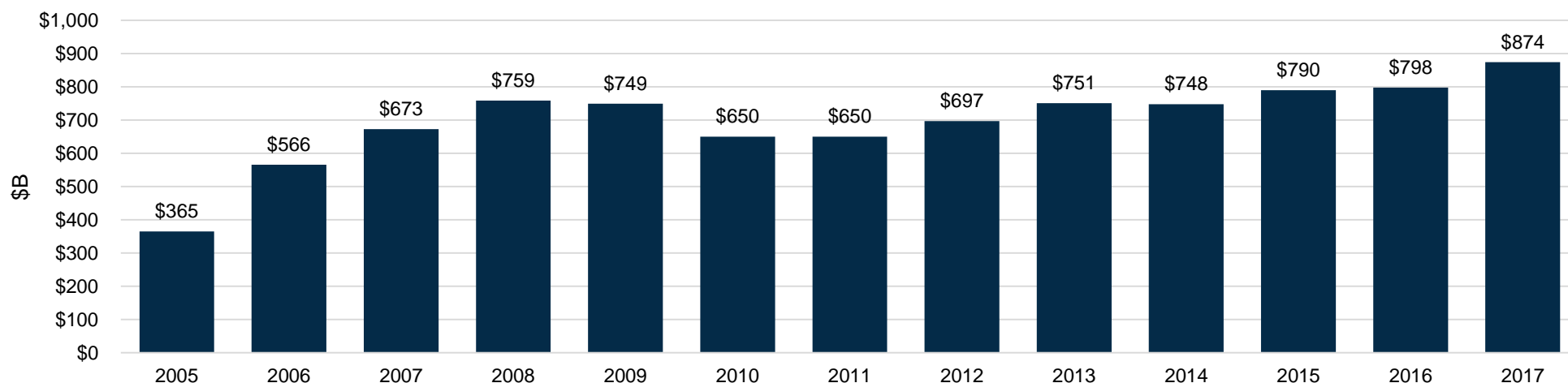
What is “Private Equity”

- Pools of private funds invested primarily in private businesses.
- Typical investors include individuals, pension funds, family offices, and other investors.
- Funds will typically acquire businesses with combination of equity and debt, hold for three to seven years, and divest to strategic buyer or another fund.
- Investors expect high returns on equity, frequently in the 15 to 30 percent range per year.
- Private equity has traditionally avoided construction due to bonding constraints, contract-based revenues, people dependency, market cyclicalities, and limited barriers to entry.

Private Equity Trends

- **Elevated deal size:** PE firms are raising increasingly larger funds which pushes deal sizes higher as those firms allocate capital.
- **Private equity now makes up a larger part of total M&A activity:** the 1st half of 2018 saw over 2,200 deals completed in the U.S. totaling over \$260 billion in value, and firms are incentivized to deploy capital now to save costs related to rising interest rates.
- **Time to deploy dry powder:** FMI expects increased activity from private equity funds, which notwithstanding a record \$874 billion in “dry powder” in 2017 — capital available for investment purposes — did not feature prominently in the 2016 M&A market. These funds are likely to come under pressure to deploy their substantial available capital in the months ahead.

Global Private Equity Dry Powder



Note: as of 12/31/2017

Source: Pitchbook



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The Buying Process



Overview



✓ Planning for acquisitions

- Industry fundamentals
- Strategic intent
- Acquisition criteria

✓ Steps in the acquisition process

✓ Fundamentals for acquiring in construction

Fundamentals of Construction Businesses

✓ The industry is fragmented for a reason

- Construction markets are local
- Few barriers to entry
- Limited economies of scale/operational leverage
- Purchasing advantages vary
- Larger firms carry additional risks

✓ Construction is a cyclical industry and businesses struggle in downturns

- Overcapacity reduces margins
- Banks and sureties turn away

✓ Market interest come in waves

- Energy, senior living, healthcare, etc.

Strategies that Might Use Acquisition

✓ Expand customer base



✓ Expand workforce



✓ Acquire asset/technology/résumé



✓ Diversify – geographically, products/services, markets



✓ Consolidate competition



✓ Integrate vertically



✓ Invest excess capital



✓ Accelerate Growth



Acquisition is not a strategy – it is a tool to implement a strategy

Key Considerations

✓ **How am I finding my target?**

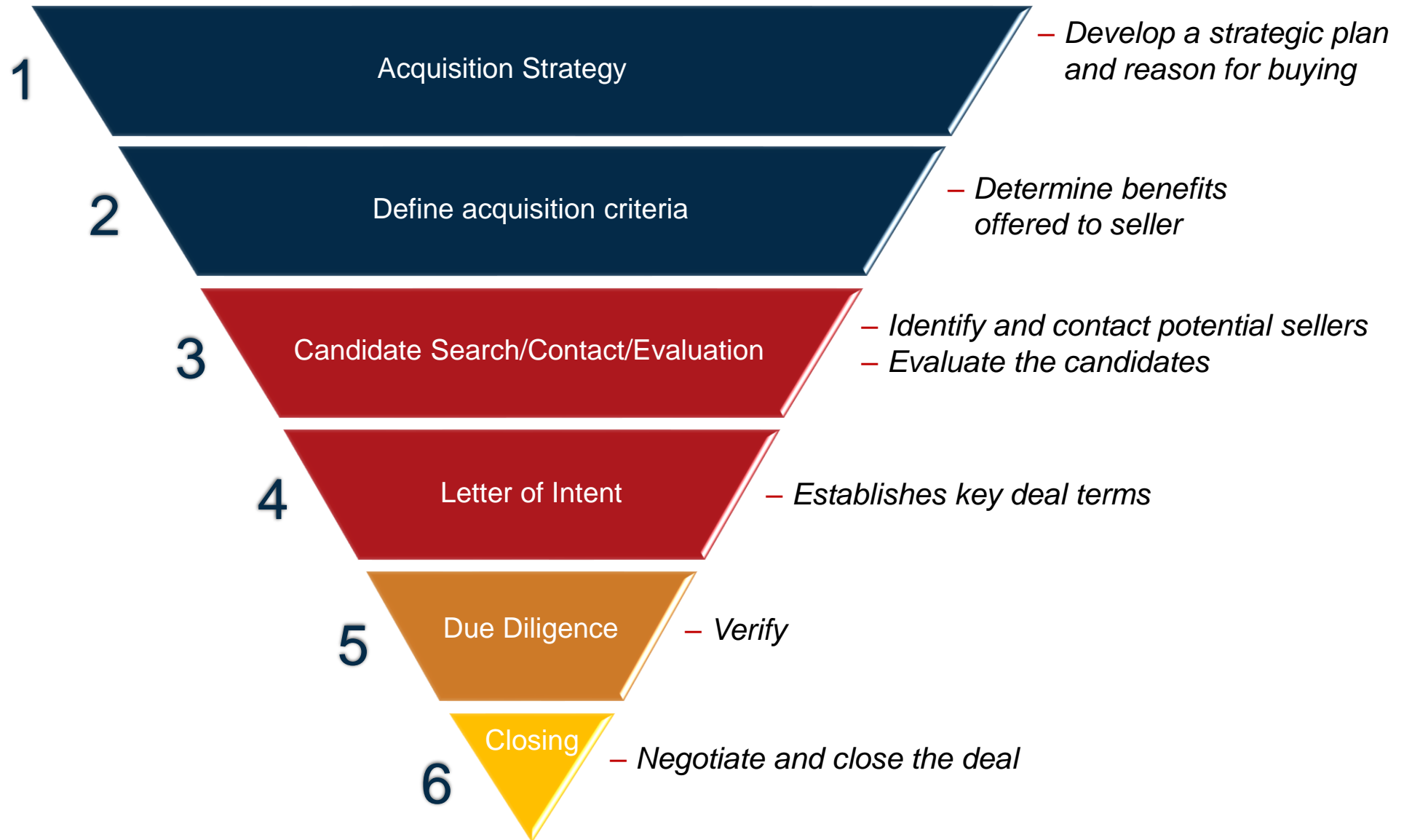
✓ **Examples**

- Competitive process
- Broad search
- Narrow search
- One-off negotiation



As we will see, some steps in the buying process are applicable to all of these examples, some are not

Steps in the Acquisition Process



Anatomy of a Purchase Agreement

- ✓ **Allocation of Purchase Price**
- ✓ **Purchase Price Adjustments**
 - Closing Payment
 - Post-Closing Adjustment
 - Resolution of Disputes
- ✓ **Treatment of Backlog for Contracting**
 - Assignable Contracts
 - Non Assignable Contracts
 - Bonding Guarantees
 - Claims



Anatomy of a Purchase Agreement

✓ Representations and Warranties (Seller & Buyer)

- Knowledge qualifiers, if any
- Time frame; \$ limits

✓ Covenants and conditions to close

✓ Indemnification

✓ Escrow



Examples of Representations and Warranties

- Corporate existence/organization
- Capital structure
- Authority to enter into transaction
- No conflict



These are fundamental reps, and typically buyer and seller both must make these. In a private, all-cash deal, these may be the only reps the buyer makes.

- Financial statements
- Title and rights to assets
- Compliance with law
- Environmental matters
- Contracts
- Employee benefit plans
- Taxes
- Employees
- Legal position



These are reps the seller makes about the target business.

- No undisclosed liabilities
- “10b-5” and “Full disclosure”



These are broader reps made by the seller.

How Much Is This Going to Cost Me?

- ✓ Appraisals
- ✓ Environmental audits
- ✓ Financial statements/accountants
- ✓ Attorneys
- ✓ Investment bankers
- ✓ Your time



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Valuation



Construction M&A



The Challenge of Construction Industry M&A

- ✓ Low barriers to entry
- ✓ Highly cyclical
- ✓ Absence of economies of scale
- ✓ Highly dependent on people
- ✓ Bonding requirements increase risk, hamper financing

Approaches to Value

Income or Earnings-Based Approach

- Capitalize historical earnings
- Discounted future earnings or cash flows



Market Approach

- Internal stock sales
- Public company comparison
- Comparable private transactions

Asset-Based Approach

- Book value
- Net asset value
- Liquidation value

Capitalization of Earnings Methods

1 Multiple of Pre-Tax Earnings

- ✓ Determines value of stock or equity
- ✓ Typically used for general building contractors
 - Generally little or no debt
 - Captures ability to generate earnings through management of the balance sheet

2 Multiple of EBIT (Earnings Before Interest and Tax)

- ✓ Determines value of invested capital (debt + equity)
- ✓ Typically used for heavy/highway firms

3 Multiple of EBITDA

- ✓ Determines value of invested capital (debt + equity)
- ✓ Generally considered a cleaner measure of earnings
- ✓ Often used for specialty contractors, building products companies, construction materials firms, engineering and architectural firms, etc.

Not All Earnings Are Equal

✓ **Growing**

- Market demographics
- Ability to establish branch offices or successfully acquire other firms

✓ **Defensible**

- Market niche

✓ **Sustainable**

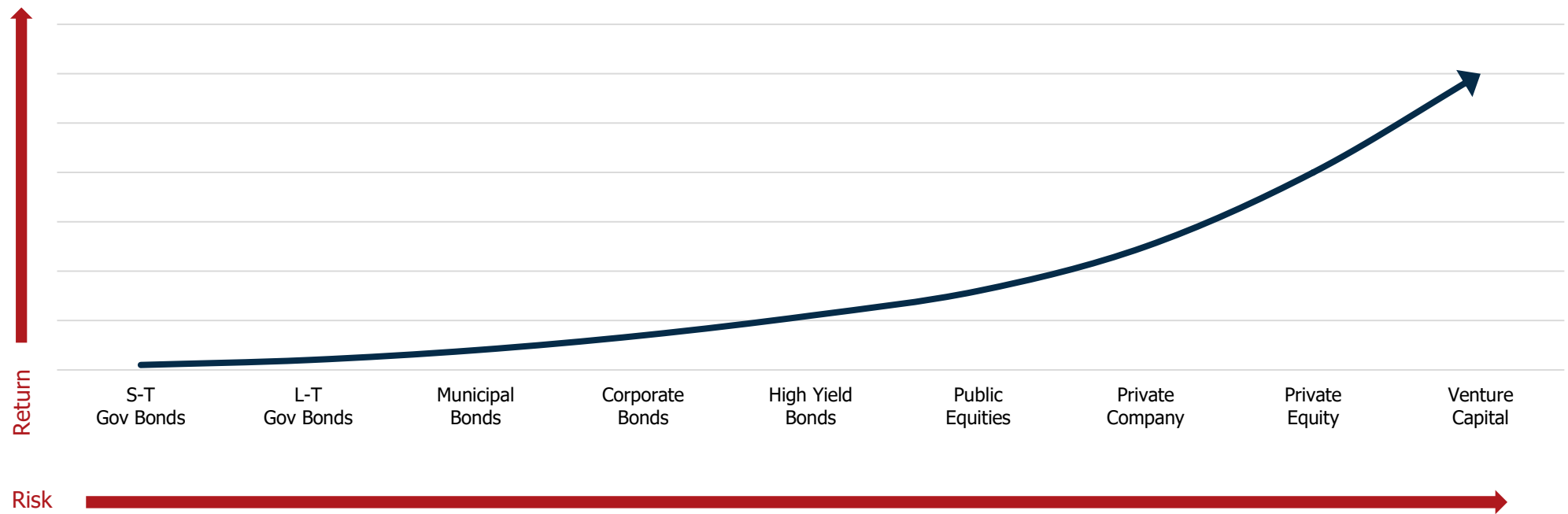
- Mix of new construction, reconstruction, service and maintenance work
- Ability to attract and develop people

✓ **Return**

- Higher margin
- Risk profile

Risk vs. Return

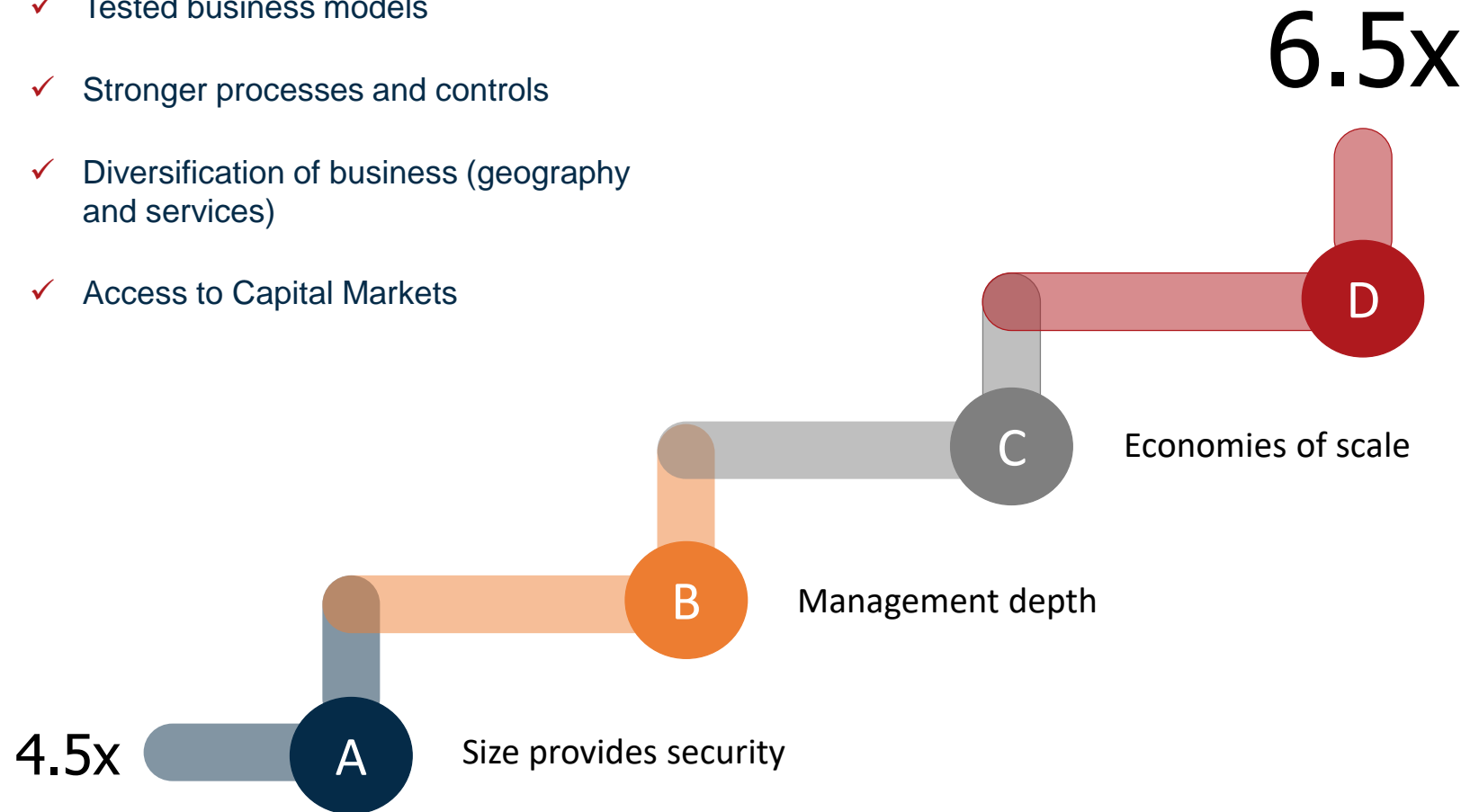
- ✓ Time Value of Money – The time value of money concept holds that \$1 received today is worth more to an individual than \$1 received at some future date, exclusive of risk.
- ✓ Risk – Risk is defined as uncertainty regarding the occurrence of gain or loss. Each investment has its own degree of risk that reflects major uncertainties. There is also the risk that business competition and conditions may impair the ability to provide the return. All of these factors combine in various weights to determine the overall risk of the business venture.



Why Are Multiples Lower for Private Companies?

Larger businesses will lead to larger multiples

- ✓ Tested business models
- ✓ Stronger processes and controls
- ✓ Diversification of business (geography and services)
- ✓ Access to Capital Markets



Realities of Buying/Selling Contractors

- ✓ Relatively few transactions are completed each year and there are limited buyers
- ✓ Sale to an outsider is often not the most lucrative alternative for a seller
- ✓ “Iron” is usually worth more to a seller than to a buyer
- ✓ Valuations based on earnings assume the Company will continue to earn at the same level or higher in the future
- ✓ The balance sheet is always considered as part of valuation

Realities of Buying/Selling Contractors

- ✓ Strategic buyers are reluctant to pay significantly more than book value upfront - premiums usually subject to performance
- ✓ Goodwill or “blue sky” is defined by earnings relative to FMV of tangible assets acquired
- ✓ People/organization are the most important assets
- ✓ Seller value expectations remain relatively high but are becoming more reasonable
- ✓ Deals need motivated buyers and sellers
- ✓ Seller expected to deliver balance sheet at closing sufficient to operate the business – excess or deficient capital directly impacts the purchase price

About FMI

FMI Capital Advisors, a subsidiary of FMI Corporation, is a leading **investment banking** firm exclusively serving **engineering and construction, infrastructure and the built environment**. With **over 700 completed transactions**, our unique industry focus enables us to provide our clients with valuable insight and advice. Clients gain access to our unparalleled network of industry contacts and relationships, deep market knowledge and technical expertise.

Sector Expertise

- A/E and Environmental
- Building Products
- Construction Materials
- General Contractors/CM
- Energy Service & Equipment
- Energy Solutions & Cleantech
- Heavy Civil
- Industrial
- Owners
- Private Equity
- Specialty Trades
- Utility T&D



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