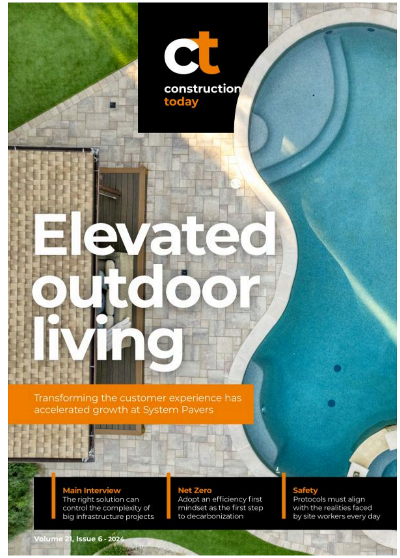
A look at the construction services M&A marketplace

Like many industries in the US, the construction services industry has experienced significant growth over the past few decades, creating substantial wealth for many owner-operators of construction companies. It is estimated that a large percentage of the 900,000 or so construction firms



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value of their business, and their life stage calls for a serious exploration of how best to unlock that wealth to secure financial comfort in retirement and address estate planning needs. But this life cycle event requires entrepreneurs to spend time exploring how best to implement a liquidity event – investment bankers speak for a sale or partial sale of their business.

Fortunately, the liquidity event process has become exponentially more commonplace and competitive for sellers in recent years. Private equity has emerged as a highly interested alternative, with many PE sponsors focusing on the favorable fundamentals in the construction services industry. This adds a robust resource for business owners seeking liquidity, in addition to the traditional options of selling to a competitor, structuring an installment sale to senior management, creating an ESOP, or some other creative approach to generate cash for business owners.

For many years, the construction business sector was viewed by many institutional investors as a lower-margin, commodity-type business model without much pricing power, where companies typically won work as the low bidder. This perception often led to low valuations in the marketplace. Construction companies were frequently sold at valuations equating to their net book value plus any excess working capital, without accounting for the value creation of a well-managed enterprise utilizing technology to better manage projects and increase profit margins. By implementing strong management practices, new technology and utilizing well-trained trade professionals, profit margins have improved, with many companies now experiencing EBITDA margins well in excess of ten percent. As a result, buyers are now imputing significant goodwill value into their pricing of acquisitions. Today, construction companies' calculus for acquisition values is heavily weighted on consistent EBITDA margins and private

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Ripe for acquisition

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Historically, M&A activity in the construction services sector was dominated by larger companies with the balance sheets and bank relationships needed to fund acquisitions. Their interest lay in fueling top-line revenue growth, adding capabilities to capture a greater percentage of project spend, and expanding geographic coverage. In recent years, private equity sponsors have recognized the industry's fragmentation and the need for consolidation. Their thesis is that by building larger construction companies through acquisition, PE sponsors can bring best practices to management, fund and employ more technology, grow top-line revenue, control project costs better and limit SG&A expenditures, and ultimately create higher margins through economies of scale.

To implement such a strategy, such as construction services, there needs to be a wide array of privately held companies ripe for acquisition. Enter the many baby boomer owners who need liquidity events for retirement, placing the construction services industry squarely in the crosshairs of private equity spend for construction has remained relatively consistent, creating a somewhat predictable revenue stream.

In recent years, the US private equity community has increasingly focused on construction services, particularly targeting middle-market, regional construction companies. Interest has been especially strong in commercial electrical contracting and civil construction sectors serving infrastructure, transportation, data centers, manufacturing, and clean energy. These companies have demonstrated an ability to create stable cash flows and build on an already growing backlog. With PE sponsors sitting on an estimated $1 trillion in dry powder (i.e., capital committed but not yet deployed), they are actively seeking opportunities among construction services candidates. This is an opportune time for private company owners who are seeking a liquidity event to learn more and start planning.

The fundamentals for an industry consolidation are inherent in the construction services sector. It is a highly fragmented industry with many participants available for acquisition, backed by strong demand from both a growing economy and government programs such as the Infrastructure Investment and Jobs Act ($1.2 trillion), the American Rescue Plan ($360 billion), the CHIPS and Science Act ($52 billion), and the Inflation Reduction Act ($369 billion), for a combined additional $1.9 trillion in spending.

Industry insights

The final variable to address in creating a strong M&A market is the cost of funds and the availability of credit in the debt markets. Debt is critical to achieving the returns needed in a PE sponsor's investment. Typically, half of the financing comes from debt, with the PE sponsor writing a check for the balance. As the Federal Reserve reduces interest rates in the motivate business owners to pursue liquidity events, maximizing the reward for a lifetime of hard and smart work.

The valuation of companies in an M&A transaction is a complex process driven by multiple factors. Typically, larger construction companies command higher valuations of EBITDA, while smaller companies receive considerably lower purchase prices. This is due to the ability to leverage better with larger companies, i.e., how much debt can be placed on the company's balance sheet – larger companies have greater leverage potential. Credit statistics maintained by SPP Capital, a leading private debt investment bank, illustrate this point: in September, the credit markets were underwriting companies with less than $5 million in EBITDA at a range of 2.5x–4.0x EBITDA total debt coverage, compared to companies with $10 million in EBITDA at 3.5x–5.5x EBITDA, and companies with at the upper end of the market; $40 million in EBITDA at 5x–6x EBITDA. For example, a $5 million EBITDA business would be able to raise roughly 3.0x while at $40 million in EBITDA 5x to 6x. If we assume a 50/50 debt equity funding, the $5 million will fetch a 6x multiple and the $40 million would be valued at 12x – that's the arithmetic.

In summary, the combination of favorable economic conditions has created a strong M&A market. For baby boomer owners seeking liquidity events as they near retirement, the time to act seems ideal.

For a list of the sources used in this article, please contact the editor.

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