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Eaton Capital CORPORATION

News & Views

Construction Materials Industry Investment Banking

Jack McGovern & Vic Serri Join Eaton Capital

We are very pleased that **Jack McGovern** and **Vic Serri** have joined the Eaton Capital team. Their talents and experience will tremendously enhance our strategic advisory and investment banking services.

Jack McGovern is a senior strategic planner and investment banker with considerable recent experience in the construction materials industry. Prior to joining Eaton Capital, Jack was President of Strategic Capital, Inc, an investment bank previously involved in the construction materials industry. Jack is a CPA, has served as CFO for two companies, and has over 15 years of corporate finance, strategic planning and transaction management experience. Jack brings a unique blend of broad strategic perspective, analytical rigor, and inter-personal skills to the Eaton Capital team.

Vic Serri is a senior operations manager and strategic planner with over 25 years of construction materials industry experience. Vic was previously employed by Ottawa Silica, Moline Consumers, Tarmac, CAMAS, and most recently as Senior Vice President at Cemex US. Vic's extensive background and vast experience in the construction materials industry give the Eaton Capital team unmatched operations management, strategic planning, company evaluation, due diligence, and company integration capabilities.

Great Expectations vs Uncertainty

One of the risks facing the owners of privately- or family- owned companies is what I call the "Great Expectations" risk. Given the extended term of our recent economic prosperity, most owners are very optimistic about their company's ability to continue to produce positive results. The construction materials industry in most regions has been enjoying increasing demand and excellent profits. The general economy has been strong, inflation and interest rates low, and the stock

market on a tear. The near future looks rosy, too, with bullish economic projections, increasing Federal highway spending, and relative political calm returning, at least momentarily. Unfortunately, some in our industry have allowed their memories of tougher times in the past to get a little foggy. Some may have even forgotten that the old adage about "what goes up must come down" applies to the economy, too. These positive expectations and diminished concerns can easily

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lead to “Great Expectations” about the future, a state of mind in which demand and profits continue to increase forever.

“So what’s wrong with being optimistic?”, you might ask this old scrooge of an author. Nothing at all, as long as a little realism creeps in now and then, especially when discussing really important decisions about the future of your company. Despite recent history, and many predictions to the contrary, we know there will be an economic slowdown eventually, perhaps even a recession. Nobody really thinks the business cycle has actually been repealed. Demand may fall, inflation and interest rates may rise, foreign economic problems may affect the U.S., the Balkan war may spread, and who knows what amazing things may happen next in Washington. And what about the competition? The construction materials industry continues to consolidate, with ever larger companies using their beneficial economies of scale to capture additional market share and stiffen competition practically everywhere.

How should company owners incorporate this uncertainty in their thinking about the future, especially given the consolidation trend in the industry? Most independent companies have been approached by potential purchasers, so most owners have at least thought about selling. This has caused owners to consider the trade-off between the certainty of receiving a large amount of money for selling their company and the uncertainty of continuing to own and operate their business. For many owners, issues such as advancing age, succession problems, diminishing energy to devote to the company, liquidity demands of other owners, and other non-economic issues may lead to a desire to sell. But even if these other issues are not pressing, the uncertainty of future cash flows may prompt owners to look more favorably at possible sale. For these owners, the challenge is to realistically evaluate the likelihood of actually receiving expected future cash flows. If everything goes according to plan and nothing goes wrong, those expected cash flows will be realized. But what if something does go wrong? What if Murphy’s Law is correct? Then a decision to retain ownership may not look so great. Nobody wants to look back and say “I should have sold when things were going well…”

The alternative to retaining ownership and hoping for the best is to sell the company and receive the large, certain cash flow of the sale price. By selling, the owners implicitly decide that receiving the selling price is “better” than waiting to receive the potential future cash flows associated with owning and operating the company. That is, the owners decide that the selling price is larger than the “present value” of the potential future cash flows. This present value calculation depends on the size of the estimated future cash flows and on the interest rate used to discount those future cash flows to the present time. So owners must use care in estimating the potential future cash flows to be sure those estimates are not overly optimistic. Additionally, owners must make sure the discount rate includes both an appropriate rate of return on the owner's capital plus a risk premium properly reflecting the uncertainty or risk of those future cash flows.

Buyers who offer to purchase a company also go through this same process of evaluating the likelihood of future cash flows and all the factors which create uncertainty about those cash flows. Some buyers use elaborate cash flow models to explicitly estimate ten or more years of future cash flows, then apply a discount rate they believe reflects their cost of capital plus a risk premium appropriate for the specific company and its market. Other buyers simplify this process by using a multiple of earnings and using a lower multiple if they perceive greater uncertainty. No matter what the method, when a potential buyer offers a certain price, that price is the amount they are willing to pay for the future cash flows they expect to receive.

The owners' decision to sell is then reduced to whether this price is large enough compared to the owners' perception of the present value of the future cash flows. So it all comes back to those future cash flows and whether they will be realized. It is critically important that owners are realistic about their company's ability to achieve their expected future cash flows, which means they have to be realistic about the future direction of the economy, their markets, their competition, their company's strengths and weaknesses, and all the things that could go wrong. If owners' expectations are too "bullish" or optimistic, that may lead to a decision to retain ownership, followed by disappointing actual results. Of course, too "bearish" or pessimistic a view may lead to selling at too low a price when retaining ownership would have been better economically.

In today's somewhat overheated acquisition market, with many potential purchasers bidding for almost every company which comes to market, prices for companies are high and owners we have represented in the past few years have all been very

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happy with the selling prices they obtained. Nevertheless, during the past few years we have also met a few owners with "Great Expectations" indeed, and I fear they may look back sadly at lost opportunities when the market becomes less seller-oriented, as it surely will.

An investment banker and strategic advisor experienced in the construction materials industry can provide valuable insight and assistance in two areas. First, the investment banker should know the acquisition market well enough to provide a very accurate estimate of the selling price a company would command. Second, the strategic advisor should know the industry well enough to provide accurate advice on whether the owner's expectations about future cash flows are accurate. If the investment banker and strategic advisor are the same group, even better. Eaton Capital has both the investment banking expertise and the industry knowledge to provide both types of advice. Let us help your company examine these important issues. C.E.

Current Engagements

Eaton Capital is currently representing a family-owned concrete block and architectural products producer in the western US. We are just starting the valuation process, helping the owners determine the fair market value of their company, possibly leading to sale later this year. Should we be helping your company, too?

Attention Recipients

If you have received this newsletter, you are in our construction materials industry database. We would very much like to have other senior managers, and especially the owners of your company, see this newsletter, too, so please pass it on. And if you are not the right person in your company to receive our newsletter, please call or write to tell us to whom in your organization we should send future newsletters. Thanks.