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Eaton Capital CORPORATION

News & Views

Construction Materials Industry
Investment Banking

Stock Market Gyrations and Acquisition Prices

A few days ago, I was ruminating about recent stock market gyrations with a business development manager at one of the big international construction materials companies. He was noting the recent surge in NASDAQ prices and simultaneous drop in the DJIA, and we agreed this seemed to reflect a general shift by investors away from basic industries toward high tech industries. We further noted that this general shift was affecting companies in the construction materials industry, too. For many companies, this shift has depressed their stock price, even as they have reported record earnings and cash flow. This lower share price,

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Is Consolidation Good for Our Industry??

Mergers and acquisitions seem to be everywhere in the news, and not just in the construction materials industry. It seems like every time you look in the newspaper, there's another record-breaking merger of a couple huge telecom or health care companies. On a smaller scale, the same thing is happening in our industry. The yet-to-be consummated purchase of Pioneer by Hanson is a big deal for our industry, but a piker in the headlines. And the sale of small and medium sized companies which make up the bulk of our industry's activity isn't even on the radar screen for the newspapers.

Although transactions in our industry don't get much publicity, they certainly have a major impact on the participants and their local markets. Most of these transactions involve small and medium sized, often family-owned, companies being acquired by large domestic and international companies. As this acquisition activity continues, we might ask whether this consolidation is good for our industry. Will there eventually be just an handful of material producers? If so, will that be good or bad?

Whether consolidation is good or bad depends a lot on your perspective. For many companies operating in highly fragmented markets, consolidation may be a blessing. In a fragmented market with many producers, it can be very difficult to increase prices and profit margins –

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Is Consolidation Good? *(Continued from page 1)*

there always seems to be some competitor willing to undercut prices in order to gain market share. If there are fewer producers in the market because a consolidator or two has entered the market, this cut-throat pricing may be much less likely. If the consolidator can lead prices upward, everybody in the market may benefit, including the remaining competitors. Of course, sometimes price competition occurs between the big companies, too, but in general the big companies are pretty careful not to shoot themselves in the foot.

Consolidation may also produce some beneficial effects in the form of increased efficiency. Large companies enjoy certain efficiencies in producing their products. Although the high cost of transporting construction materials reduces some potential efficiencies, this same high cost allows companies to reduce market risk through geographic diversification. These factors make larger companies more efficient, and in today's ultra-competitive economy, greater efficiency may mean better profits and a better chance of survival.

Government regulation is another area in which consolidation can improve efficiency. Regulatory compliance, especially ever-tightening environmental regulation, is becoming more burdensome for all companies. Large companies have staffs of specialists who focus on compliance issues, but for small companies, compliance can be a real problem. Poor compliance often leads to negative publicity, deteriorating relationships with neighbors and can seriously threaten a company's ability to continue operating. Larger companies have the resources to maintain compliance and avoid these pitfalls.

Obviously, today's consolidation trend is <u>very</u> good for company sellers. The general prosperity of recent years has enhanced the profitability of almost everyone in the industry, including both buyers and sellers. This means that companies being sold are more profitable and will therefore command higher prices. Additionally, buyers are more profitable, so they have more money to reinvest in the industry via acquisitions. Plus, recent consolidation has reduced the number of potential acquisition targets for these buyers and the increasing difficulty of obtaining permits in most areas has reduced the number of potential greenfield investments. These factors have created an environment in which there are many purchasers chasing few targets, so prices being paid for construction materials companies are extraordinarily high. This is clearly a very big benefit for company sellers.

On the other hand, if you are a user of construction materials, consolidation may increase the price of your raw materials and, unless you can pass through these increased costs to your customers, profit margins may shrink. But many of the consolidators are vertically integrated, so the same consolidation which leads to increased raw material prices may also lead to increased prices for value-added products, allowing companies to maintain profit margins. But this rise in the general level of prices for construction materials is definitely one of the potential downsides of consolidation, especially if price increases begin to attract the attention of government regulators. From this author's perspective, maintaining a competitive business environment is one of the few areas in which government can actually do more

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good than harm, and the construction materials industry should be no exception. The Federal Trade Commission seems to be keeping a somewhat watchful eye on the larger combinations in our industry and has recently required divestitures where they thought a combination was anti-competitive. As members of the consuming public, we should be happy someone is keeping an eye out for anti-competitive business combinations, whether they occur in our industry or some other. So far, consolidation in our industry has not progressed to the point that the regulators need pay too much attention, but the current trend may lead us there soon.

So is consolidation good or bad? Like almost everything else, it depends on your perspective. For some companies, it may lead to more rational market pricing. For others it will increase costs. It may lead to better overall efficiency and better regulatory compliance, helping improve the public's image of the industry. Offsetting this improved image, consolidation will probably lead to increased prices. For company sellers, consolidation is great. Although the decision to sell a company in which the owners have invested their lives can be very difficult, consolidation has created unprecedented value and opportunity for owners to realize the fruits of their labor. C.E.

Stock Market Gyrations *(Continued from page 1)*

combined with higher reported earnings, has been a double-whammy, resulting in significant decreases in the price-to-earnings or price-to-cash-flow ratios of their stock. In fact, for many companies, P/E's are amazingly low, with some perfectly good companies trading at only four and five times cash flow.

My friend at the big international company then argued that if this price / earnings relationship continues for any length of time, we will begin to see a reduction of acquisition prices because no buyer wants to purchase a company at a six or seven earnings multiple if it is only earning a four or five multiple itself. Unfortunately, I think I agree with him, even though his argument may be a bit self-serving. (Buyers are always telling us why they should pay less, while we are telling them why they should pay more, for the companies we represent.) Additionally, we agreed that if P/E's stay this low, companies may begin to buy back their own stock.

However, recent history has demonstrated how volatile the stock market can be despite an overall upward trend, so it is not at all clear that the current fad of depressed prices for basic industries will continue. Additionally,

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Eaton Capital Corporation

101 Larkspur Landing Circle, Suite 116
Larkspur, CA 94939

Phone 415-464-5500
Fax 415-464-5505

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stock market investor sentiment can change pretty rapidly, leading to rapid shifts of cash into and out of different stocks, which has very little to do with the basic health of the underlying companies or industries. Recent increases in the general level of interest rates may begin to slow the economy, as the Fed hopes, and recent oil price increases may slow things, too, but happily the general health of the economy appears very strong. The basic economics of our industry are still very strong, and there are still plenty of potential purchasers seeking acquisitions, so prices will continue to be bid up, although perhaps not quite to the lofty levels of the last couple years. Of course, in our fast-changing world, by the time newsletter is printed and mailed, these comments may seem pretty stale, but in general we continue to be very bullish on consolidation in the industry.

So to all you company owners out there, take heart, the sky is not falling, and, if you choose, you can still sell your company at a very handsome price.

Current Engagements

Eaton Capital is currently representing the owners of five construction materials companies in various stages of selling their companies, two block manufacturers, a ready mix producer and two aggregate producers. One of these transactions is expected to close late this or early next month, three later in the second quarter, and the fifth near the end of the year. If you have been wondering if the time is right to consider selling, give us a call.

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.