



News & Views

Construction Materials Industry

Investment Banking

Copyright 2003

Valuation of Private Companies

Business owners have a variety of reasons for wanting to know the value of their companies. Owners who are considering selling their company have the most interest in knowing value so they can decide whether to sell and know whether potential buyers are quoting appropriate values. But even owners who are not really interested in selling would sometimes like to know what their company is worth. Maybe they want to borrow to expand and the lender is telling the owner the company is not worth what the owner thinks it is worth. Or maybe they are doing some estate planning or maybe they are involved in a divorce settlement. There are many reasons for owners to be curious about value, but determining value is not easy for a privately-owned company. If the company is publicly-held, it is pretty easy to determine what the stock market thinks the company is worth by multiplying the number of shares outstanding by the market price. But a privately-held company has no market price, so this method doesn't work. For private companies, there are three commonly used methods for determining value, and each has its advantages and disadvantages.

Asset Value

One potential way to value a company is to total the value of all the company's assets. For some assets, this is fairly straightforward, with values for equipment and real estate relatively easy to determine by looking at recent sales of similar assets. Unfortunately, other assets such as aggregate reserves can be difficult to value because the location and quality of reserves differs so much between deposits, and there may not be other reserves similar enough to provide meaningful comparisons. Plus, it is not very useful to value reserves in the ground because this value ignores the cost of removing, processing and transporting the aggregate. And some assets like customer and community relationships may be so unique it can be virtually impossible to measure their value. Plus, simply adding together the value of all the assets ignores the value of the business as a going-concern, a potentially significant component of overall value. So valuing a company by adding together asset values is rarely satisfactory.

Just owning a bunch of assets does not make a business worth a bunch of money. To create

value, those assets must be used to make a profit which can be returned to the owners of the assets in the form of cash flows. Those cash flows may be taxed, they may be deferred, they may not all end up in the owners' pockets immediately, but eventually the business must produce cash so the owners can recover their original investment, plus some return on that investment.

So any useful valuation method must take into account the profitability and cash flows of the business and compare the return on investment in that business to other available investments. And an important part of comparing potential investments is judging the risk of whether the expected profit will actually occur. That is, if investors judge that there is substantial risk that expected profit may not be realized, they will require a higher rate of return on their investment to reward them for taking this risk.

Thus, there are three primary issues a useful valuation method must address - profitability, risk and return. In the construction materials industry there are two widely used methods of addressing these issues. The first method uses historical profit and knowledge of prices paid on recent transactions of similar risk to determine value. Let's call this the "profit multiple" approach. The second method uses future cash flows and required rates of return for similar risks to determine value. Let's call this the "cash flow modeling" approach.

(Continued on page 3)



The Top 25 Aggregate Producers

Here's the most recent list of the largest aggregate producers in the U.S., ranked by volume. Note that the top four producers have maintained their top rankings, with some significant changes in the remainder of the list over the past few years, mostly caused by consolidation. For example, the acquisition of South-down places Cemex high on the list, Lafarge's acquisition of Redlands pushed them up to 5th, MDU has acquired enough small- and medium-sized companies to make the top 10, and two of last year's top 25, Kiewit (16th) and US Aggregates (19th) were acquired.

<u>2002</u> <u>Ranking</u>	<u>Producer</u>	<u>2001</u> <u>Ranking</u>	<u>2000</u> <u>Ranking</u>	<u>1999</u> <u>Ranking</u>	<u>1998</u> <u>Ranking</u>	<u>1997</u> <u>Ranking</u>
1	Vulcan	1	1	1	1	1
2	Martin Marietta	2	2	2	2	2
3	Hanson	3	3	3	3	3
4	Oldcastle	4	4	4	11	11
5	Rinker	6	8	8	9	9
6	Lafarge	5	5	5	16	16
7	Cemex	7	10	11	18	18
8	Florida Rock	8	7	7	5	5
9	Aggregate Indus.	9	6	10	22	22
10	MDU Resources	14	—	—	—	—
11	Ashland Oil	10	14	16	13	13
12	Rogers Group	11	9	9	7	7
13	General Dynamics	15	15	17	14	14
14	RMC	13	13	22	23	23
15	TXI	12	20	18	15	15
16	Luck Stone	17	19	19	17	17
17	New Enterprise	18	23	24	—	—
18	Teichert	23	—	—	—	—
19	National Lime & Stone	21	21	20	21	21
20	Dolese Bros	20	—	—	24	24
21	Irving Materials	22	25	—	—	—
22	Oglebay Norton	25	24	21	19	19
23	Vecellio & Grogan	—	—	—	—	—
24	Edward C. Levy	24	—	—	—	—
25	S.E. Johnson	—	—	—	—	—

Source: US Geological Survey

(Continued from page 1)

Profit Multiples

To use the profit multiple method, you must know what prices have been paid for companies of similar risk and you must know the profitability of those companies. With this information, you can calculate the profit multiple by dividing the price by the profit. By looking at profit multiples on numerous transactions, you can begin to estimate the “market” multiple, and therefore estimate value of a company by multiplying the company’s profit by the market multiple.

Unfortunately, this process is not as easy as it sounds, for several reasons. First, it is not always easy or even possible to obtain the pertinent numbers. In most transactions for privately-held companies, neither buyer nor seller divulge the details of the transaction. Sometimes there is an announcement about the cash price paid, but there is often little detail about debt assumed, deferred payments, employment contracts and other details which can be significant components of actual value. And it is often very difficult to determine the profitability of the acquired company, especially in enough detail to compare profit figures from different companies. Most analysts like to calculate EBITDA (earnings before interest, taxes, depreciation and amortization) to calculate profit multiples because this figure “normalizes” many company-specific variables, but often these details are not available.

The second difficulty with using profit multiples is that it is difficult to compare companies with different risk profiles. Companies in different markets can have very different pricing, cost structures, competition and other factors, which create different risks. If company risks are not comparable, neither are profit multiples.

Another reason the profit multiple approach can be difficult is that the circumstances of the specific buyer must be considered. For example, two very rational and well-

informed buyers might be willing to pay very different prices for the same company because the company is a great “fit” for one buyer, but not for the other. And there can be numerous factors affecting “fit”, including geography, product mix, composition of workforce, vertical integration, or other synergies. Or perhaps one of the buyers knows something about the market the other buyer does not know, and that leads to a disparity in prices they are willing to pay. These factors can lead to unusual multiples for certain companies and must be considered in estimating value using this method.

Despite these drawbacks, however, the profit multiple approach is widely used within the industry, at least for initial estimates of the value of a company. For example, by spending an afternoon with a company owner and asking the right questions, a competent investment banker should be able to give an owner a reasonable estimate of value, and a couple days research on the company and its market can refine this estimate further. However, few transactions actually get done using just these rough estimates. Most large companies who acquire smaller companies use some form of the “cash flow modeling” method to confirm their initial estimates of value. And many owners want more than just the profit multiple estimate before they make decisions about selling, borrowing, financing, etc.

Cash Flow Modeling

The cash flow modeling method of estimating value involves predicting the future cash flows the company will generate, then estimating what a potential buyer will pay for the right to receive those future cash flows. This method necessarily requires a thorough investigation of the company and its market in order to estimate the future cash flows. This investigation will include detailed modeling of the every operation of the company (each aggregate operation, each ready-mix plant, each asphalt plant, etc.), along with the corporate overhead structure. Projected revenue and expense of each separate operation is modeled, then the separate operations are combined into a company model. For a small company, this can be a pretty simple exercise. For a larger company with multiple operations, the model becomes more complex, and if the company is fully-integrated, with multiple aggregate, ready-mix, asphalt and construction operations, the model can get pretty complicated.

The process of developing the model can be quite beneficial, because the analyst must think about every operation, market, competitor, product, expense and other variable which could value effect the profit of the company. This process generally involves consid-

(Continued on page 4)





PRSRT STD
U.S. POSTAGE PAID
Mill Valley, CA
Permit No. 7

7 Fielding Circle
Mill Valley, CA 94941

Phone 415-381-4300
Fax 415-381-6570

Return Service Requested

erable interaction between the analyst and company management, as well as independent investigation of the market by the analyst. This leads to comprehensive analysis of the company's operations, market, competitors, risks and opportunities, which gives the analyst relatively complete and deep understanding of the company. This comprehensive level of understanding enables the analyst to complete the modeling, make appropriate assumptions about the future of the company's operations and develop estimates of future cash flows which are as accurate as possible.

Once estimates of future cash flows are obtained, the analyst then estimates how the market would value those cash flows. This involves "discounting" the cash flows to a "present value", a standard financial analysis technique. The judgment and experience of the analyst are critical in selecting the "market" discount rate for that specific company, and is dependent on the perceived risk of the company. Generally, the higher the perceived risk, the higher the discount rate and therefore the lower the present value.

General Themes

Whatever method is used to estimate value, there are several general themes which apply to company valuation. First, the higher the perceived risk, the lower the price investors will pay. This stands to reason, since rational investors want to be rewarded for taking additional risk, so they do not pay as much for a

company with higher perceived risk. Second, the higher the perceived growth rate, the higher the price investors will pay. This also makes sense, because the added growth should translate into larger cash flows in the future, so the investor will receive an acceptable rate of return even if they pay a higher price up front. Third, and this may be a bit counter-intuitive at first, the better managed the company, the lower the profit multiple. If a company is already well-run and producing good profit margins, buyers know they may not be able to improve profit margins, so they will be reluctant to pay a high multiple. If the company is not well-run, buyers may perceive it as "broken" and may believe they can "fix" the company, so may pay a higher multiple. Note that the dollar profit of the "broken" company is low, and the high profit multiple figure is multiplied against this low dollar profit figure, so the dollar price actually paid may be lower than if the company were already well-run.

This article just scratches the surface of the topic of valuation, with many more details and sub-topics which can be discussed. At Eaton Capital we've been calculating profit multiples, modeling cash flows and valuing companies for over 25 years, so we have the experience and expertise to assist company owners in valuing their companies no matter what the purpose. We've performed valuations for lenders, for estate planning, as an expert witness in a divorce proceeding and for numerous owners considering selling their company. Curious about the value of your company? Call us to discuss how we