



By Charles E. Eaton

Owners who are considering selling their company need to know its value so they can decide whether to sell and whether potential buyers are quoting appropriate values.

But even owners who are not interested in selling would like to know what their company is worth. They may want to borrow to expand, and the lender is saying the company is worth less than the owner believes. Or maybe the owner is involved in estate planning, a divorce settlement or partner buy-out.

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.

One method is to total the value of all the company's assets. For some assets, this is fairly straightforward. Values for equipment and real estate are relatively easy to determine by looking at recent sales of similar assets.

Other assets such as aggregate reserves can be very 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.

Some assets like customer and community relationships may be so unique it can be virtually impossible to measure their value. And simply adding 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.

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. That is, a business enterprise has value only if it gives the owners a return on investment 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 pro-

duce cash so the owners can recover their original investment, plus some return on that investment.

Any useful valuation method must consider the business's profitability and cash flows and compare the return on investment available in that business with 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, they will require a higher rate of return on their investment to reward them for taking this risk.

Happily, profits and cash flows in the construction materials industry have been reasonably predictable. This indicates relatively low risk and therefore requires relatively low rates of return compared with many other industries. Yet there still can be substantial market, management, environmental and other risks for specific companies in the industry.

Valuation Methods

There are three primary issues that 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 uses historical profit and knowledge of prices paid on recent transactions of similar risk to determine value. This is called the profit multiple approach.

The second method estimates future cash flows and required rates of return for similar risks to determine value. This is known as the cash flow modeling approach. To some extent, the profit multiple approach is a shortcut method for the cash flow modeling approach. But it is widely used, especially for initial estimates of value, and is less detailed and time consuming than full modeling.

To use the profit multiple method, one must know what prices have been paid for companies of similar risk and the profitability of those companies. These numbers lead to the profit multiple for each of those transactions by dividing the price by the profit. By looking at profit multiples on numerous transactions, one can estimate the market multiple, and therefore estimate value of a company by multiplying the company's profit by the market multiple.

Unfortunately, this is not as easy as it may seem. It is difficult, sometimes impossible, to obtain the pertinent numbers. In most transactions for privately held companies, neither buyers nor sellers divulge the details of the transaction. Sometimes the cash price paid is announced, but there is often little detail about debt assumed, deferred payments, employment contracts and other details that can be significant components of actual value.

It is often very difficult to determine the profitability of

the acquired company in enough detail to compare profit figures from different companies. Most analysts will calculate EBITDA (earnings before interest, taxes, depreciation and amortization) to calculate profit multiples. This figure normalizes many company-specific variables, but often details about interest, taxes and depreciation are not available.

When using profit multiples, it is difficult to compare companies with different risk profiles. For example, different markets can have greatly different product pricing, cost structures, growth rates, competition, and numerous other differences. If risks between companies are incomparable, the multiples of profit also are incomparable.

The profit multiple approach also can be difficult because of the specific buyer's circumstance. For example, two rational, well-informed buyers might be willing to pay very different prices for the same company. What is a great fit for one buyer may not be for the other. Numerous factors can affect fit—including geography, product mix, work force composition, vertical integration or other synergies. Perhaps one of the buyers knows something about the market the other buyer doesn't. This leads to a disparity in what 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.

“The higher the perceived risk, the lower the price investors will pay.”

Despite these drawbacks, the profit multiple approach is widely used, at least for initial estimates of a company's value. However, few transactions get done using just these rough estimates. Most large companies that acquire smaller companies use some form

of the cash flow modeling to confirm initial estimates of value. And many owners want more than just the profit multiple value estimate before making decisions to sell or borrow.

The cash flow modeling method involves predicting the future cash flows the company will generate, then estimating what a potential buyer will pay for the right to collect those future cash flows. This method requires a very thorough investigation of the company and its market.

This investigation will include a detailed model of the company's every operation (each aggregate operation, ready-mixed plant, asphalt plant, etc.), along with the corporate overhead structure. Projected revenue and expenses of each separate operation is modeled and combined into a company model. For a small company, this can be a pretty simple exercise. If the company is fully integrated, with multiple aggregate, ready-mixed, asphalt and construction operations, the model can get pretty complicated.

The process of developing the model can be beneficial, because the analyst must think about every operation, mar-



Valuation of Recent Transactions

Three relatively large acquisitions in the construction materials industry during the past year merit closer examination. It is sometimes difficult to extrapolate from such transactions and reach general conclusions about the state of the market. Yet these transactions seem to indicate that prices for construction materials companies are still quite attractive, despite the relative dearth of such transactions.

Based on press releases and other publicly available information, the three transactions can be summarized in the table below. All three are good-sized companies with substantial aggregate operations and reserves in addition to large ready-mixed concrete operations. Kiewit Materials and Better Materials also produced asphalt. SE Johnson had substantial construction revenue.

For these deals, the revenue multiples (price divided by revenue) and EBITDA multiples (price divided

by EBITDA) are quite good, meaning that these companies were sold at prices that should have made their sellers pretty happy.

These multiples compare quite favorably with multiples from the late 1990s when acquisition markets were very hot and there were many bidders for almost every company.

During the late 1990s, a few acquisitions commanded even higher multiples. But those situations usually occurred where there was an unusually attractive market-consolidation opportunity for the buyer.

These acquisitions show that sale prices of good quality companies are still quite attractive to owners, despite the recent reduction in the pace of industry consolidation. In fact, with the increasingly robust general economy, we may see industry consolidation regain at least some of the pace we saw a few years ago.

—Charles Eaton

Buyer	Company	Revenue (\$ million)	EBITDA (\$ million)	Sale Price (\$ million)	Revenue Multiple	EBITDA Multiple
Rinker	Kiewit Materials	509	76.1	540	1.1	7.1
Hanson	Better Materials	115	21.1	155	1.3	7.3
Oldcastle	SE Johnson	272	28.0	217	0.8	7.7

ket, competitor, product, expense and other variable that could affect the company's profit. This generally involves the analyst having considerable interaction with company management and conducting an independent investigation of the market.

This leads to comprehensive analysis of the company's operations, market, competitors, risks and opportunities, which gives the analyst relatively complete understanding of the company. The analyst can complete the modeling, make appropriate assumptions about the company's future operations and develop estimates of future cash flows, which are as accurate as possible.

Once estimates of future cash flows are obtained, the analyst must estimate how the market would value those cash flows. This involves discounting

the cash flows to a present value, a standard financial-analysis technique. The analyst will select the market discount rate based on his judgement and experience and on the company's perceived risk and on the potential buyer's investment requirements.

Whichever method is used to estimate value, there are several general themes that apply to company valuation. The higher the perceived risk, the lower the price investors will pay. Investors want to be rewarded for taking additional risk, so they do not pay as much for a company with higher perceived risk. The higher the perceived growth rate, the higher the price investors will pay. The added growth should translate into larger cash flows in the future, so the investor will receive an appropriate rate of return even if they pay a higher price.

Although this may be a bit counter-intuitive at first, the better a company is managed, the lower the profit multiple. If a company is already well run and producing good profit margins, the buyer may not be able to improve profit margins and will be reluctant to pay a high multiple. If the company is poorly run, buyers may believe they can fix the company and will pay a higher multiple. Note that the dollar profit of the poorly run company will be lower, so the higher profit multiple is multiplied against this lower dollar profit figure. The dollar price actually paid may be lower than if the company were already well run.

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