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Construction

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Discipline, Patience, and Pragmatism: Construction's New Fundamentals

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Capital markets, including mergers and acquisitions and debt and equity financing in construction, are stabilizing but continue to be challenging. In order for us to better understand the weakness in deal flow, it's important to divide the construction business into two key segments: contractors and construction services.

Most contractors are struggling when it comes to financing M&A deals, and they'll continue to be frustrated in this area because business is down on a broad basis, both regionally and nationally.

Given the general softness in the market, contractors that want to sell their companies need to have a profitable EBITDA—earnings before interest, taxes, depreciation, and amortization—on a trailing 12-month basis as well as a positive EBITDA forecast. Also, if contractors enter the due diligence phase of selling their company, they should expect more stringent standards and more rigid financial constraints by both the buyer and the institutions financing the transaction.

One of the ongoing problems we continue to see are scores of partially completed construction projects. The hope, of course, is that companies will be able to complete their projects and keep their original financing packages in place. However, many companies, of all sizes, are being forced to walk away from their unfinished projects, and as a result, there are many short sales taking place.

In construction services, the prospects for financing natural resources companies, such as sand and aggregate businesses, are slightly stronger than those for contractors, but not significantly. The reason? Natural resources and construction services companies have more tangible assets, which makes them not only more fungible but also usable in a number of ways. It should be noted that in the current market, potential buyers of natural resources and construction services companies tend to be larger, strategic purchasers who expect to purchase a target company for a low to mid single-digit EBITDA multiple.

Regardless of nuances between segments, contractors, construction services businesses, and natural resources companies are all facing issues with credit. Criteria for those companies that are in dialogue with financial institutions are, in a word, brutal.

Financial terms for more traditional lending, such as bank lines of credit, continue to be priced at prime or LIBOR (the London Interbank Offered Rate) plus an interest rate spread of typically 2 to 4 percent. Additionally, personal and corporate guarantees, in almost all cases, are absolute requirements—even for larger, well-managed construction services and natural resources companies.



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Not surprisingly, banks and loan underwriters are requiring much more documentation. The additional financial and operating details sought include a company's current and projected operating performance, including detailed current and projected full cash-flow analyses, itemized balance sheets and income statements, one to two years of financial projections, a detailed three-to-five-year financial history, a well-prepared management discussion and analysis, a comprehensive list of fixed assets, and recent

appraisals on selected property, plant, and other assets. Of course, good management teams, with tested and proven track records, significantly help in negotiating reasonable financing in today's market.

Furthermore, explaining a company's story clearly, precisely, and accurately to a lender and to potential strategic partners is more critical now than it has been in years. Parties are scrutinizing all possible details about a company's current and projected performance. Executives must be prepared to discuss all their strengths, weaknesses, and business challenges in order to establish and preserve confidence and credibility.

When the economy does recover, there will be a new set of rules for raising debt or equity capital. The key building blocks will be more equity, less leverage, and a good management team. More specifically, the best companies will have strong financial management teams in place that understand the balance sheet, the importance of strong project managers, and have a solid, meaningful strategic plan in place.

Our belief is that real estate and construction companies will be forced to hold on to their property longer than they have in the past. The companies will purchase, build, or renovate and then sell properties in seven to ten years—not five years, as many firms expected to do in the past.

Looking ahead over the next 12–18 months, we believe the financial markets will continue to experience a steady, though at times bumpy, recovery. More onerous financial due diligence reviews and more restrictive covenants will remain the new standard for banks. Interest rates will, for the most part, remain attractive over the short term. However, contractors, construction services businesses, and natural resources companies should make every effort possible to secure working capital and credit lines today in order to avoid unexpected, perhaps even irrational, tightening in the financial markets down the road.

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