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What's Driving Contractor Acquisition Trends?

By Scott Duncan

Understanding buyer strategy is essential to comprehending exit options and making the best possible choice for your company.

More than half of today's construction firms will change hands over the next 10 years due to the impending generational shift within the construction market. This shift will undoubtedly provide substantial opportunity for acquirers while also leaving many multigenerational, family-run construction firms with limited transition options. Internal transition will be the preferred path for many, but other owners will assume that a third-party sale is not only feasible, but also the best way to maximize value.

This is a critical mistake.

Unfortunately, for many contractors, a third-party sale is not feasible. For starters, contractor markets have few barriers to entry and are inherently people-dependent. For many companies, the very individuals involved in the management of the company are often those who want to retire from it. And contrary to popular belief, most buyers do not have a bench of managers that they can send in to run newly acquired companies.

Adding to the challenge, strategic buyers frequently evaluate acquisitions with a "buy versus build" mindset, which makes it difficult to justify the capital investment that acquisitions often require. However, while transactions in contractor markets can be challenging, there are ways to make firms more salable and attractive to the third-party marketplace. Understanding them is a key business planning exercise for all business owners, but doing so first requires an education on buyer behavior.

Want to Be a Contractor? Have a Shovel?

Barriers to entry are extremely limited in many contractor markets. As a result, most contractors face enormous competitive pressures. These barriers to entry differ by market and project size, but the reality is that contractors rarely find themselves in a niche position where price is not a critical driver of an owner's decision-making process. Because of this dynamic, consolidating markets or driving value through economies of scale is usually a limiting factor for contractors.

So how do buyers react in a low barriers-to-entry market? Typically, they rely on one of three solutions: Achieve scale that allows them to bid on larger projects in which capital costs are high (thus excluding smaller players); integrate vertically in an effort to deliver projects more cheaply or at a higher overall project margin; or diversify into multiple markets over time to limit the effects of market concentration.

Put simply, there is no strategic panacea. Even larger contractors that deliver multibillion-dollar projects are subject to substantial cost pressures. While vertical integration deals (e.g., a general contractor acquiring a trade subcontractor) will likely increase as labor constraints continue to influence project delivery and overall contractor strategy, this approach produces a limited number of contractor success stories.

Texas Comes Into Focus

By far the most common expansion strategies for contractors are geographic and service diversification. And the strategy of "where and how" to compete often leads to questions around key customers, labor dynamics, buy versus build and other factors. In the end, however, the analysis is frequently driven by one critical question: Where is the growth? And since the great recession of 2009, Texas has been at the top of the list of states that are experiencing healthy economic growth.

On an overall basis, Texas is the largest market for private, nonresidential construction put-in-place (CPIP). Since 2011 (the trough in private, nonresidential CPIP), Texas has outgrown other states by nearly a 3-to-1 margin, with a 26% compound annual growth rate (CAGR). This was largely due to the growth in the oil and gas/industrial markets, and also to the favorable investment environment in Texas, which drives substantial amounts of private commercial dollars.

Texas is third, behind Washington, D.C., and Nevada, in the strongest growth in commercial construction since 2011, growing from \$5.2 billion in 2011 to \$12.8 billion in 2016. In fact, lodging in Texas grew the fastest of any state in the country, up 22.5% since 2011. In short, the Texas construction market is one of the largest and fastest-growing in the U.S. With its low taxes, a business friendly regulatory environment and strong infrastructure spending programs, Texas attracts a high number of new businesses every year. And, as such, it's a very attractive market for companies looking to acquire construction firms.

The Risk Spectrum of Contractor Attributes

Operating in a growing market alone does not necessarily dictate salability; other factors play a key role as well. And all contractors are not created equal. There are numerous attributes that affect the salability and value of a contracting firm. The most important of these include:

1. **Strength of the Management Team.** The strength, depth and duration (i.e., retirement timelines) of the management team are among the first questions acquirers will ask about target companies. If one or two owners/managers are actively managing multiple aspects of the business and are seeking to retire shortly after a transaction, what is the buyer actually acquiring?

2. **Project versus Recurring Revenue.** Project-based businesses typically demonstrate greater volatility in revenue than companies with non-project-based revenues. Buyers tend to treat predictable, consistent revenues much more favorably than those that are more volatile in nature.

3. **Bonded versus Unbonded Work.** In some markets bonding is required to obtain and execute work. For companies in these markets, the buyer pool can be limited to strategic buyers who understand and are willing to accept this risk. Financial buyers typically shy away from bonded revenues due to the effect bonding has on the ability to finance transactions primarily with debt.

4. **Competitive Hard Bid versus Negotiated T&M.** Companies operating in highly competitive, hard-bid markets are at much greater risk of job losses. Furthermore, they are more easily displaced on bid day than companies operating in a negotiated capacity. Buyers understand this risk and react accordingly.

5. **Prime versus Sub.** Companies working in a prime capacity for clients drive more value in acquisitions than those who serve in a subcontractor capacity. That's because subcontractors are dependent on general contractors (GCs) or prime contractors for their work and are often chosen based on price.

6. **Self-performance.** Self-performance is a growing bottleneck in the construction supply chain. Companies that control the labor pool are inherently less risky than those that are dependent on subcontractors.

7. **Size and Diversity.** Larger, more diversified companies present less risk to a potential buyer than smaller, less diversified firms. This can play a key role in salability, particularly in heavy civil and general contractor markets.

Other factors can also weigh heavily on buyer interest. Many strategic buyers, for example, are not interested in entering states with high rates of taxation and/or substantial regulatory compliance burdens. Workforce issues can also play a key role in salability, depending on the market.

Risk Attributes at Work

While buyers often prefer prime contracting relationships, there remains a strong consolidation trend in the specialty trade market. Companies like Comfort Systems and EMCOR are serial acquirers that understand and accept many of the challenges subcontractors face. And while buyers almost universally prefer recurring revenues, dozens of transactions with lump-sum, competitive-bid contractors are executed annually. As a result, it's important to look more closely at individual markets.

GCs and construction managers (CMs) for example, frequently execute in a lump-sum, competitive environment, and projects are frequently bonded. These attributes and the lack of self-performance limit the buyer pool for GCs. As a result, many of these firms turn to internal transition as an exit option. However, larger general contractors have benefited from the emergence of the international buyer community that, with ample capital and nearly unlimited bonding capacity, has actively acquired firms in the United States. Recent Texas examples of this include Balfour Beatty/SpawMaxwell/Howard S. Wright and Webber's (Ferrovial's) acquisition of Pepper Lawson.

Heavy civil firms face many of the same market pressures as GCs and CMs, but with the added stress of operating in a highly competitive bid environment with more complex, risky projects. However, the bright spot for heavy civil firms is that foreign interest in this market has grown substantially over the past two decades. Italian-based Salini Impregilo's acquisition of Connecticut-based Lane Construction is a good recent example of foreign interest in this market.

Specialty trade contractor transactions are fairly common in the industry. And while they are frequently in a subcontract position, specialty trade contractors can increasingly find opportunities to develop prime relationships with clients through service contracts and other mechanisms. Furthermore, the self-performing nature of this work is attractive to many acquirers. Recent examples of mechanical/electrical/plumbing (MEP) transactions include Comfort Systems' acquisition of Dallas-based Dynaten and Florida-based BCH Mechanical.

Who Is Buying Texas Contractors?

FMI reviewed its historical database of transactions, coupled with publicly announced transactions, and focused on identifying key transactions in the following segments since the end of the great recession:

1. ***General Contractors/Construction Managers* –** Companies performing general contracting and construction management work primarily in commercial markets and typically subcontracting the majority of the work.
2. ***Specialty Trade Contractors* –** Self-performing contractors that typically act as subcontractors to GCs and CMs, most frequently serving commercial markets. These contractors are a diverse group and range from electrical contractors to mechanical/HVAC contractors to concrete and earthwork contractors.
3. ***Civil Contractors* –** Contractors executing primarily government projects (e.g., roads and bridges/water infrastructure) and typically operating in a prime capacity.
4. ***Industrial/Energy Infrastructure* –** Contractors working in industrial, oil and gas or utility markets with a primary focus on construction or construction services delivered in a prime, self-performing capacity. This excludes hauling, roustabout, inspection, wellhead services and other nonconstruction-related oilfield services.

Finally, industrial and energy infrastructure contractors are among the most salable in contractor markets. Higher barriers to entry driven by operator qualifications, safety and experience requirements—and large, blue chip clients—create an investment environment that both strategic and financial buyers find favorable. The prime, self-performing nature of these companies adds further value to strategic buyers. The Wood Group's acquisition of Infinity, Quanta's acquisition of Price Gregory, Primoris' acquisition of Sprint Pipeline, Team's acquisition of Furmanite, and Zachry's acquisition of JV Industrial are all examples of recent deals in this market.

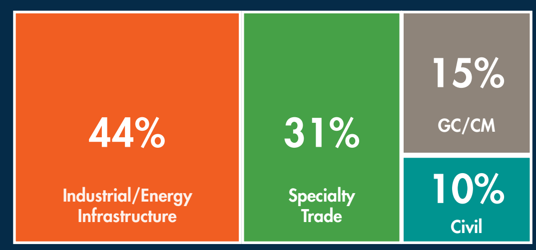
Assessing the Implications for Your Firm

Regardless of where your firm falls on the salability spectrum, early preparation can pay extraordinary dividends. Address the questions below as early as you can:

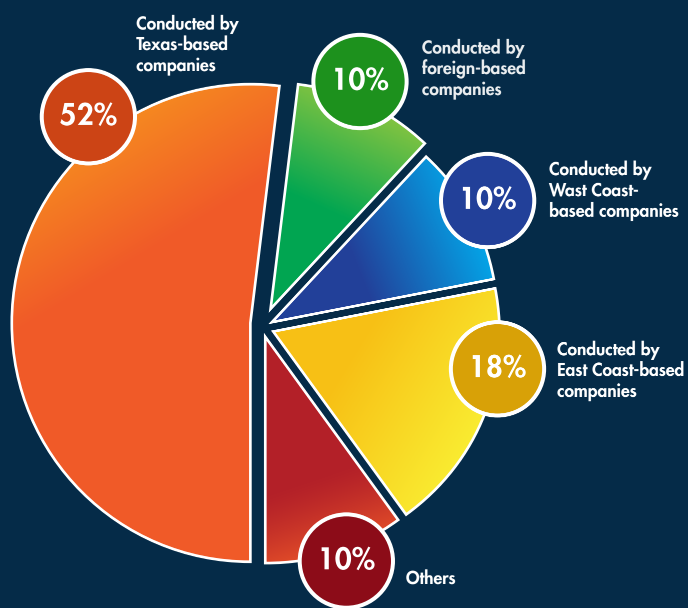
- Where does your firm fall on the salability spectrum? If third-party sale is not feasible, have you explored how long an internal sale will require?
- What legacy do you want to leave? Does a third-party sale facilitate that?
- What are your valuation expectations? Many owners assume a third-party sale is the best way to maximize value, but this is typically not the case. Internal sales can often reap exiting owners substantially greater proceeds, so long as they have the patience and willingness to work through an internal sale.
- Who will manage the company post-closing? Do they have the leadership capabilities and management skills to be successful? If not, how will you prepare them?
- Does the company have robust systems and processes that will facilitate a thorough understanding of the company from an outside perspective? If it's all "in your head," there's a problem.

FMI's analysis of M&A transactions since the recession in the Texas contractor market yielded the following key data points:

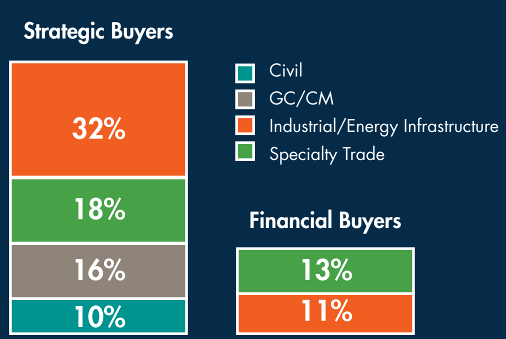
Transactions
by Market Segment



Total Transactions
by Geography



Transactions
by Buyer Type and Market Segment



Source: FMI, Capital IQ

Every construction firm has its own set of attributes that will determine salability and value. A clear understanding of your ownership objectives, coupled with an understanding of salability and value, will allow you to prepare for a successful transition.

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FMI serves all sectors of the industry as a trusted advisor. More than six decades of context, connections and insights lead to transformational outcomes for clients and the industry.

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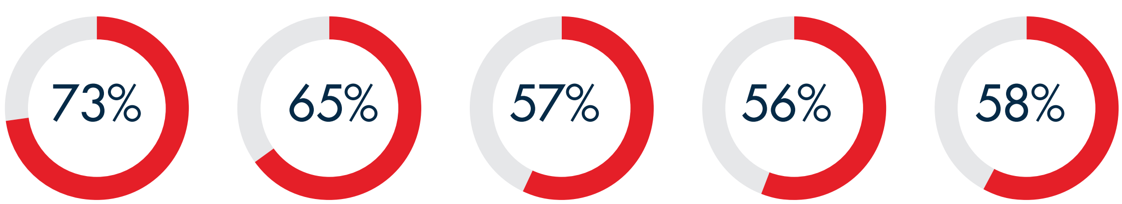
FMI Client Highlights



- 73% of the ENR Top 400 Contractors
- 65% of the ENR Top 200 Specialty Contractors
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- 56% of the ENR Top 200 Environmental Firms
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