PRIVATE EQUITY: FINDING THE VALUE IN THE BUILT ENVIRONMENT

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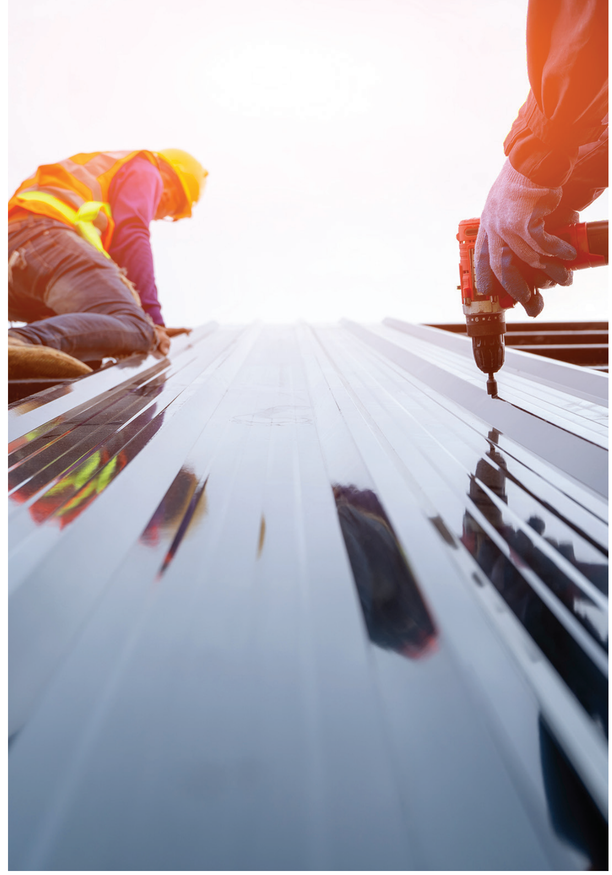

In 2020 there were more than 400 private equity (PE) transactions in the engineering and construction (E&C) sector, representing more than $27 billion in deal value, according to Pitchbook data.

These figures climbed to nearly 600 deals in 2021, representing more than $34 billion, a 26% increase. As of September 2022, there were more than 350 closed transactions, worth more than $51 billion—51% more than last year's total, part of a growing trend where PE continues to deploy money into segments and geographies ripe for disruption, consolidation and innovation.

Skilled investors can spot opportunities, but the complicated outlook for the economy and the construction industry, including building products, facilities services and related E&C industrial industries, means that it's going to take deep industry knowledge to find the right prospects.

The outlook for the built environment and related spending is changing quickly as the global economy slips into a potential recessionary environment (see FMI's three recession scenarios and the potential outcomes for the industry).

Looking ahead, the potential recession and recovery are expected to be uneven across E&C sectors, and we're beginning to see that companies within certain sectors and segments will grow, while others will see their business models shift drastically. In our latest paper, we outline some of the larger trends that will likely drive the built environment for the coming years.

But what does this mean for private equity? There are several components that PE leaders should understand to drive greater value and resulting returns within the built environment. Like much of the rest of the economy, there will be pockets of opportunity for those with well-supported insights and the ability to act accordingly.

Recession Exposure

While everyone is subject to current economic conditions, there are sectors and businesses within the built environment that have varying degrees of exposure. This is critical for private equity investors and owners to understand, since the nuances of the broader industry can be challenging for those who don't work in it day to day.

For example, 70% to 80% of money spent on roofing is for replacements, not new construction, which is typically not as affected by the broader economy because roofing updates are necessary repairs. The remaining 20% of the market for roofing new construction is cyclical. It's critical to understand a roofing company's revenue mix, whether it's heavily exposed to new construction or replacements, when evaluating different investments which at first glance might look similar.

Continuing the roofing example, the differences also extend to the sales process. For most new construction, roofing companies are focused on selling to general contractors and building relationships with that consolidated client base. Replacements require selling to individual building owners, facilities managers and building envelope consultants, a market that is far more fragmented.

During a downturn most companies will continue to invest in maintenance and upkeep, which could push some commercial roofers to move from new construction to replacements. But that does not automatically guarantee success since variables such as the sales staff, service employees, supply chain relationships, labor and contracts vary greatly between the two business models.

As such, PE firms need to understand and evaluate the revenue mix and type of customers for the roofing company in addition to the sales pipeline, service and maintenance plans, the bid process for the market and other nuances of the company's operating environment before investing.

But the market drivers and the resulting impacts are only part of the picture. Investors should also look at the competitive reaction to economic circumstances and whether other roofers in the area will be able to quickly pivot their businesses to rebalance their revenue mixes. While this example focuses on the already PE-heavy roofing industry, the same context applies to many other segments and businesses within the built environment.

Position in the Value Chain

Deep knowledge of where a company sits in the construction value chain, the efficiencies required to compete in that market, and the true value brought to a project are critical components for private equity investors to understand before putting capital to work.

Take the market for independent sales rep agencies serving the heating, ventilation and air conditioning (HVAC) industry, for example, an interesting play in a market already dense with PE competition. A company's position in the market and who it's working with are critical to accurately understanding its value. Is it working with the leading contractors and mechanical subcontractors in the market on marquee projects or a different subset? Is it advantaged or disadvantaged by the manufacturers it represents? (i.e., is its line card a benefit or detriment?) The sales team is also important for understanding an HVAC rep agency's value. A company with an internal team grounded in engineering fundamentals and knowledge of how a construction project comes together is more valuable than one with a less experienced workforce. To create long-term value, PE firms also need to understand how entrenched they are in the local construction value chain and companies' participants.

Private equity firms that understand the nuances of the value chain and how HVAC equipment is sold and installed will be more competitive in bidding. This provides a solid foundation for private equity firms to start thinking about value creation and their strategies post-close. Retaining this skilled workforce and leveraging its experience to grow become a critical part of the acquisition strategy.

Market Opportunities

Investing in one profitable company over another means understanding the nuances of the market opportunities and how a company can capitalize on its positioning. Anyone can look at the bottom line, but smart money needs more detailed analysis to truly understand the differences.

Where a company operates matters. Long-running trends and migration patterns show that southern and southeastern states will offer more favorable markets for certain segments of growth than other areas in the next five years. Conversely, companies operating in states seeing an exodus of people will be at higher risk as the local economies become less diversified, more concentrated and increasingly dependent on their remaining employees. Labor constraints hamper growth and alter the post-acquisition strategy.

A company may be profitable, but a thorough investment decision considers the talent pipeline, project management, systems and operations needed to expand.

The Talent Equation

Talent is critical to any business, but even more so in construction-related services where labor is scarce. The lack of skilled labor is nothing new, but it takes more than productivity models to recognize the best employees. Many firms in the space are small or family-run, and sometimes processes and business knowledge aren't always well documented or obvious.

Recognizing those culture carriers, such as the charismatic founder or the estimator who has won business for 25 years without documenting a methodology or system, requires investors to dig into the nuances of not only if the work is being done, but also who's doing it and how.

Successful investors will take the time to properly conduct due diligence beyond financials and the market outlook to gain an understanding of the value of those working in the office as well as the field. Private equity firms that discount this could find themselves lacking the workforce to win business and execute in one of the most competitive labor markets in the country.

Creating Long-Term Value

Where private equity can often add value is by bringing knowledge and expertise of new trends to construction companies. Take the need to halve carbon emissions by the year 2030 and the role that the broad construction industry will play in reaching those goals. Buildings account for around 50% of U.S. emissions when you take into account consumption as well as embodied carbon, the emissions from materials extraction, production and transport, disposal of old structures, construction equipment and activity, and maintenance over the life cycle of the structure.

Private equity firms with an interest in energy and an expertise in emissions reductions can help service providers understand how to mitigate carbon in their materials, processes and technology. Thinking through current areas of expertise, portfolio holdings and where companies can transform a business can also help private equity investors make innovative investments.

Private equity firms looking to invest in the built environment need to have a deep understanding of the nuances of the markets, segments and geographies they're considering. But that knowledge needs to go beyond profit and loss to understanding a target investment's talent pool, sales cycle and sales team; the impact on the economy, on the sector and on how that affects competitors' decisions; and other intangibles that aren't readily found in financial statements.

Author

Paul Giovannoni's focus at FMI is partnering with private equity firms to assist in developing strategic insights into businesses and market opportunities within the built environment. Paul concentrates on providing commercial diligence studies to support transactions in the industrial sector as well as post-close value creation activities by leveraging FMI's deep relationships in the industry and a nuanced understanding of how businesses in the sector operate and win.

Segments where Paul has direct experience include infrastructure services, engineering, building products and distribution, industrial services, energy and cleantech, HVAC services, construction materials, construction technology, utility services, specialty trade contractors, general contractors, and construction equipment and tools.

Before focusing his efforts on supporting private equity firms, Paul worked closely with some of the nation's largest trade contractors and building product manufacturers to help develop their organizational strategies and go-to-market plans. Through these engagements, Paul developed an insider's understanding of the drivers of value for these businesses, which he leverages for his current clients.

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FMI is a leading consulting and investment banking firm dedicated to serving companies working within the built environment. Our professionals are industry insiders who understand your operating environment, challenges and opportunities. FMI's sector expertise and broad range of solutions help our clients discover value drivers, build resilient teams, streamline operations, grow with confidence and sell with optimal results.

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