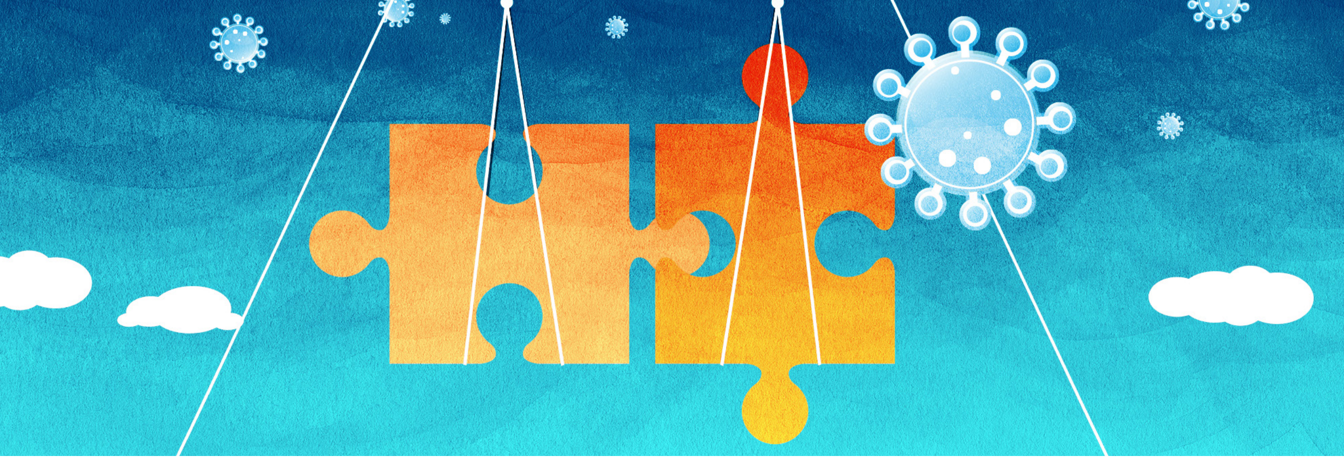


Selling Your E&C Company During Covid-19

By Ryan Foley

A look at COVID's impact on engineering and construction M&A and what could be around the corner in 2021 and 2022.

With COVID-19 continuing to affect engineering and construction (E&C) around the world, the industry's mergers and acquisitions (M&A) activity has also felt the ramifications of the ongoing pandemic. In March 2020, FMI saw about one-third of its contractor deals get paused, put on hold indefinitely or canceled as acquiring companies turned their attention to more pressing matters. This was done to protect the buyers' balance sheets, shield those buyers from vulnerable end markets (i.e., office and hospitality), and address overall trepidation about the world's economy.

During the late summer and early fall, FMI witnessed a marked uptick in transaction activity and interest on the part of buyers and sellers in the E&C space. As some of the early virus-related panic began to subside, select buyers came back to the deal table. Concurrently, sellers began calling FMI investment bankers to discuss exit strategies.

While we're not in a full recovery, we are seeing sellers become more interested in potential transactions as well as shifts in deal structures, heightened due diligence and surprisingly stable valuations. This article will explore these M&A trends with an emphasis on risk mitigation and heightened due diligence in the age of a pandemic.

Buyers Are Still Buying

The first notable shift in the market environment was, not surprisingly, created by buyers. In March there was a distinct subset of acquisitive contractors that put their ongoing or planned transactions on indefinite hold. This was particularly true for end markets like office, retail, amusement and hospitality, all of which are now in the throes of combatting a substantial decline in project backlogs.

In early spring, FMI received several calls from large, well-capitalized general and industrial contractors expressing an eagerness to deploy resources on acquisitions. While none of these firms expected a global pandemic to be the catalyst, those buyers who were waiting for a market correction in early 2020 were keen to communicate their desires to find good acquisition opportunities.

Concurrently, those acquirers who hit the pause button on M&A as a growth strategy—and particularly specialty trade contractors—were suddenly back in the market. We are now also witnessing increasing interest from market segments such as heavy civil, which remains bullish on the prospects of a permanent infrastructure package sometime in 2021.

In addition, companies and people migrating away from dense urban areas and natural disaster-prone regions are creating demand for housing and, to some extent, commercial development in select locations such as Texas, Utah and the southeastern U.S.

Curious Sellers Are Coming Out of the Woodwork

As the country settled into a pattern of addressing and dealing with COVID-19's impacts, sellers began to take an interest in potential exits. In August and September, FMI Capital Advisors was inundated with calls from prospective sellers seeking information on the marketplace, valuations and M&A processes. We attribute this to several factors. First, many business owners are nearing retirement age and aren't interested in managing through another downturn after the Great Recession.

Second, we see business owners looking to exit their companies after back-to-back record-breaking years. We do, however, caution these prospective owners to avoid trying to time the market as it can be exceptionally challenging. Put simply, sophisticated acquirers won't be fooled by the notion of continued record years and will be paying particular attention to work in progress (WIPs) and project pipelines.

Third, as construction cycles tend to lag gross domestic product, we still see a degree of optimism from both buyers and sellers. However, the great overhang of uncertainty could dampen these ambitions next year and even into 2022. Lastly, the change in U.S. presidency could spur concerns about a higher tax environment, driving some sellers to the deal table.

Changing Deal Structures

While there is great uncertainty heading into 2021, buyers are seeking ways to mitigate the risk of a precipitous drop in the financial performance of target companies. As a result, changing deal structures have become a sign of the times. We're seeing earnouts (i.e., portions of the purchase price contingent on future earnings) as well as sellers' notes increase in offer structures from 10%-20% of purchase price to 20%-30%. This is not surprising, as construction is notoriously unpredictable. Also, these mechanisms help buyers and sellers bridge the gap on valuations and get to the closing table.

Heightened Diligence

The environment during COVID-19 is creating increased due diligence streams. In the second quarter, there was tremendous uncertainty surrounding Paycheck Protection Program (PPP) loans; their impact on M&A transactions was a large unknown. Would the loan be forgivable? And if not, should the acquirer assume the loan? The Small Business Administration and other government institutions had no answers to these questions, yet the lessons learned in the Great Recession taught Congress that the first priority is to get the money out as quickly as possible and figure out the regulatory environment and fraud risks later.

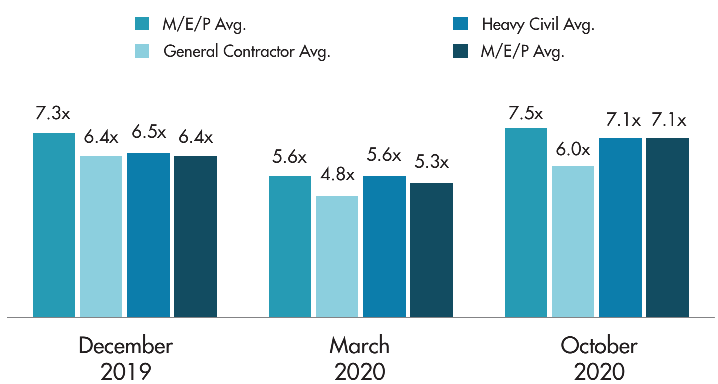
We now know that the most common treatment for PPP loans places the onus of forgiveness on the seller. Other trends we have seen are increased scrutiny of unfunded pension liabilities, WIP profit fade/gain trends and other financial instruments that could be negatively impacted by an economic downturn.

So Where Are the Bargains?

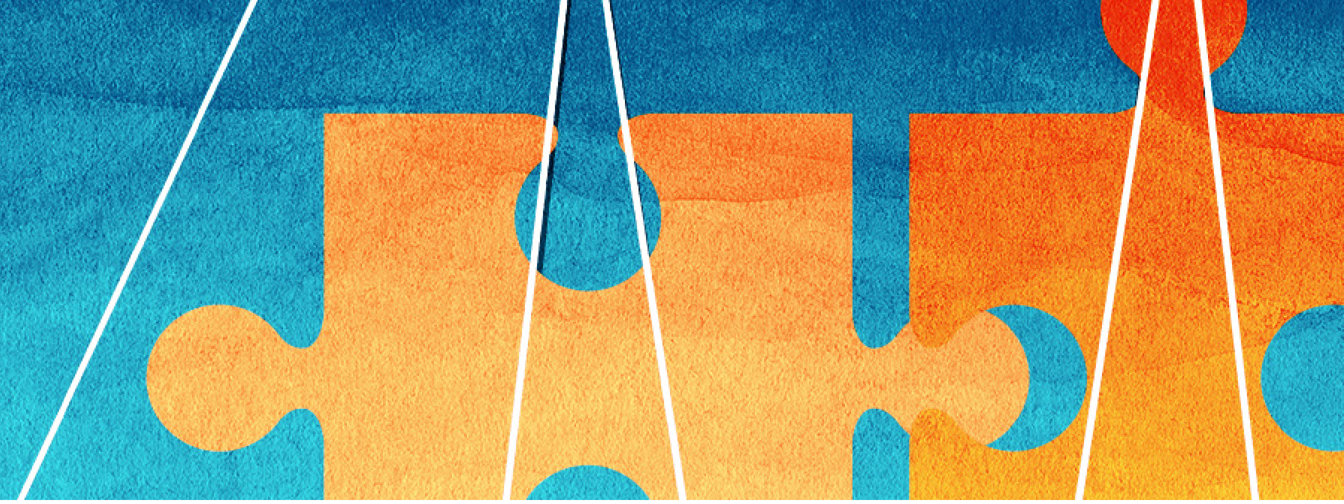
Both buyers and sellers are now wondering just what the current market and economic volatility means for valuations. Surprisingly, the answer is not much. With companies working through robust backlogs, both buyers and sellers are still experiencing attractive financial performance on existing jobs. At the other end of the spectrum, opportunistic buyers anticipating a downturn in valuation multiples have been disappointed as sellers have not yet conceded a willingness to trade for less. Of course, this may change as project backlogs are expected to soften in the coming months, possibly all the way into 2022.

In December 2019, for example, mechanical, electrical and plumbing (MEP) public comparable companies were trading at 7.3x enterprise value forward EBITDA. This multiple dipped to 5.6x enterprise value in March 2020, but as of October 2020, these multiples were largely unchanged at 7.5x. In fact, for E&C as a whole (both domestic and international public companies), this multiple increased from 6.4x in December 2019 to 7.1x in October 2020 (Exhibit 1).

Exhibit 1. Enterprise Value / 1-Yr Forecast EBITDA



Source: CapitalIQ



Our Crystal Ball

As we close out 2020 and move into the new year, FMI expects these M&A trends to either continue or begin to take shape:

- Based on conversations with contractor management teams, we expect an increase in deal activity in 2021 versus 2020, particularly due to the lost quarter that happened in early 2020, when M&A transactions were on hold.
- We also expect to see deal announcements in mechanical and electrical trades, where there continues to exist robust interest from large private and publicly held companies.
- In addition, we anticipate a few announcements from industrial contractors with heavy exposure to oil and gas seeking to diversify into other end markets such as food and beverage and pharmaceutical.
- We expect continued bullishness on the proposed infrastructure and pandemic rescue package to spur deal activity in the heavy civil and highway segments (although this will be offset by diminished state and municipal budgets).
- On the bear side, we expect M&A activity among commercial contractors with exposure to retail, office, hospitality, transportation, amusement and multifamily to be dormant.
- In addition, while we expect there will be interest from large general contractors to acquire attractive targets, we expect valuation to remain a hurdle for closings. For example, we're seeing a number of buyers that want to acquire contractors that service data centers, pharmaceuticals, warehousing and distribution. The question is, why will sellers be willing to trade when they are amid record-setting demand.

All in all, the M&A market for construction is faring better than we anticipated at the outset of the pandemic. We hope that vaccines and treatments continue to show positive progress through clinical trials and that at least one outcome of the election will be less uncertainty, which always bodes well for both the economy and demand for new construction.

About the Author

Ryan Foley is a managing director with FMI Capital Advisors, FMI Corporation's investment banking subsidiary. Ryan co-heads the Contractor & Construction Services industry practice of FMI Capital Advisors, FMI Corporation's Investment Banking subsidiary. In this capacity, Ryan provides strategic M&A and capital raising services to the construction and engineering industry. He can be reached at ***rfoley@fminet.com*****.**

FMI

for the Built Environment

Denver
210 University Boulevard
Suite 800
Denver, CO 80206
303.377.4740

Houston
1301 McKinney Street
Suite 2000
Houston, TX 77010
713.936.5400

Raleigh (headquarters)
223 S. West Street
Suite 1200
Raleigh, NC 27603
919.787.8400

Tampa
4300 W. Cypress Street
Suite 950
Tampa, FL 33607
813.636.1364

WWW.FMINET.COM