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The M&A Sector of the Building Services Industry: Current Status

OPINION - *Gary A. Penrod*
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Depending on one's source of information and/or political persuasion, the U.S. economy is gathering strength or it is flat. We are not sure which it is, however, we at GPA remain positive about the United States and its historical ability to rebound, so we remain cautiously optimistic.

The M&A market sector of the building services industry, like the industry itself, is in the midst of a rebound. The M&A rebound, while not necessarily robust, is showing positive signs that activity is approaching pre-recession activity. We at GPA feel that the momentum that began during Q 1 '10 will continue and that 2011 will have a relatively strong finish. The prospect of a capital gain increase in 2011 that concerned many has largely been forgotten since that possibility has been put off for another 18 months. Some, however, are beginning to think ahead that a rise in the rate is still a possibility. That prospect is likely to spur some activity among those that have been thinking about selling their company, but need some incentive to move the thought process ahead.

The building service industry itself has rebounded as it has always done in the past. A few bruises here and there, but most companies have emerged as strong as before the recession, and some, even stronger. For sure, many shareholders are paying much more attention to their company's balance sheet than they did prior to Q 4 '08. Those with focus on balance sheet health, selective growth and cash conservation have found that being engaged in the industry, while always challenging, can be rewarding and fun too.

Why Sell; When Is a Good Time To Begin the Process? As mentioned earlier, there appears to be new-found energy among many company owners. That energy translates into not only having fun and enjoying a sense of achievement, but gaining the realization that what you are also doing is building equity. For all of us that are engaged in work activity, building equity (personal wealth) is very important in the world in which we live. That is not to say that personal wealth is a panacea and more important than other aspects of life, but gaining personal wealth through the creation and operation of a successful business enterprise can help to make other important aspects of life even better. For those in the building services industry, personal wealth (a relative term) is usually achieved when one's business is sold partially or in its entirety; although many entrepreneurs enjoy lucrative compensation, some of which may be used to also build wealth along the way.

Nothing is forever, so it is a good idea to plan ahead, as the cliché goes. That means developing a plan that works for you and your family. Building a business as life goes on means that, at some point, there will be a nexus, or a joining of personal circumstances and business circumstances that will dictate that now is the time to consider selling one's interest in the business so that the other aspects of life can continue on course. The plan needs to be active, updated as circumstances change. Then, when the stars align, business is on the up-swing and the economy is such that there are qualified buyers, it may be time to sell or, at least, test the water. The alternative is to not have a plan and simply react when one of the hundreds of letters from prospective buyers or brokers is received on a day when things are not going well and the business feels like a weight on your shoulders. This sort of reaction can lead one down a path that may or not lead to a satisfactory transaction, wondering why you did what you did. It will be much better to look in retrospect, saying; "I planned, everyone did well in the transaction and I am glad that I did what I did."

The question always arises, "how much money (price) is enough?" This question must always be asked of oneself when considering the prospect of selling one's life work and primary source of income for many years. It can be a rude awakening that, this is it! Whatever is received (net) is what I have to make do for the rest of my life. Is retirement a consideration? Maybe, a new venture? Or, maybe a new career with the acquiring company. These are all possibilities and for each, the answer to the how much is enough question can be different. Price is important, but so are the transaction terms. Net cash is cash that can be put to work. A promissory note, usually subordinated, will earn interest. The earn out, a risk sharing method between the buyer and the seller can grow, or, if not structured properly, can decrease. The earn out component of the price may vary from transaction to transaction, but frequently is for about 20% to 25% of the price and has a life of anywhere from 1 to 3 years. We have seen 6 month earn outs and 7 year earn outs.

Back to the original question," how much is enough?" Plan and one will find out! However, keep in mind that the net amount received is not necessarily the end of the game. Money can work for you, continuing the equity growth that your building service company once did.

Why Acquire; When Is It a Good Time To Buy? Acquiring a company, like selling one's company requires thought, planning, ability to undertake the acquisition without crippling yourself and understanding and accepting the risk that exists in every acquisition. Why acquire? What does the company that is being considered have that is wanted and will add strength to your existing business plan? Perhaps, it has contracts in a contiguous market area. Maybe it is engaged in providing services to a market sector that is attractive to the buyer and through the company's acquisition will provide the acquirer with credentials in that particular market sector. Adding revenue and earnings can also be a consideration, but that can also be achieved through organic sales. Actually, all of the good reasons to acquire can be achieved through effort and a good marketing plan. Often, however, acquisition does make sense, so long as one is financially qualified and the acquisition has been carefully analyzed, executed and a strong transition plan has been put in place. My view is that there are some signs that need to be recognized as being poor reasons to consider an acquisition. One is simply to ramp up sales, as opposed to going to work and achieving new sales through organic growth. Why buy a company in the same market area that is engaged in the same market sector? Could it be that the buyer has in mind that a competitor will be eliminated? Dare I mention that sometimes ego takes the place of sound judgment for an acquirer? It has been known to happen!

Assuming that the acquirer's reasons for considering an acquisition make business sense, there are things about the company that the buyer must understand: (1) historical performance, (2) customer retention rate, (3) reputation, (4) management infrastructure quality, (5) corporate culture and (6) a vision of how the blend of companies will work in the short term and the long term. Of course, the acquisition effect must be carefully analyzed so that all financial considerations are understood and are workable. Due diligence must be thorough and should include all financial, operational, legal and personnel matters.

There are buyers and there are buyers. Strategic buyers are those that are already engaged in the building services industry. They may be engaged in a slightly different service, but still engaged to providing services for buildings. They may be located in a different market area. Strategic buyers know the industry, at least, from their perspective. They will be interested in the target acquisition's financial information, performance, customer retention and other, softer aspects of the company to see whether or not there will be a fit. Often, they will visualize the company as being fully integrated with their company, including the back office functions. In many cases, but not all, their basis model will be that fully integrated company.

Investor buyers are another category of buyer. These groups, of which there are many, will usually have interest in companies will revenue of $40 Million or more with adjusted ebitda of 10%, although, there are some groups that will have interest in smaller companies. While some of these equity fund groups may have building service contractor companies among those in its portfolio, they are financial people and in some cases have only limited understanding of the industry. They are very often astute financial people with the thought of buying, building and later selling the company purchased. To accomplish this, the purchased company will have to be led by the acquired company's owner or, at least another proven executive within the acquired company ranks. Often, as part of the purchase price, the former shareholder will be expected to retain some stock or agree to an earn out for a period of time. Like other companies, equity groups come in all sizes and shapes. Some are better than others at what they do. It pays to thoroughly understand a particular group's goals and to make a judgment about whether or not there will be a good fit for the company giving consideration to partnering with the equity group. It should be noted that there have been many successful transactions completed between equity fund groups and building service contractors over many years. Now, however, seems to be a period of heightened activity among equity fund groups with interest in the building services industry as evidenced by the countless letters of inquiry from the scouts for the equity fund groups. Even GPA receives inquiries!

What About Valuation (price, terms)? That is the question, but let me suggest that there are no bargains. As in other purchases, "one gets what one pays for!" It all has to do with how a particular buyer perceives the value of the company being considered. That perception is unique to that buyer. Another buyer, looking at the same company may see something entirely different. They can each be correct; therefore, value is relative. A prospective buyer should, in my view, analyze a company being considered based on its own management's perception about how the acquired company will fit and what the combined companies will produce that is better than if the acquisition had not taken place.

Everyone in the industry is aware of the “rule of thumb” valuations based a multiple of adjusted ebitda. Add the rule of thumb valuations to the rumors about what companies have been sold and at what price, there remains an indelible impression of what value is. It is unfortunate that some would-be acquirers use this valuation thought process, because they could purchase a company, paying too much, or, they could lose a company that would have been a really good fit, providing a combined company that, in the long-term, would have put them much further ahead of where they would be without having done the acquisition. This, for the sake of adhering to a rigid valuation thought process that may or may not make sense for their particular situation. Buying a company is not like buying a car and there is no Blue Book that lists the price. Arriving at a price and structure that is fair, reasonable and workable requires careful analysis of one’s own situation and working diligently with the seller. A good transaction requires both the buyer and the seller to feel as though they each made a good deal! It does not always work out that way, but it is what we at GPA try to accomplish for our clients.

So, whether a prospective seller or buyer; caution, motive analysis and planning are advised. There are horror stories of transactions gone bad, but thankfully, most of these have been long ago, when the industry itself was in its infancy. While there is always risk, any transaction that has been built on mutual trust , good-faith and careful analysis by all parties, will likely succeed.

As always, I will appreciate your questions and comments. I will look forward to hearing from you.

STAY TUNED! Gary