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Construction M&A: Trends and the Changing Role of Risk Managers

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Introduction

Overview of FMI

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- Focus on contractors, including specialty trades, heavy civil and general contractors
- Over 20 years of investment banking experience
- Experience in M&A, private equity, public/private placements of capital, recapitalizations and restructuring transactions in an aggregate amount of $3.0 billion
- Previously an investment banker at Green Manning & Bunch, a Denver-based M&A advisory firm
- Additional banking experience at Allegiance Capital and BMO Capital Markets
- B.S. in finance from Boston College and an MBA from The University of Texas at Austin
- Holds Series 79 and 63 licenses with FINRA and the SEC

Who is FMI?

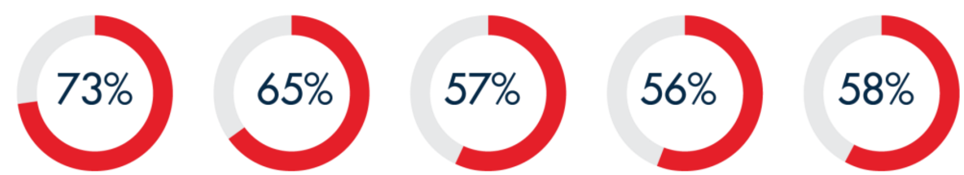
6	65+	175+	500+	25+
North American Offices	Years in Business	Professionals	Annual Client Engagements	Annual M&A Transactions

Investment Banking (FMI Capital Advisors)

- Sell-Side M&A
- ESOP Advisory
- Buy-Side M&A
- Private Capital Placements
- Financial Advisory

Management Consulting (FMI)

- Strategy
- Market Research
- Business Development
- Operations
- Risk Management
- Organizational Development



73%	65%	57%	56%	58%
of the ENR Top 400 Contractors	of the ENR Top 200 Specialty Contractors	of the ENR Top 100 Design Firms	of the ENR Top 200 Environmental Firms	of the ENR Top 100 CM for Fee Firms

Objectives

- What we'll cover in this presentation
  - Section 1: The Market and Construction M&A Trends
  - Section 2: Risk Management in M&A Transactions
  - Section 3: Policies to Mitigate Risk

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Section 1

The Market and Construction M&A Trends

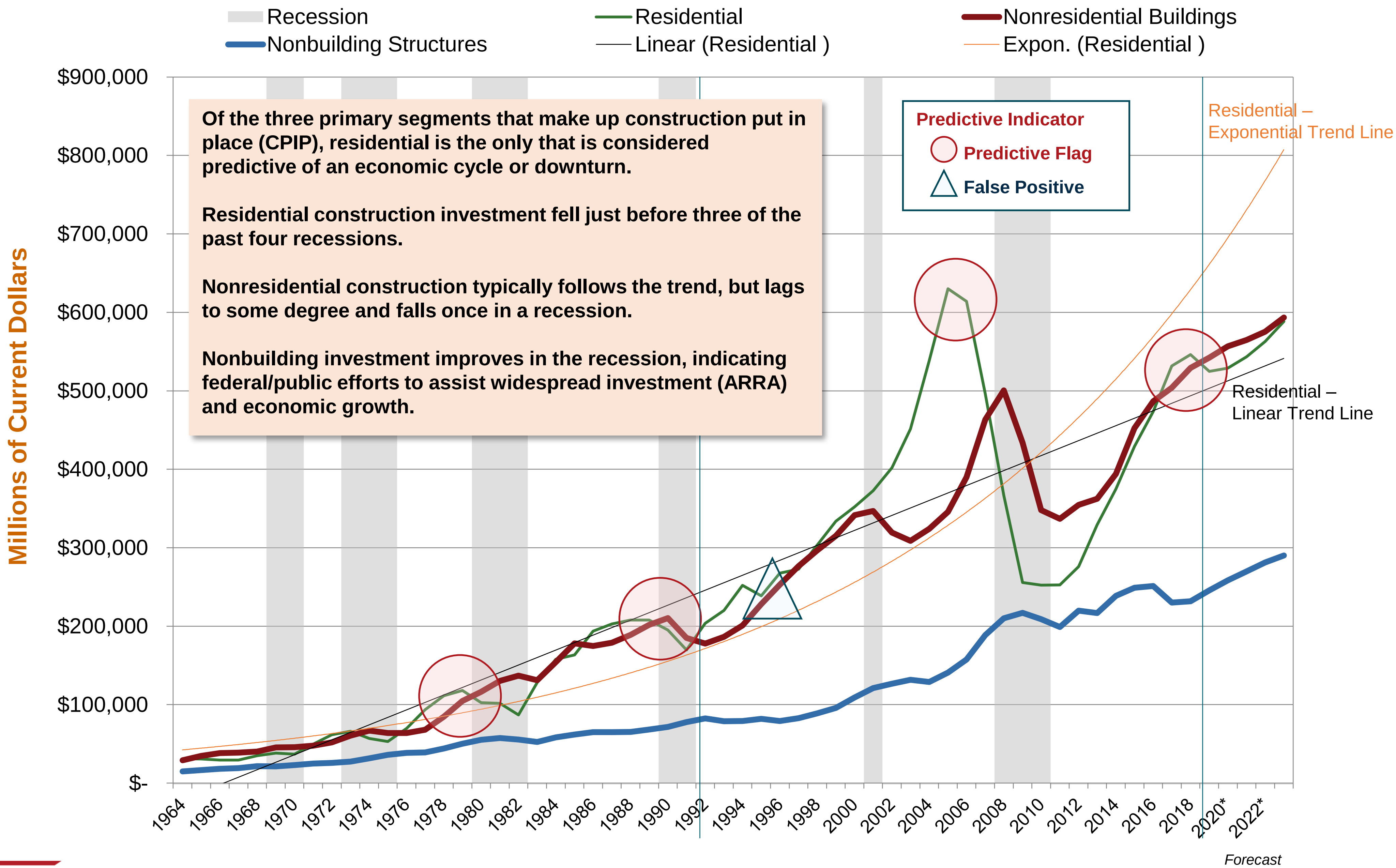
Current Economic Signals

- Unemployment 3.5% (Nov) near 50-year low
- Inflation below 2%; low energy prices
- Business investment slowed
- Manufacturing index slipping; lowest sentiment in 10 years

- Personal consumption increased; forecast +2.5%
- Consumer confidence is <u>down</u> 1.5% YoY, increasing from a multi-year low in August
- Economy growing at ~2+%
- Consumer spending on durable goods slowing; auto sales flat and off-peak since 2015
- Residential housing starts are down, new home sales are down, median home price down (YoY)

Source: Bureau of Economic Analysis; Silvercrest Asset Management

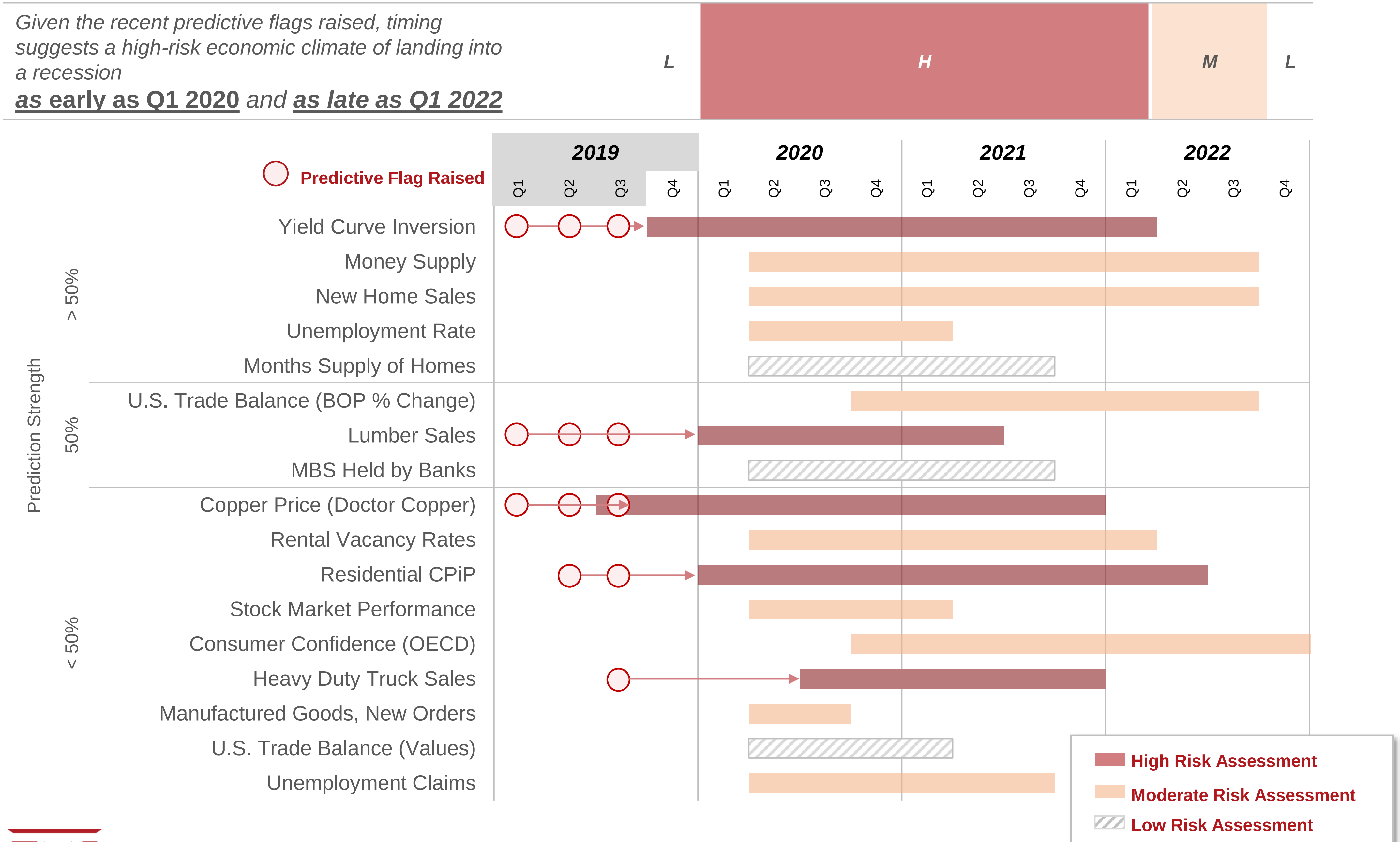
Construction Cycles Don't Always Follow Economic Cycles



Source: FMI Forecast Q3 2019

Predicting the Next U.S. Recession – The Timing

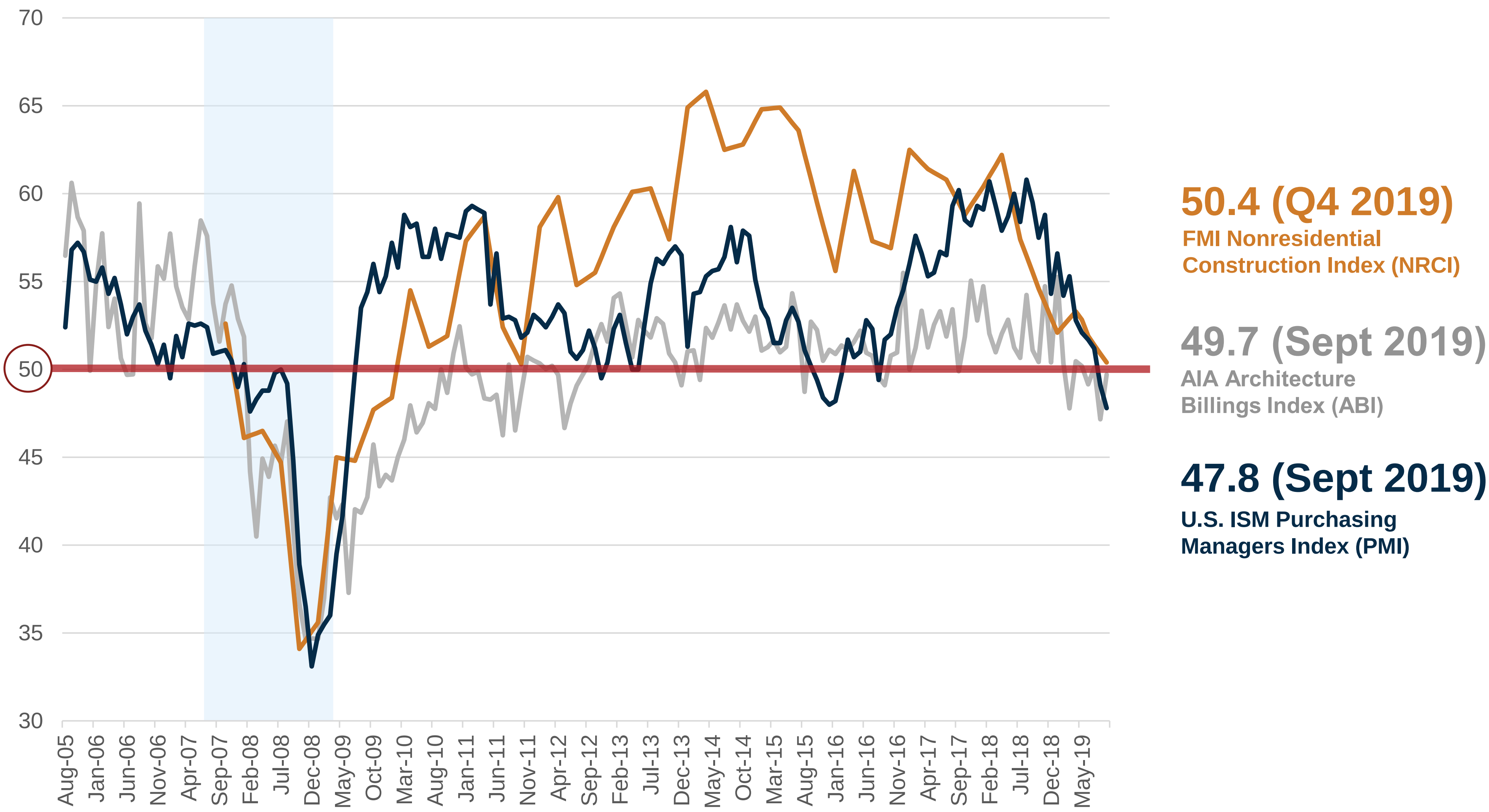
Given the recent predictive flags raised, timing suggests a high-risk economic climate of landing into a recession ***as early as Q1 2020*** *and* ***as late as Q1 2022***



Growing Cause for Concern?

AEC-specific economic indicators

AIA Architecture Billings Index (AIA), FMI Nonresidential Construction Index (NRCI), U.S. ISM Purchasing



Source: AIA, ISM, FMI

U.S. Market is a Relative Winner, Globally

Real GDP 2019 – 2024 CAGR	
Brazil	2.30%
Sweden	1.92%
Canada	1.74%
United States	1.72%
Spain	1.68%
U.K.	1.48%
France	1.36%
Germany	1.26%
Italy	0.64%
Japan	0.50%

Major international acquirors see the U.S. as a solid investment in a large market with reasonable growth prospects, particularly given the relative lack of risk

Source: International Monetary Fund

Recent Construction M&A Activity

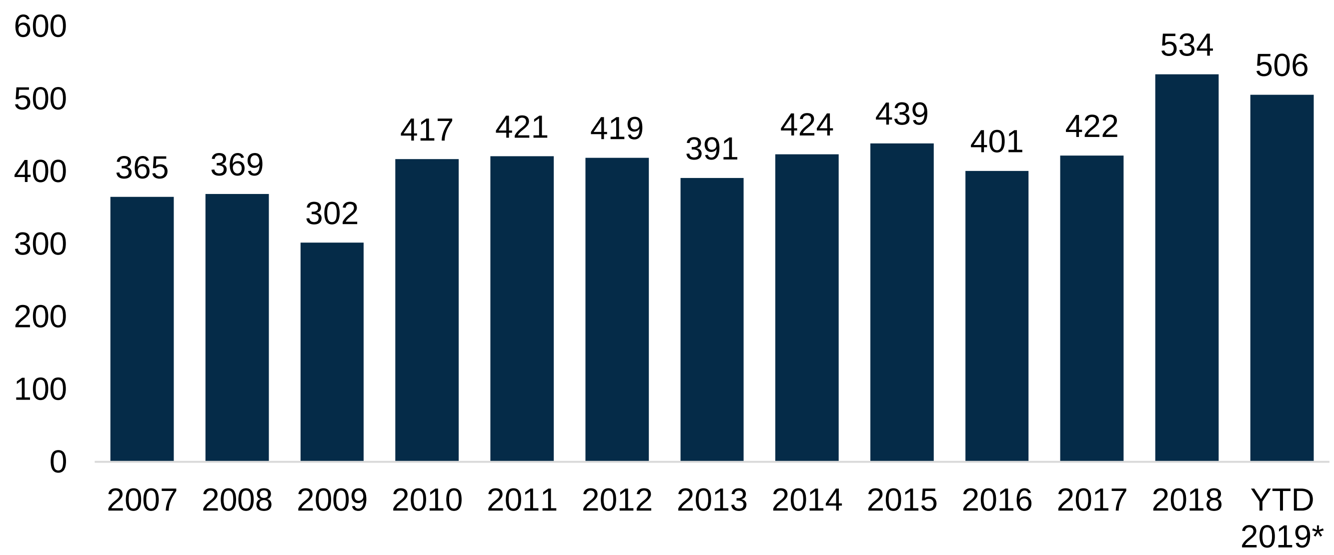
Demographic succession needs

+

Increased buyer interest

=

Record M&A activity



2018 represented 26.5% increase in deal activity over 2017 and, by far, the highest level of activity we have ever recorded

2019 is also proving to be a strong year in terms of deal activity – expected to be on pace with 2018 with 506 deals YTD in 2019*

Source: FMI
* Through 11/20/2019

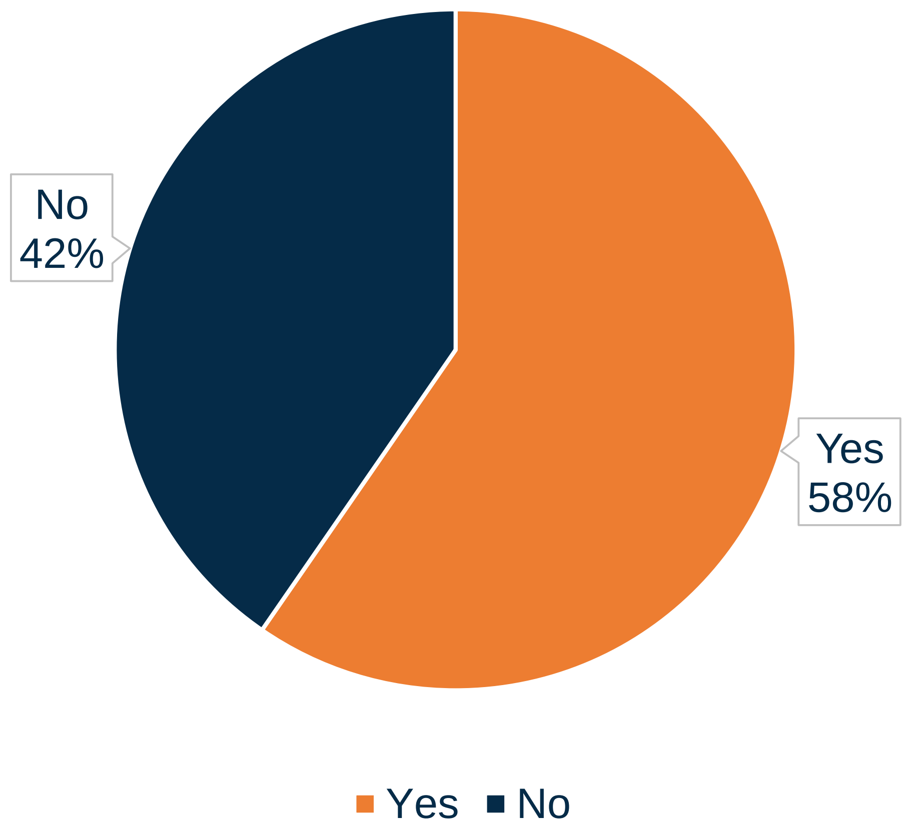
Key Contractor M&A Trends – 2019 and Beyond

The Year Ahead

- **Continued bifurcation of the industry between very large and smaller niche firms driving M&A activity**
- **Self-performing contractors draw most interest**
- **Sustained international interest in the United States**
- **Energy efficiency and green solutions are driving increased interest from buyers**
- **Some uneasiness has crept in as fears of recession, fully priced assets, trade tensions, and market and regulatory uncertainty rise**

FMI Survey:

Are acquisitions a part of your current strategy?



Source: FMI

Buyers' and Sellers' Markets

	Buyers' Markets	Sellers' Markets
Attributes:	Union Firms; Prime Contractors; Small Firms; Lump Sum; Hard Bid	Open Shop; Sub Contractors; Self Performers; Large, Diversified Firms; Recurring Revenues; Negotiated Work
Sectors:	Oil & Gas; GCs	Industrial; Engineering and Consulting Services; Specialty Trades

Spanning both markets (sectors): Construction Materials; Heavy Civil

Private Equity – a Key Player in M&A

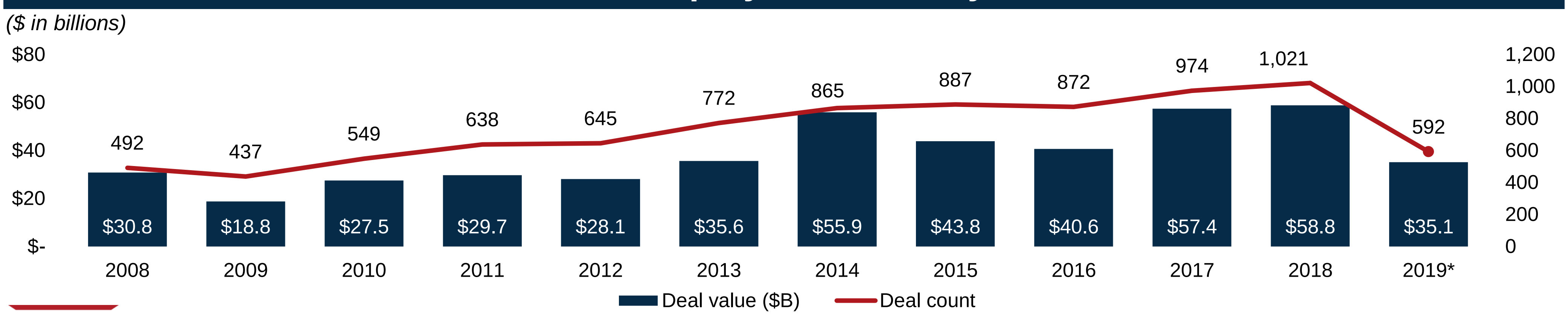
What is "Private Equity"

- Pools of private funds invested primarily in private businesses.
- Typical investors include individuals, pension funds, family offices and other investors
- Funds will typically acquire businesses with combination of equity and debt, hold for 3 to 7 years and divest to strategic buyer or another fund
- Investors expect high returns on equity, frequently in the 25-30% IRR range per year
- Private equity has traditionally avoided construction due to bonding constraints, contract-based revenues, people dependency, market cyclicality and limited barriers to entry

Private Equity Trends

- **Elevated deal size:** PE firms are raising increasingly larger funds which pushes deal sizes higher as those firms allocate capital
- **Private equity now makes up a larger part of total M&A activity**: the first three quarters of 2019 saw over 6,907 deals completed in North America 40.7% of which were PE deals and firms are incentivized to deploy capital now to save costs related to rising interest rates
- **Time to deploy dry powder**: FMI expects increased activity from private equity funds, which notwithstanding a record $803 billion in "dry powder" in 2018 — capital available for investment purposes

U.S. Private Equity Deal Activity Growth



Source: Pitchbook

* As of 9/30/2019

Continued Foreign Interest in U.S. Construction

Construction Market Trends (1 of 3)

Current / Short-Term: 1 - 2 years

- Most markets have recovered, profits rebounded
- Tax reform has improved valuations; infrastructure funding hopes dashed
- Contractors are strategically expanding their businesses through selective acquisitions
- Specialty trades remain the most attractive segments of the U.S. construction market
- Continued interest in building services
- Revised strategies leading to corporate divestiture activity

Construction Market Trends (2 of 3)

Current / Mid-Term: 2 - 5 years

- Recession likely
- Contractors that embrace technology and energy efficiency capabilities will continue to drive activity
- Infrastructure spending will be driven primarily by states, with federal infrastructure spending a wild card
- Surety markets may tighten; return of personal guarantees and stricter ratios
- Large will continue getting larger; rise of megaprojects

Construction Market Trends (3 of 3)

Mid / Long-Term: 5 - 10 years

- More rigorous regulations and commercial demand for “green” infrastructure will foster revenue growth into the future
- Labor will influence contractor strategy, project delivery and M&A
- Long-term U.S. population trends will offer tremendous growth opportunities
- Megaprojects and urbanization will draw interest to growing cities

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Section 2

Risk Management in M&A Transactions

The Importance of Risk Mitigation in Construction M&A

What % of M&A transactions fail?

The Importance of Risk Mitigation in Construction M&A

Between 70% and 90% of acquisitions fail to create value for the acquiror and its shareholders

→

Higher levels of diligence than ever before

Prominent Examples of Lack-luster M&A Outcomes in Construction

McDermott	AECOM	Morrison Knudsen Corporation
Acquisition of CB&I	Acquisition of URS	Acquisition of Raytheon Engineers & Constructors

Source: Harvard Business Review analysis of multiple sources

Risk Management Environment (1 of 3)

Key Risk Management Statistics

35% of contractors think their organizations are **ineffective at managing risk**

80% of contractors see a limited supply of skilled craftworkers as **today's top risk**

58% of contractors see an economic slowdown as the **top risk in the future**

It is crucial to determine which risks a seller has poorly managed in the past which may become major liabilities for the buyer post-acquisition

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Source: 2019 AGC/FMI Risk Management Survey

Risk Management Environment (2 of 3)

Most-Cited Conditions Contributing to Contractor Default / Insolvency

57% due to a catastrophic project:

- Problem on a large job
- Poor estimate / large bid spread
- New job type / location

49% due to internal cost system failures:

- Inability to identify issues
- Lack of communication / cohesion between field and main office

36% due to overextension:

- Multiple large jobs / larger backlog
- Strain on workforce / financial resources

23% due to excessive debt:

- Fixed and long-term debt negatively impact cash flow

It is critical to understand if a target has a robust go / no-go decision-making process *and* thorough post-bid review in instances of large bid spread

Source: Travelers Insurance

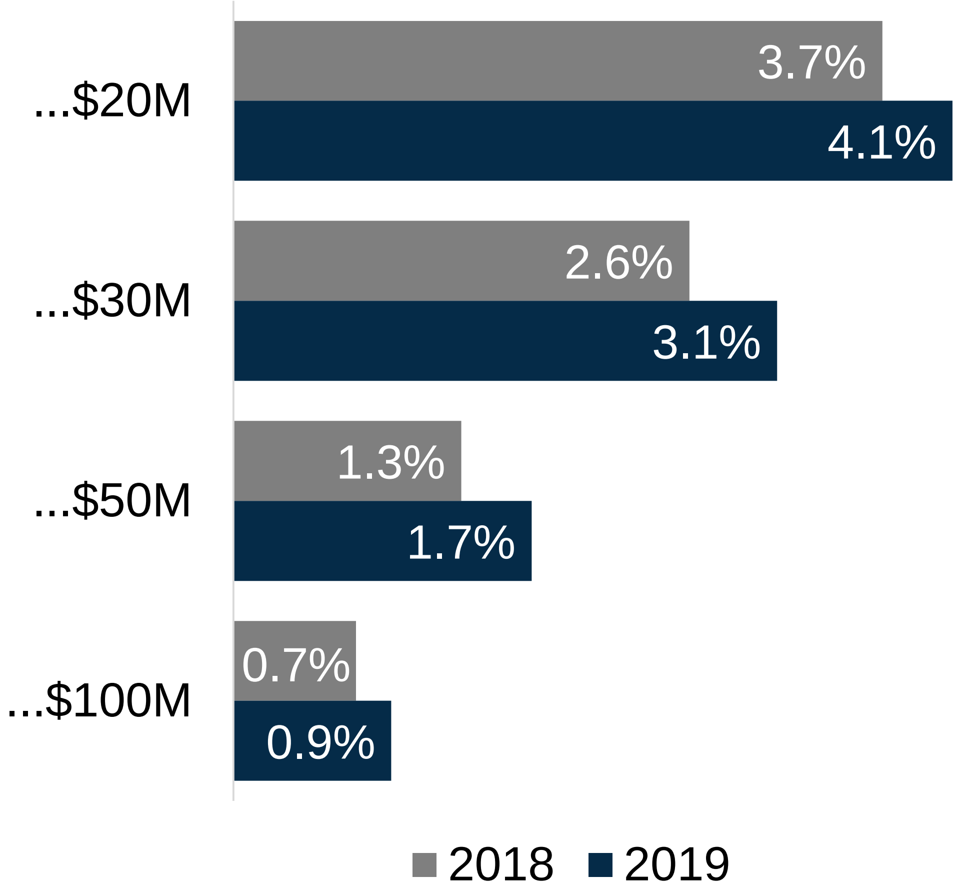
Risk Management Environment (3 of 3)

Increasing Social Inflation

Defining Social Inflation

- Social inflation typically refers to an upward creep in:
  - Perceptions by an injured party of what they are owed
  - An injured party's willingness to pursue a perceived culprit via the legal system
  - Larger jury awards against big companies
- Increasing social inflation is putting pressure on corporate liability policies
  - Certain loss-impacted accounts have risen by as much as 75%, and by up to the high teens for big company excess liability policies

Percentage of verdicts over…



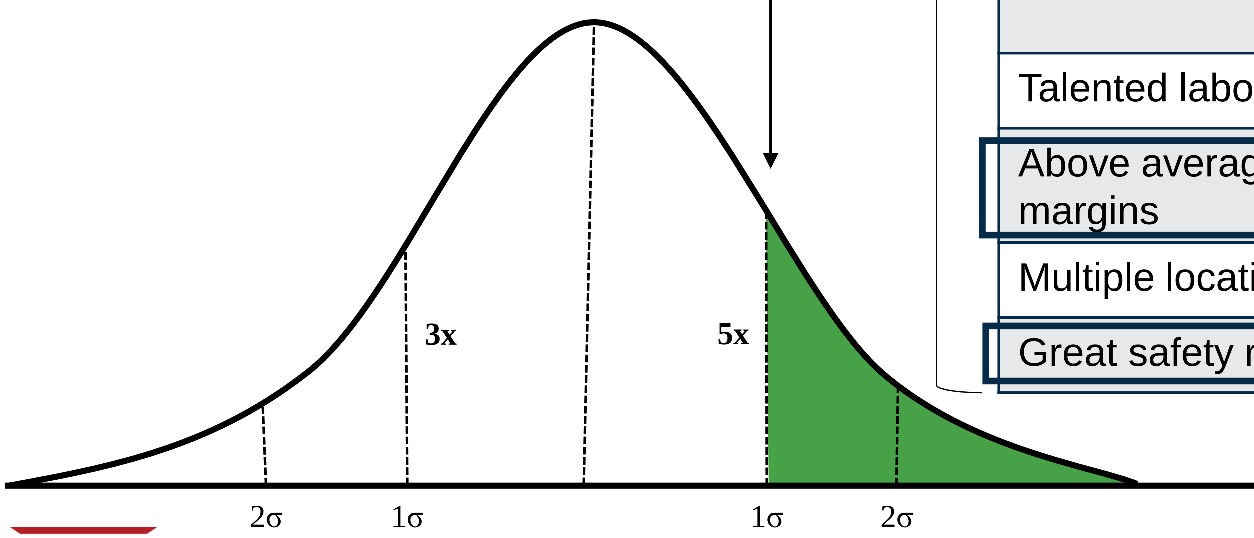
Source: Swiss Re; VerdictSearch (based on a database of more than 200,000 U.S. cases reported)

Value in Construction

Basics of Construction Company Valuation

1. Valuation is a measure of risk vs. reward
2. Growth is a key factor
3. Investment alternatives must be evaluated
4. People > profits
5. In some markets, the balance sheet is worth more than the P&L

Value Enhancers	Value Detractors
Large in size	Small in size
Strong backlog	Flat or decreasing earnings
Recurring revenue	Project-based revenue
Synergies with buyer	No synergies with buyer
Dense population	Sparse population
Strong management team	Weak management team
Low claims	High claims
Flexibility	Exclusive arrangements
Diverse customer base	High customer concentration
Talented labor pool	Scarce labor pool
Above average profit margins	Below average profit margins
Multiple locations	Single market
Great safety record	Safety issues



Risk Management Overview

- **In today’s construction market, an effective risk management program is structured to be not only defensive, but also offensive**

- The purpose of risk management is twofold:
  1. Protect the value of the business by de-risking the balance sheet and stabilizing the income statement
     – Inherent risks to construction – both known and unknown – represent significant threats to the value and viability of the company
  2. Leverage risk management as a strategic asset
     – Transform risk from a cost center to a profit center and optimize competitiveness

Strategic Elements of Risk Management

- **Strategic Elements represent the transition from managing risk as a tactic to leveraging risk as a strategic asset**

Risk Management Partners

- Procure capable partners who add value to your organization
  - Carriers
  - Sureties
  - Attorneys
  - Brokers
- Dedicated construction practice
- Depth of industry knowledge
- Appropriate resources
  - Bench strength
  - Succession

Enterprise Risk Management

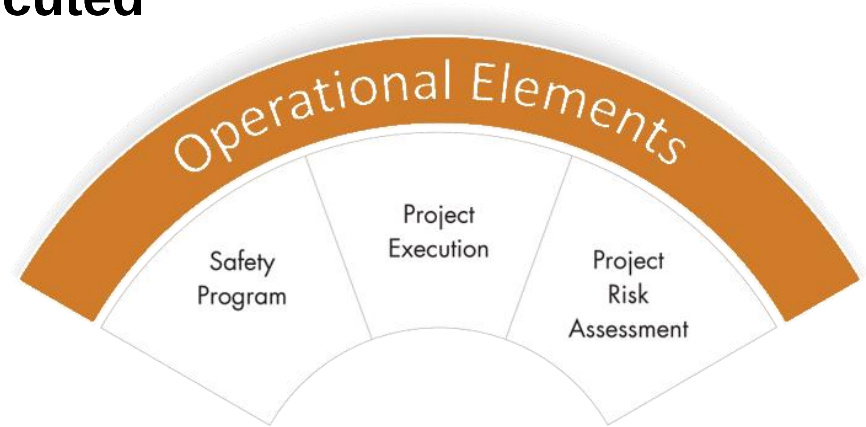
- Formalize a process to identify potential risks, beyond the traditional risk elements, which could significantly impact the business
- Inject a comprehensive and repeatable procedure into the strategic management process

Leveraging Risk Management

- Paradigm shift of how risk is viewed
  - Recognition that risk management can add significant value to an organization
- Effectively incorporating risk management programs into all parts of your business will create value for customers

Operational Elements of Risk Management

- **Operational Elements ensure a firm is managing risk effectively as projects are procured and executed**



Safety Program

- Culture of safety embedded in the organization
  - Safety department is a resource to operations
  - Internal metrics and reporting in place to support and promote the program
  - Will be heavily evaluated by acquirers

Project Execution

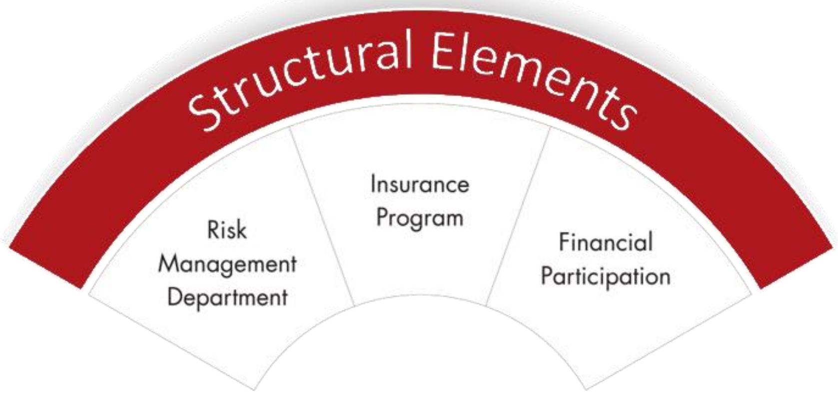
- Subcontractor Management
  - Pre-qualification & selection process in place and utilized
  - Management processes for:
    - Pay requisitions
    - Quality
    - Liens
- Project Quality Assurance & Quality Control
  - Integrated into all projects
  - Appropriate documentation/ archives

Project Risk Assessment

- Supports strategic job pursuits
- Assists in appropriately pricing risk
- Process to systematically and consistently evaluate potential projects on key areas of risk

Structural Elements of Risk Management

- **Acquiring a business is in and of itself a high risk transaction**
  - Acquiring managers should spend significant resources on mitigation of risk



Risk Management Department

- Risk management function effectively connected to all functions of the organization
- Seat at the senior management level
- Formalized risk management structure
- Dedicated resources appropriate to the size of the organization
- Charter and authority to manage risk management throughout the organization

Insurance Program

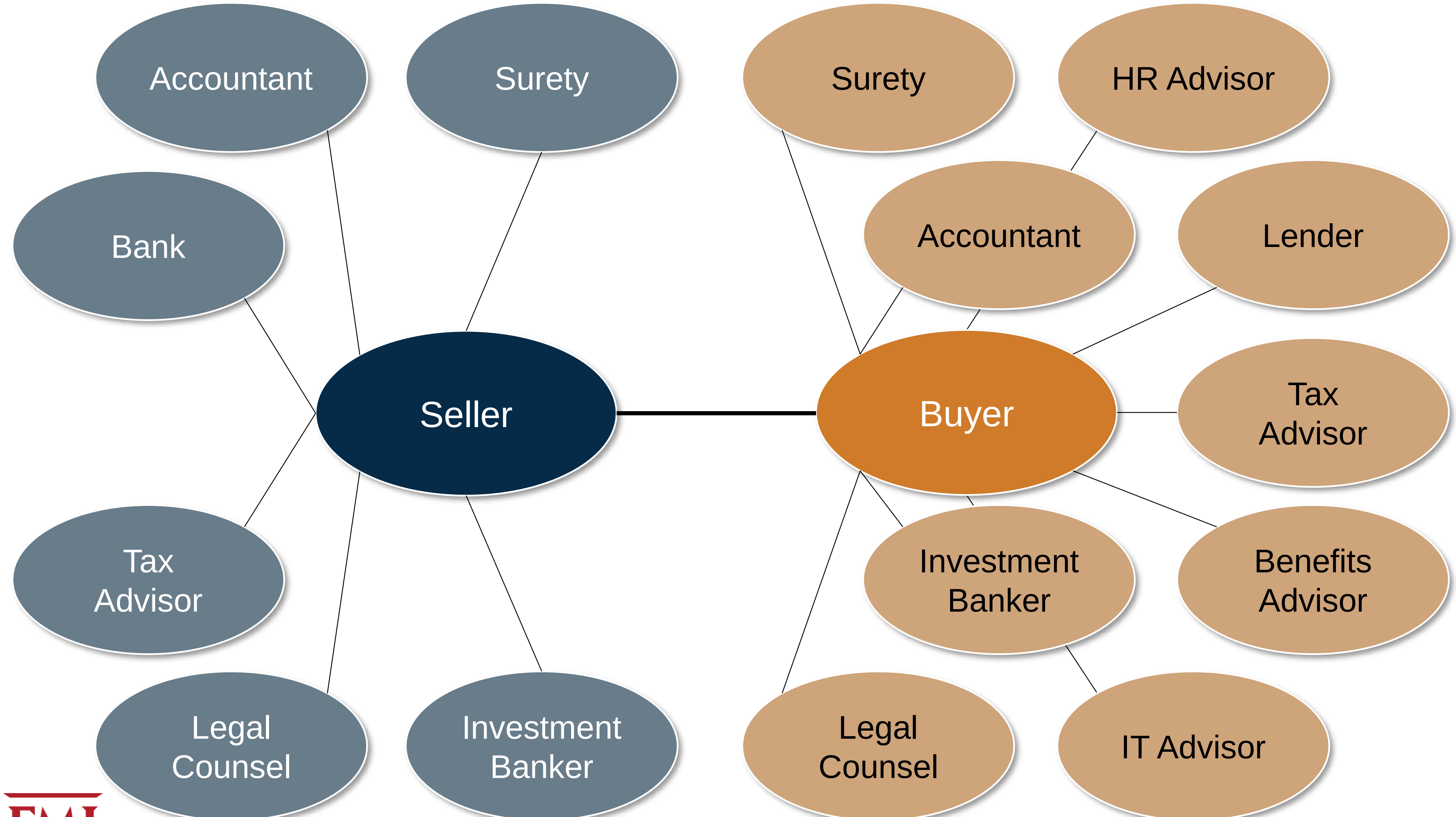
- No "gaps" in the program which leave the organization exposed
- Leveraging innovative product options in the insurance industry

Financial Participation

- Maximizing financial benefit by retaining as much risk as your balance sheet will allow
- Appropriate retention levels
- Strategies to minimize the price of insurance

Stakeholders and Diligence Parties in a Transaction

There are <u>many</u> diligence workstreams and limited time to complete a transaction



Diligence for the Risk Manager

- Brokers and sureties are often brought in late to an M&A process
  - Time may be tight, sometimes as little as 30 days
- Responsiveness and flexibility are key for ensuring a smooth process

Seller Surety

- Seller surety can offer to remain if the buyer is a financial sponsor without an existing construction platform and/or existing surety relationship
- Must get comfortable with the new capital structure, particularly in a financial sponsor deal
- A transaction generally ensures business continuity for owners getting close to retirement

Buyer Surety

- Responsible for helping evaluate seller risk management practices
- Must get comfortable with new capital structure of buyer

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Risk Management Considerations and Diligence Questions

The buyer risk manager has more to consider and will have the go-forward risk of the projects being taken over. **It's imperative that the buyer and its surety ask the right questions and consider the risks in an acquisition:**

- Ask carrier for job losses
- Provide organizational chart of your risk management team
- What systems have you put in place to modernize your cybersecurity threats?
- Do you employ systems to identify, classify and respond to risk?
- Do existing controls and processes adequately mitigate identified risks?
- Is risk management embedded across all functions of the business?
- In the event of a dispute, do you have a team that recommends appropriate responses?
- Explain your Go / No Go decision process

The Importance of Risk Management in Mergers & Acquisitions

- **Acquiring a business is a high-risk proposition → risk vs. reward**
- **Due diligence is critical to limiting risk and liability exposure**
  - Existing risk programs, employment and environmental liabilities, contractual obligations, loss history
- **Risk management drives value for the seller**
  - Less claims = better EMR
  - Stabilizing earnings (“lumpy” vs. smooth)

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Section 3

Policies to Mitigate Risk

Common Risk Management Tools in Construction M&A (1 of 2)

- **Earnouts**
  - Earnouts are common in construction M&A and are helpful in bridging gaps between buyer and seller on value
  - Mutually agreed upon financial hurdles are set and specific amounts of the purchase price are released when goals are met (typically over a two- to five-year period)
- **Lookbacks**
  - Lookback provisions can be added to verify the level of liquidity at close (e.g. verify the estimated margin of certain projects on the WIP at close)
  - Typically performed by internal accounting teams or a mutually agreed upon third-party within 90 days of close

Common Risk Management Tools in Construction M&A (2 of 2)

- **Representations and Warranties**
  - Seller and buyer make statements about what is being sold and their ability to act
- **Escrows**
  - Escrows are bank accounts which hold portions of the purchase price to protect the buyer, primarily for any breaches of reps and warranties by seller
  - The release of funds is subject to verification of working capital accounts and potentially other items defined in any lookback provisions
- **Covenants**
  - Agreements to take (or not take) certain actions between signing and closing
- **Policies to help mitigate risk beyond reps and warrants**
  - There are many types of successor casualty liability coverage options to help mitigate risk

Mitigating Risk through Additional Protection

An acquiring company needs to partner with its insurance brokers and carriers to identify, in collaboration, the areas in which it should dig deeper. Potential buyers and sellers must make themselves more aware of their risk management exposure:

- Various successor casualty liability products
- Environmental policies
- Director and officer insurance
- Cyber
- Professional liability

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Loss Portfolio Transfer (LPT)

A Loss Portfolio Transfer is a retroactive insurance program that transfers future payment obligations to a specialized M&A insurer

- LPTs transfer obligations of an unknown size, which are related to known past liabilities, either from current operations or discontinued businesses
- For example, an LPT can be structured to absorb the financial liabilities of the deductible obligations within the target company's insurance policies
- Target companies that will have multiple captive insurers post-acquisition, or that are looking to exit self-insurance, can benefit from LPTs
  - The LPT can be used as a mechanism to close out the captive(s) or exit self-insurance for already-incurred liabilities

Umbrella and Excess Casualty Insurance

Umbrella and Excess Casualty Insurance are two other risk transfer solutions addressing M&A-related liabilities

- High financial limits of protection can come into play as either:
  - Umbrella insurance attaching above the primary layer of coverage, or
  - Excess insurance attaching at different layers in a tower above the umbrella

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Representations and Warranties Coverage

Representations and Warranties (R&W) insurance will indemnify the acquiror if the seller's representations and warranties prove inaccurate down the line

- Examples involve reps and warrants made around compliance with local regulations, such as employment laws, or the accuracy of financial disclosures such as seller's inventory levels
- R&W insurance can accelerate the timeline of a transaction due to both parties spending less time on inventory or AR/AP analysis or haggling over definitions of items such as working capital
  - It may ease tensions in the first few months after closing because if, during the lookback period, something was misstated or misrepresented, the buyer can pursue compensation through the policy instead of directly from the seller

Directors and Officers Liability

Directors and Officers (D&O) insurance is one of the most common M&A insurance policies in the industry, with many buyers making it a condition to close within the final purchase agreement

- Securities class-action lawsuits represent some of the most costly and complex cases against directors and officers
  - Class-action suits are typically brought by investors and shareholders in the target corporation
- Most D&O insurance policies have terms of one year, yet claims may be brought as long as six years after a transaction, depending on the statute of limitations
  - Most target companies purchase a non-cancellable, pre-paid policy for a six-year period, which is known as run-off or tail coverage
- As the D&O and tail policies may be all they have to protect them, many target companies will purchase an additional layer of insurance devoted to the directors and officers, known as Side A, or CODA, insurance

Construction M&A: Trends and the Changing Role of Risk Managers

Questions?

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