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MERCER CAPITAL

Understand the Value of Your Brick Business

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Nicholas J. Heinz is a senior member of Mercer Capital's investment banking and corporate advisory division. Investment banking services include both sell-side and buy-side merger and acquisition representation services, fairness opinions, solvency opinions, business interest and securities valuation, and board presentations, among others. Services are typically provided for middle market private companies, small cap public companies, as well as middle market banks and other financial institutions.

Mr. Heinz has extensive experience in working with both sellers and buyers in merger and acquisition advisory engagements, as well as with public companies in the divestiture of divisions and subsidiaries. He has assisted clients through all phases of the sales process, from conducting strategic alternatives analyses to determine if selling is indeed the best option to structuring, negotiating, and closing transactions.

He is also responsible for valuation and transaction analyses in connection with fairness opinions, corporate financings, strategic planning, mergers and acquisitions, ESOPs, tax planning and compliance, and litigation matters.

Mr. Heinz has extensive experience in a wide range of industries, including manufacturing, distribution, and service industries. Specific industry experience includes transportation and distribution, healthcare, telecommunications and building materials.

About Mercer Capital

Mercer Capital's business valuation services are provided for a wide variety of needs, including corporate valuation services, tax compliance, litigation support, financial statement reporting compliance, and employee stock ownership plans. Clients range from public to private, from smaller companies to large multi-nationals in a broad range of industries as well as numerous governmental agencies.

In addition, Mercer Capital provides investment banking and corporate advisory services including sell-side and buy-side merger & acquisition representation, fairness opinions, solvency opinions, business interest and securities valuation, and board presentations, among others.

Mercer Capital is an employee-owned independent financial advisory firm. We have experience in a broad range of industries, including, but not limited to, automotive, consumer products, distribution, energy, financial services, health care, industrial products, media and entertainment, pharmaceuticals, technology, telecommunications and utilities.

For twenty-five years, Mercer Capital has been bringing uncommon professionalism, intellectual rigor, technical expertise, and superior client service to a broad range of public and private companies and financial institutions located throughout the world. Rely upon the expertise, experience, reputation and critical thinking of Mercer Capital.

Understand the Value of Your Brick Business

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It is inevitable; all successful businesses eventually undergo some form of ownership transition. People do not live forever, so businesses must be passed on in one way or another. There are numerous scenarios under which such transitions occur; however, all transitions must invariably address the question of value.

The purpose of this article is to provide an informative overview regarding the valuation of businesses operating in the brick industry. We will discuss value as it relates generally to both manufacturers and wholesalers within the industry. A lack of knowledge regarding the value of your business could be very costly. Opportunities for successful liquidity events may be missed or estate planning could be incorrectly implemented based on misunderstandings about value. In addition, understanding how brick businesses, both manufacturers and wholesalers, are valued may help you understand how to grow the value of your business and maximize your return when it comes time to sell.

THE BUSINESS TRANSFER MATRIX

Above, we introduced the concept that all business ownership will eventually be transferred. At Mercer Capital, we have developed the Business Transfer Matrix to illustrate the universe of ownership transition scenarios. As depicted below, these scenarios range from voluntary transfers such as gifts to family members or an outright sale to a third party to involuntary transfers such as those precipitated by death or divorce. Our essential point is worth reiterating: an understanding of the value of your business or business interest is a critical element in preparing yourself for any of these eventualities.

OWNERSHIP TRANSFER MATRIX	Partial Sale/Transfer	Total Sale/Transfer
Voluntary Transfers	ESOP Outside Investor(s) Sales to Insiders/Relatives Combination Merger/Cash Out Going Public Gifting Programs Buy-Sell Agreements	Sale of Business Stock-For-Stock Exchange w/Public Company Stock Cash Sale to Public Company Installment Sale to Relatives/Insiders ESOP Management/Buyout Buy-Sell Agreements
Involuntary Transfers	Divorce Forced Restructuring Shareholder Disputes Buy-Sell Agreements	Death Divorce Forced Restructuring Bankruptcy Shareholder Disputes Buy-Sell Agreements

BACKGROUND CONCEPTS OF "VALUE"

Before covering some specific details related to the brick industry, it is important to understand some basic concepts related to valuation analysis.

It comes as a surprise to many business owners to learn that there is not a single value for their business. Numerous factors (legal, tax or otherwise) play important roles in defining value based upon the circumstances of the transfer of equity ownership. While there are significant nuances to each of the following topics, our purpose here is to help you combine the economics of valuation with the legal framework of a transfer (either voluntary or involuntary).

Valuation Date

Every valuation has an "as of date" which simply means that it is the date around which the analysis is focused. The date may be set by legal requirements related to a death or divorce, or be implicit, such as the closing date of a transaction.

Purpose

The purpose of the valuation is important because it is linked to the transfer event (such as a sale, estate planning, etc.). A valuation prepared for one purpose is not necessarily useful for another.

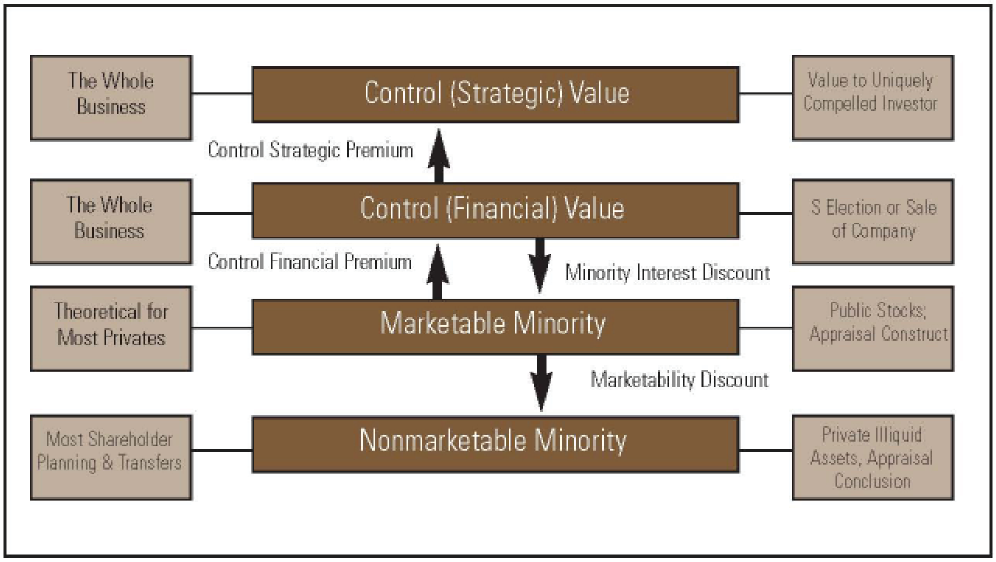
Standard of Value

The standard of value is an important legal concept, which must be addressed in every valuation assignment. Fair market value, which is most commonly used in tax matters, is the most familiar. Other important standards are investment value (purchase and sale transactions), statutory fair value (corporate reorganizations), and intrinsic value (public securities analysis). Using the proper standard of value is crucial in obtaining an accurate determination of value. There are many standards of value just as there are many types of ownership transfers. The standard of value will influence the selection of valuation methods and the level of value.

Levels (Premise) of Value

When business owners think about the value of their business, they are almost always implicitly thinking about the value of the business in its entirety. The value of a single share, for example, is the value of the whole divided by the number of shares. In the world of valuation, this may not be true if the block of stock under consideration does not have control of the enterprise. The determination of whether the valuation should be on a controlling interest or minority interest basis can be a complex question, yet it is of great importance. A minority interest value can include discounts for the lack of control and marketability, therefore it is quite possible for a share of stock valued as a minority interest to be worth far less than a share valued as part of a control block.

The following chart presents the concept graphically.



A lack of basic knowledge about these issues will leave you short of the required vocabulary and understanding needed to comprehend the context with which the value of a business interest is developed.

INDUSTRY FACTORS

A detailed review of the brick industry is important in establishing a credible value for a business operating in this space. Such a review should consider a wide range of issues (far too many to list in full here), with primary considerations as outlined below.

Construction Environment

The health of the brick industry is closely tied to the level of construction activity in the general economy. Upwards of 80% of bricks are utilized in residential construction, so the rate of new home construction carries a heightened importance. New home construction has historically followed a cyclical path, increasing during strong, low-interest rate economic environments and declining during weaker economic periods. In any review of the construction environment, it is important to note the current level of activity, both nationally and in the local market, as it relates to both recent and long-term historical levels. Such a review is key to determining where current performance fits in the market's cyclical pattern.

Until mid-2006, home construction activity had been robust for an extended period. Fueled by relatively strong economic conditions and historically low interest rates, the market set new annual highs for several years. Given rising interest rates, the speculative nature of some purchases, over-building in key markets, and high foreclosure rates, the residential home market has turned strongly downward.

Consolidation Activity

As any operator in this industry knows, consolidation activity in the brick industry has been running at a sharp pace for several years. The acquisition programs of consolidators (mostly manufacturers) generally seek to expand manufacturing capacity and build/expand wholesale distribution networks through acquisition. The valuation implications of consolidation activity are numerous. Most obvious, the consolidation activity, in many ways, sets the market for businesses in this industry. The value of a brick manufacturer or distributor in today's market is directly linked to its relative attractiveness to industry consolidators.

Value can also be impacted by the implications of industry consolidation. For businesses that continue to operate independently, the outlook could be one of increased competition from larger and stronger competitors. Possible implications from this consolidation range from a cut-off of a wholesaler's product supply to an increasingly competitive pricing environment.

Alternative Products

For some time now, the brick industry has faced the continued threat of replacement products such as aluminum siding, stucco, and wood. Industry participants have attacked this problem through various forms of marketing designed to educate the public regarding the benefits of brick and related materials. A review of alternative products and the outlook for new developments in each is an important consideration in any assessment of the brick industry.

FINANCIAL CONSIDERATIONS

Balance Sheet

The balance sheet of a typical brick wholesaler is dominated by accounts receivable and inventory. From a valuation perspective it is important to test each of these assets to determine their true market value. Most brick wholesalers sell to a variety of large and small contractors. Contractors, especially small ones, are notorious for their financial instability. A business that is not careful can easily be faced with a material write-down in the value of accounts receivable.

Regarding inventory, the questions are two-fold: 1) Is it there? and 2) What is the current value? It is important to understand any material inventory issues that management is aware of.

Brick manufacturers, while also having accounts receivable and inventory, are typically more heavily invested in fixed assets (buildings, manufacturing equipment, etc.). For valuation purposes, it may be necessary to make adjustments to consider the market values of these fixed assets. It is also important to identify and properly adjust for any non-operating assets held on a company's balance sheet, as well as any un-booked assets that may be owned by the business but not reflected on the balance sheet. As with any asset intensive enterprise, the ongoing capital needs of the business must be understood and quantified in the valuation process.

Income Statement

The income performance of brick manufacturers and wholesalers is substantially impacted by the cyclical nature of the home construction market (as noted previously). This raises an important valuation concern. In determining the ongoing earning power of a brick business, it may be necessary to average several years of earnings versus determining value based solely on the most recent year's earnings. There are numerous specific considerations that need to be weighed in this determination. The development of ongoing earning power is one of the most critical steps in the valuation process, especially for businesses operating in a cyclical environment.

When assessing profitability, it is important to consider what type of business is being analyzed. A wholesaler will have a different profitability profile than a manufacturer based solely on the nature of the two businesses. A manufacturer that operates its own distribution network will likely have lower percentage profit margins than a comparable business with manufacturing only, though it may be a much stronger business with greater growth prospects going forward. Profitability at the manufacturing level is primarily impacted (among a vast array of other factors) by product/brand market positioning and production efficiency. A brick wholesaler's profit levels (especially those of an independent operator) are uniquely tied to the popularity and market power of it suppliers. This can be a tricky position for a wholesaler. As its supplier's products gain popularity, the wholesaler obviously reaps benefits via higher profits. However, as a supplier becomes more powerful in the market (which has occurred with the consolidation activity in the brick manufacturing sector), it will generate a certain degree of pricing power over the wholesaler, potentially impacting ongoing profit margins. While certain general elements can be cited, it is a necessity to assess the unique income characteristics of the business under consideration when analyzing value in the brick industry.

APPROACHES TO VALUE

There are three general approaches to valuing a business – asset-based, income and market. Specific applications of these approaches are called "valuation methods." As a general rule, every valuation should address value using these approaches. Each approach incorporates procedures which may enhance awareness about specific business attributes that may be relevant to determining the final value. Ultimately, the concluded valuation will reflect consideration of one or more of these approaches (and perhaps several underlying methods) as being most indicative of value for the subject interest under consideration.

Asset-Based Approach

The asset-based approach can be applied in different ways, but in general it represents the market value of a company's assets minus the market value of its liabilities. As noted previously, the book value of several assets, most notably accounts receivable, inventory, and fixed assets, may need to be adjusted to reflect differences in the reported and market values of these assets.

Investors make investments based on perceived required rates of return, and only look at assets as a source of rate of return. While an asset value consideration can be a meaningful component of the overall valuation of a brick business (especially for a more asset intensive manufacturer), it is the income generated by these assets that typically drives the value of a business. For this reason, the asset-based approach is typically not the sole (or even primary) indicator of value.

Market Approach

The market approach utilizes market data from comparable public companies or transactions of similar companies in developing an indication of value. In many ways, this approach goes straight to the heart of value: a company is worth what someone is willing to pay for it. In many industries, there are ample comparable public companies that can be relied on to provide meaningful market-based indications of value. For brick businesses, such options are limited. There is, however, an active acquisition market. Acquisition data from industry acquisitions (typically a median from a group of transactions) can be utilized as a multiple on the subject company's performance measure(s). This will often provide a meaningful indication of value as it typically takes into account industry factors (or at least the market participants' perception of these factors) far more directly than the asset-based approach or income-based approach.

The market-base approach is not a perfect method by any means. For example, industry transaction data may not provide for a direct consideration of specific company characteristics. Say a company is a market leader and operates in a prime geographic market. Since the market and the specific company are relatively more attractive than the average transaction, the appropriate pricing multiple for this company is likely above any median taken from a group of industry transactions. Clearly, the more comparable the transactions are, the more meaningful the indication of value will be. Finally, caution is a must when utilizing data from market transactions since you never know all the circumstances surrounding each sale.

Income Approach

The income approach can be applied in several different ways. Generally, such an approach is applied through the development of an ongoing earnings or cash flow figure and the application of a multiple to those earnings based on market returns. The income approach allows for the consideration of characteristics specific to the subject business, such as its level of risk and its growth prospects relative to the market. Given the weaknesses discussed with both the asset-based approach and the market approach, the income approach tends to provide the most relevant indication of value for both a brick manufacturer and wholesaler.

Synthesis of Valuation Approaches

As noted, a proper valuation will factor, to varying degrees, the indications of value developed utilizing the three approaches outlined above. A valuation, however, is much more than the calculations that result in the final answer. It is the underlying analysis of a business and its unique characteristics that provide relevance and credibility to these calculations. This is why industry "rules-of-thumb" (be they some multiple of revenue or earnings, or even bricks sold) are dangerous to rely on in any meaningful transaction. Such "rules-of-thumb" fail to consider the specific characteristics of the business and, as such, often fail to deliver insightful indications of value. A business owner executing or planning a transition of ownership can enhance confidence in the decisions being made only through reliance on a complete and accurate valuation of the business.

CONCLUSION

Mercer Capital has long promoted the concept of managing your business as if it were being prepared to sell. In this fashion you promote the efficiencies, goals and disciplines that will maximize your value. Despite attempts to homogenize value through the use of simplistic rules of thumb, our experience is that each valuation is truly unique given the purpose for the valuation and the circumstances of the business.

Mercer Capital has experience valuing businesses in the brick industry. We hope this information, which admittedly only scratches the surface, helps you better shop for business valuation services and understand valuation mechanics. We encourage you to extend your business planning dialogue to include valuation – sooner or later a valuation is going to happen. Proactive planning and valuation services can alleviate the potential for a negative surprise which could make worse an already stressful time in your personal and business life. Perhaps Yogi Berra wasn't specifically commenting on valuation, but his advice is nonetheless sage: "You got to be careful if you don't know where you're going, because you might not get there."