

How To Tell If the Acquisition Fits

Knowing how to determine fair market value and using certain screening criteria can help you decide whether to buy or pass on an opportunity.

by Mike Nowobilski

Remember a few years back to 1999 and 2000 when millionaires were being minted on a daily basis? Everyone was talking about the college kids who were being given millions of dollars to found Internet and high-tech companies. Shortly after, just before the downturn in the economy, many of them sold out and made millions in profits.

Wow, what a bubble that was. However, these high-tech industries were not the only ones making their mark and making a buck. Although we may forget, millionaires were also routinely being minted in the construction materials industry, which includes aggregates.

You may recall that large international producers routinely issued press releases to the effect that they viewed the U.S. market as a growth market and had allocated hundreds of millions of dollars for acquisitions. As a result, these larger companies participated in bidding contests that significantly drove up the selling prices of not only attractive properties, but also less desirable ones.

In 2000, Hanson paid \$2.4 billion to acquire Pioneer International. That same year, Cemex SA de CV paid \$2.8 billion for Southdown Inc. Then in 2001, Hanson PLC paid \$7.4 billion to acquire Blue Circle. With all this growth, it seemed things could only get better.

We may forget, but the bubble also impacted many smaller producers, perhaps even your firm. I remember attending various state

association meetings and conventions where several of the producers discussed acquisition targets — such as available quarries — located thousands of miles away in lieu of discussing local opportunities. Why? Typically they were not familiar with the market, nor did they have any market presence. Many may conclude it was because things would only get better. Many may have felt they had the Midas touch.

For the most part the sellers were the winners. The buyers often ended up in a similar position to the holders of Internet company stock. In short, buyers often paid too much.

The purpose of this article is to describe several criteria and a methodology that can be used to ensure an acquisition target — a quarry, mineral reserve, or company — is a good fit, a good acquisition. Price is a very important factor, but making a good acquisition requires that an acquisition target meet several additional screening criteria.

The non-financial screening criteria are primarily used to assess the risk associated with the acquisition target as well as its growth potential. As a buyer is ultimately buying cash flow, we're assessing risks affecting the ability to maintain the level of historical sales revenues, costs, and resultant cash flows, versus the ability to improve or increase them. For example, we assess whether market demand is stable, or whether factors are present that will either increase or reduce market demand and sales prices.

The primary screening criteria that is assessed when determining the attractiveness of an acquisition target include market attrac-

tiveness, mineral reserve competitiveness, operating performance, ability to add value, and acquisition price

During the past few years, several prospective purchasers of quarries needed to determine the attractiveness of specific acquisition targets. By objectively employing the criteria and methodology, several of the clients involved completed a transaction where the seller was the winner. In some instances, the buyer walked away from the table. The article begins with a review of the non-financial criteria followed by a brief description of how to properly determine a fair price for the acquisition target — its fair market value. Finally, we will apply these techniques to an example.

Non-financial criteria

Market Attractiveness. An operating quarry, or acquisition target, has a track record of historical sales volumes and revenues. Projecting future sales levels begins with an assessment of associated risks and growth opportunities. Positive factors might include an expanding population, changes to the competitive landscape such as the closure of a competing quarry or quarries, or increased highway construction budgets. Risks might include a stable or declining population, the expansion of existing quarries, the opening of new facilities, or a reduction of highway spending budgets.

Reserve Competitiveness. The initial question to be answered is whether there are sufficient mineral reserves of acceptable quality to support the existing customer demand for the desired period of time. However, the analysis should not stop there. These questions must also be asked: Is the quality of the mineral reserve comparable with that of competitors' quarries? Can the mineral be mined as cheaply as the competitors' reserves? If not, are there offsetting factors such as a transportation advantage?

Operating Performance. An operating quarry has a track record of historical cash operating costs. Projecting future cash costs requires an assessment of the historical mining conditions versus the future mine plan. Perhaps the amount of overburden, seam height, or the haul distance significantly increases/decreases. Additionally, the amount of royalty payments may increase or decrease. These factors and others impact the future

cash costs and resultant profits.

Ability to Add Value. If a prospective buyer can realistically improve the acquisition target's financial performance — such as their profits — through competitive advantages or synergies, its value to the buyer increases. Assuming it can purchase the acquisition target at the fair market price — without pricing the value of its competitive advantages and synergies — it may be able to significantly lower its risk profile. Synergies might include purchasing a competing quarry, the ability to recapitalize a quarry with spare equipment, or devising a more effective mining plan.

Determining a fair price

A fair purchase price is commonly referred to as the fair-market value. This term may be defined as the most probable price that a property (quarry) should bring in a competitive and open market between a buyer and seller who are each acting prudently and knowledgeably. There are several accepted techniques that can be utilized to determine fair market value. Three of the more widely used techniques include the following approaches: asset-based, market-based, and income-based. The income approach is typically described as the most reliable valuation method. It is straightforward and widely used. (For a more thorough discussion of valuation techniques, please refer to the article, *What Is Your Quarry Worth?* published in *Aggregates Manager*, November 2003.)

The income approach uses a forecast of future profits and discounted cash-flow analysis to determine value and is based on an acquisition target's long-term plan (greater than 10 years in duration) that takes into account several of the following non-financial criteria:

- Sales and Market Forecast — Historical sales volumes and prices are considered as well as future demand forecasts.

- Mineral Characteristics — Projected mine life, mineral deposit quality, depth of overburden, and processing requirements.

- Mine Design & Capitalization — Mine design, level of capitalization, and annual production capacities of a mine or quarry.

The plan's resultant pro forma financial statements include cash-flow projections that are discounted to their present value at an appropriate discount rate. The discount rate — an investor's required returns — are based

on perceived risk and the buyer's weighted average costs of capital.

Assuming the analysis employs a credible development plan that includes sales, costs, and capital forecasts, the resultant pro forma income statements, cash-flow projections, and fair market value may be viewed as representing a reasonably accurate estimate of value. This is important. In order to reach deal terms, there must be an agreement between a knowledgeable seller and buyer on the quarry's or company's fair-market value. The prospective buyer's objective is to purchase the acquisition target at a price that is less than or equal to the calculated fair market value. If necessary, prospective buyers may consider including some of the identified synergy value, but arguably this does represent overpaying.

Does it fit?

After taking everything into consideration, the most important question must be asked: Does this acquisition fit?

To illustrate the use of the described criteria and methodology in screening acquisition targets, let's assume that a prospective purchaser is trying to decide whether to purchase Quarry A or Quarry B. Quarry A is priced at \$5.5 million and Quarry B at \$2 million. Does either represent a good acquisition?

The following table summarizes the assumed historical operating performance of both quarries. As indicated, both quarries had similar sales volumes, unit sales prices, and profits during 2003.

A comparison of the observed performance trends summarized by the following table illustrates several significant differences. The observed trends include the following:

- Quarry A experienced solid growth during the past 10 years. Sales volumes, unit sales prices, revenues, and profits all increased.

- Quarry B by contrast experienced a significant decrease in sales volume, cash profits, and a relatively small increase in unit sales prices.

Observed Performance Trends (Assumed)		
	Quarry A	Quarry B
Sales volume (tons)	+100,000	-200,000
Sales revenue	+\$875,000	-\$875,000
Sales price (\$/ton)	+\$1.50	+\$0.25
Cash profits	+\$275,000	-\$675,000

In either case, the prospective buyer must assess the cause of the respective quarry's performance trend as well as determine whether it is reasonable to assume the trends will continue into the future. Quarry A's performance (40% growth in sales volumes) implies an expanding market, or perhaps a curtailment of a competitor's operations. By contrast, Quarry B's performance (40% decrease in sales volume) seems to imply that there must be a weakening market, increased com-

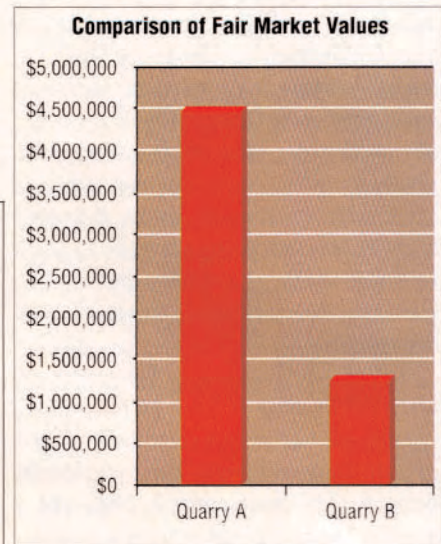
Quarry Information (Assumed)			
		Quarry A	Quarry B
Sales volume (tons)	Year 1993	250,000	500,000
	Year 2003	350,000	300,000
Sales revenue	1993	\$875,000	\$2,375,000
	2003	\$1,750,000	\$1,500,000
Sales prices (\$/ton)	1993	\$3.50	\$4.75
	2003	\$5.00	\$5.00
Cash profits	1993	\$250,000	\$1,125,000
	2003	\$525,000	\$450,000
Remaining reserves (tons)		10,000,000	10,000,000

petition, or a depletion of competitive mineral reserves resulting in a curtailment of production levels. Quarry A was also able to increase prices by about 4% annually as compared to less than a 1% increase experienced by Quarry B.

Assuming both quarries are fairly priced, Quarry A appears to be the more attractive quarry. But is it fairly priced?

For purposes of calculating the fair market value using the income approach, long-term pro forma financial models were built for the indicated sales and profit margins. (These models included several additional assumptions that were similarly applied to both quarries.) Using discounted cash flow analysis, the calculation was done using the theoretical values of \$4.5 million and \$1.3 million for the

respective cases. The following figure graphically summarizes the results.



Summing up

Quarry A appears to have a favorable performance trend with respect to several of the non-financial screening criteria, however, the calculated fair market value does not appear to justify a purchase price of \$5.5 million. The prospective buyer should consider a counter offer of \$4.5 million.

Application of the described screening criteria against potential acquisition targets can help a prospective buyer make the right decision. If the acquisition target is a good fit, it will meet most, if not all, of the non-financial criteria, and be priced at or below its fair market value. Otherwise, the prospective purchaser might consider moving on to the next opportunity.

Sellers might also consider analyzing their business operation against these criteria and methodology prior to beginning the sale process. The analysis can highlight the business' strengths and weaknesses, improve seller-buyer communications, and most importantly, enable a seller to establish a realistic sales price. ■

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