by Mike Nowobilski

Vertical Integration

As construction materials companies continue to buy and sell bolt-on operations, which path should members of the aggregates industry choose?

Downstream vertical integration into the asphalt and road construction markets has helped some aggregates companies diversify and grow their businesses.

A couple of years ago, I performed a business valuation of a very profitable construction materials and road construction company. During breakfast one morning, the founder and president noted that for most of the firm's history it had been an aggregates company producing crushed stone. During this time, the firm had been marginally profitable. He observed that the company was squeezed by many of its customers for the lowest prices, and it was often one of the last suppliers to be paid. About five years earlier, he decided to vertically integrate by purchasing an asphalt plant and launching into road construction projects. He noted with pride that this strategic decision dramatically strengthened his firm. The company currently produces nearly 2 million tons of aggregates and 600,000 tons of asphalt. It also generates revenues of $20 million.

This company's success resulted from the successful implementation of a downstream vertical integration strategy by expanding into businesses previously performed by its customers — asphalt production and road building.

Last year, I also performed a business valuation of a construction company that had made the decision to implement a strategy of upstream vertical integration. This firm wanted to control its supply of construction materials so its first purchase was a small quarry. During the next couple of years, two additional purchases were made. At the time of its valuation, the firm had just finished erecting an asphalt plant. As the result of the successful implementation of its vertical integration strategy, the firm not only became a stronger competitor within the construction segment, but also enjoyed the profits and cash flows from the operation of the quarries and asphalt plant.

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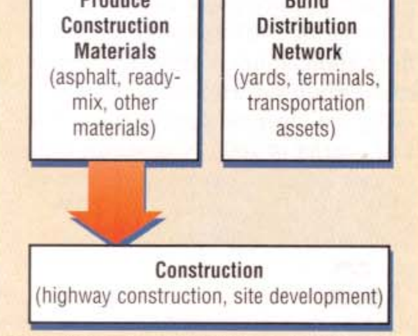
Controlling the prices of construction materials may yield strategic advantages in the marketplace.

Why do firms employ vertical integration?

When done well, vertical integration should result in stronger companies and greater profits. Both of the previous examples represent vertically integrated companies within the construction and road building industry. Companies that similarly use vertical integration within this industry segment include APAC, Barrett Paving Materials Incorporated, Delta Companies Incorporated, and Rogers Group, Incorporated. Each of these companies is engaged in road building, and they produce aggregates, asphalt, and ready-mix concrete.

Representatives from this market segment say that their firms employ vertical integration because they believe it affords them strategic advantages in the market place. Typically, they believe that controlling construction materials provides their firms with pricing advantages, as well as greater flexibility in project design, implementation, and scheduling when competing for road building and construction projects. Controlling the closest aggregate source for a particular project is just one example of several competitive advantages. The end result is higher revenues, lower costs, and greater profits.



Source: Mike Nowobilksi, president, Mid-America Energy & Mining Sources, Incorporated.

Just as a construction company benefits from vertical integration, an aggregates producer can often significantly increase aggregate demand and corresponding sales via successful implementation of a downstream vertical integration strategy where it expands into highway construction. This is sometimes referred to as "stone pull through."

Vertically integrated companies

Rinker Materials is an excellent example of a company that uses a vertical integration strategy involving downstream expansion into the manufacture of higher value products and control of its distribution channels.

Rinker is Florida's largest supplier of building and construction materials, including aggregates, cement, ready-mix concrete, masonry products, and building products. From the perspective of an aggregates producer, the firm has vertically integrated downstream into the production of higher-value products. Alternatively, if viewed from the perspective of a building materials company, the firm enhances its competitive position and profits by controlling its supply of quality aggregates and its distribution network. For example, the company maintains a network of facilities and sales offices throughout the state. Through its rail distribution system, it can competitively ship aggregates from its FEC Quarry in Miami to Jacksonville.

Cemex — the second largest distributor of cement and one of the largest ready-mix producers within the U.S. — is another noteworthy example of a vertically integrated firm. Cemex's network includes 12 cement plants, 60 distribution terminals, and nearly 100 ready-mix concrete plants. In 2000, Cemex purchased Southdown's network of cement manufacturing plants and distribution terminals. By contrast, the company has sold off aggregate quarries within the United States that were not strategic to its cement operations.

As these examples illustrate, a company's ability to dominate the distribution channels within a market may be a competitive disadvantage to smaller independent firms and a deterrent to new entrants.

On a regional basis, Mulzer Crushed Stone, Incorporated successfully competes in the Ohio River aggregates market by using downstream vertical integration to control its distribution channels. That distribution system includes strategically located terminals along the Ohio and Kanawha Rivers, which allows Mulzer to sell crushed stone from its quarries located in southern Indiana to customers as far away as Pittsburgh, Pennsylvania, and Charleston, West Virginia.

One strategy doesn't fit all

Not all aggregate producers, nor all companies within the construction materials segment, employ vertical integration. For example, Martin Marietta Materials operates as a producer of construction aggregates in many of its mar-

The impact of consolidation on the aggregates industry has been significant.

A construction materials and road construction company executive said that his company was squeezed by its customers for lower prices. Through vertical integration, the West South Central firm was able to dramatically strengthen its position in the market.

kets. Similarly, Vulcan Materials Company operates as a supplier of construction aggregates and other construction materials within many of its domestic markets.

Firms that have elected not to vertically integrate into construction typically cite two primary reasons. First, many believe that competing with their customers may ultimately result in lower sales volumes and profits. Second, others note that the decision to vertically integrate is dependent upon the specific market dynamics.

Zoning and permitting restrictions often associated with aggregate sources are another deterrent to companies. Arguably, this results in higher margins than might be associated with activities with lower barriers to entry, such as entry into road construction.

In addition, firms tend to be most efficient focusing on activities where they have developed core competency, processes, and managerial experience. For example, several contacts noted that construction companies often tend to run less efficient and more expensive quarries because they focus on construction projects.

Finally, expansion — whether through vertical integration or not — requires additional capital investment, stretches management, and may reduce strategic flexibility.

Integration and industry impact

Vertical integration has been one of the driving forces for consolidation within the aggregates and broader construction materials industries. Most major companies have been active participants.

Many of the larger acquisitions, such as the referenced Southdown acquisition by Cemex, have been well publicized. What has escaped much of the press coverage has been the smaller bolt-on acquisitions being completed by the majors. As a bolt-on acquisition, this activity typically enhances the acquirer's existing competitive position, or permits the acquirer to expand its geographic presence.

Depending on an acquiring company's strategy and extent of its vertical integration, the targets can be quite varied. In one instance, a target could solely be an aggregates operation. In another, it could be an asphalt or ready-mix concrete plant. If control of the distribution channel is the objective, the acquisition may involve a transportation company, terminal, or yard.

The resulting impact of consolidation on the aggregates and related industries has been significant, especially within the construction arena. In many markets, the acquired companies and their acquirers become dominant competitors. More and more, these large companies control strategically important sources of construction materials, expertise, economies of scale, and capital resources within a market. As a result, they often place the small independent company at a significant disadvantage. One contact for this article noted that he believes this strategy is especially effective in rural markets.

Domination of distribution channels within a market may also create significant competitive disadvantages. For example, a former client developed a new quarry on the Ohio River with the intent of competing in the large market for river-borne aggregate. Lack of an established distribution network negatively impacted its expansion plans. Subsequently, the operation was sold to a company, which was better positioned to compete in the market.

Should You Consider Vertical Expansion?

Answering the following will assist you in making the correct decision:

- Does a real market opportunity exist, not just in the short term, but during the long term as well?
- What benefits can you reasonably expect to gain from pursuing vertical integration?
- Can many of these same benefits be achieved through strategic alliances or partnerships?
- Does your firm have sufficient resources? This includes capital, relevant experience, and a sufficient management team.
- Is it reasonable that the expected profits and cash flows from undertaking the expansion will be high enough to justify it?
- Is the anticipated rate of return high enough to justify the capital investment?

Looking toward the future

Vertical integration and consolidation within the industry has created a playing field containing several larger and better capitalized competitors. More and more, the small independent company is placed at a disadvantage.

Arguably, there will always be a place for well-run, cost-efficient independent companies, but it seems that the consolidation within the industry will continue. In many markets, it is becoming more and more difficult for smaller, non-vertically integrated companies to compete.

As a business broker facilitating the sale of mining companies and mining properties, I saw a slow down in acquisitions during 2003. However, several of the consolidating companies resumed making bolt-on acquisitions during 2004, and the trend continues into the first quarter of 2005. Noteworthy transactions include Cemex's acquisition of RMC Group plc, and Holcim LTD's acquisition of Aggregate Industries plc. **AM**

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