

Service Center Mergers Roll On

LAST YEAR THE ENVIRONMENT WAS ideal for mergers and acquisitions due to the availability of significant liquidity in the capital markets, closely aligned valuations for both buyer and seller and the changing dynamics in the steel industry. In short, those considering a purchase or sale would have done well to act then. The good news is that transaction activity remains robust in the metals market. While the environment has changed, there are still compelling reasons for buyers and sellers alike to proceed with their M&A plans.

Specifically, the blurring of the supply chain continues to drive mergers and acquisitions, though credit markets are tighter, making private equity investors less willing to participate in the industry. Valuations are now regressing from their long-term average levels, but for the moment remain attractive for sellers.

Blurring the supply chain

New strategic planning philosophies among the steel industry's major players are beginning to challenge traditional supply chain delineations.

In recent years, the industry has witnessed the consolidation of iron ore production into the hands of a few, very large players (i.e. Rio Tinto, CVRD and BHP Billiton). This consolidation may continue further with the acquisition of Rio Tinto by BHP Billiton.

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As a result, mills have been vertically integrating their operations through the acquisition and development of mining properties. This provides not only a hedge on the supply side, but also reduces the leverage held by major suppliers. Large steel producers have also effected a record number of mill acquisitions in the last year.

With today's large-scale mills, the consequences of over-production are more serious. Management efforts to improve production discipline have been largely successful. Since plants have begun making as much steel as needed, rather than as much as they can, inventory quantities are better managed and market prices are more stable.

This new production discipline is causing mill management to pay attention to other activities that will potentially enhance their margins. In some cases, mills are beginning to deal directly with major end-users outside of their traditional automaker base by providing products offered by larger service centers.

As a consequence, some large service centers whose profits are being squeezed by the loss of customers find themselves motivated to grow. One such path to growth is through acquisition, with the aim of customer diversification and expansion into the mid-market. In doing so, a large service center ensures that it maintains buyer leverage with the mills, as well as the price privileges of this relationship.

Mid-market service centers—facing new price competition from larger service centers that have moved down market—find themselves under pressure to drive costs out of their business and find new

customers. Lower margins resulting from this competitive shift make mid-market service centers less attractive to would-be strategic buyers. Margin compression is exacerbated by lower levels of secondary steel, a result of improved operations at the mills.

The choice faced by mid-market service centers is clear: grow within the context of a large service center (i.e. sell your company) or go bust. While growth is the preferred choice, prospects are also limited due to tightening credit markets.

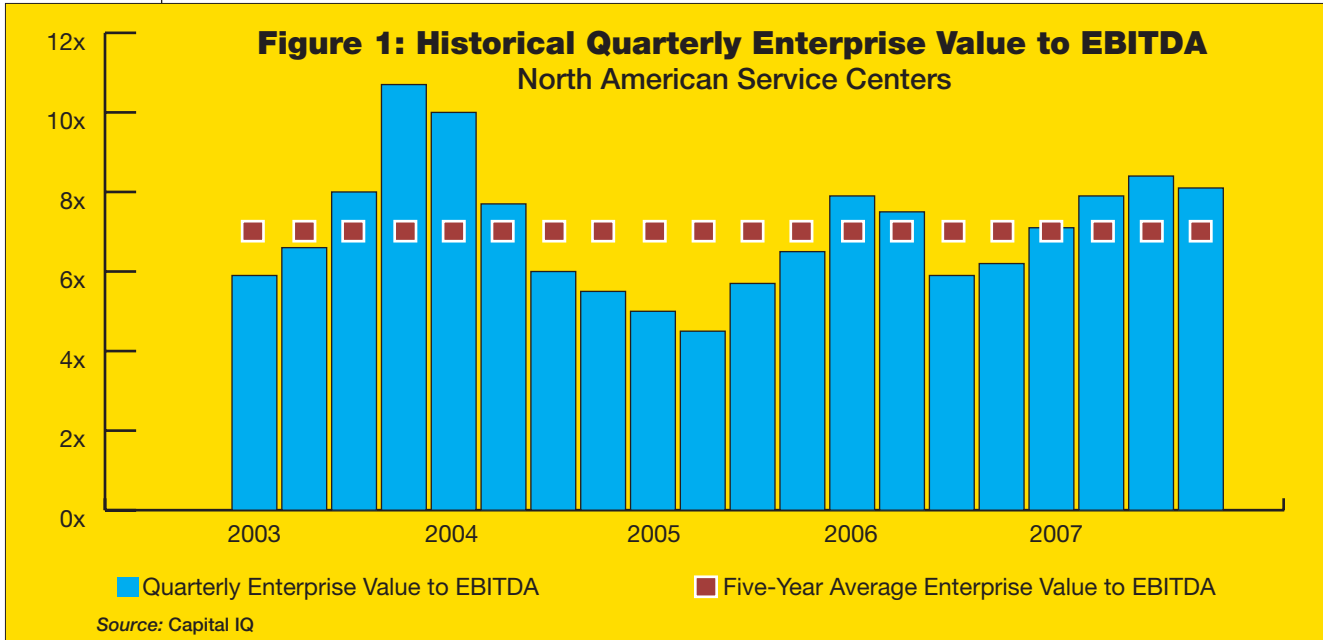
Credit markets are tighter

The sub-prime mortgage crisis in the United States, currently making dark headlines in the financial press, has caused pullback in the private equity investment community. Private equity investors and lenders are waiting to see just how the situation will play out before getting back in the game.

In fact, the amount of credit available in the marketplace has dropped so low that private equity investors are required to provide nearly double the up-front equity. Only six months ago, the amount of equity required by lenders was in the range of 20 to 30 percent. By contrast, today's number falls in the range of 40 to 50 percent. With a larger equity requirement, investors must lower the value they pay for a service center to a level where some owners may be unwilling to sell. Reduced liquidity is therefore one of the primary explanations for regressing valuations.

Valuations remain attractive

Service centers valuations continue to be driven by four major factors: the scale and diversity of



the company’s customer base (size, industry and geography); consistent and strong margins in rising and declining price environments (suggesting a high degree of inventory discipline); the pace of revenue and earnings growth; and the quality of the management team.

Over the past three active months, realities in credit markets have reduced private equity interest and caused transaction liquidity levels to drop, putting downward pressure on valuations. However, valuations of larger, public service centers are in the range of 8.0x EBITDA (Figure 1). This is still above the five-year average of about 7.0x EBITDA, and indicates an environment that remains

positive for buyers and sellers alike.

Deloitte expects service center merger and acquisition activity to continue, despite the decreased participation of private equity investors. Their absence means that the auction processes will be less contested, with favorable consequences for buyers. That said, recent declines in valuations have yet to make prices so unattractive that sellers will retreat.

Mid-market service centers, which are somewhat shielded from the current credit market malaise, are also subject to lower valuations, as shifting dynamics create lower margins and levels of customer leverage. Mid-market transac-

tions, such as acquisitions by Reliance Steel & Aluminum Co. in the last year, fall in the range of 5.5x to 6.0x EBITDA and are more indicative of current valuations (Figure 2).

The current situation continues to suit both buyer and seller. The former is heartened by the fact that targets are cheaper now than they were six months ago, while the latter knows that today’s prices are still better than average. In the absence of 20/20 foresight, no time is the perfect time to buy or sell, but based on 20/20 hindsight, now would appear to be as good a time as any in the past decade. ■

Figure 2: Recent Transaction Valuations

Target	Buyer	Enterprise Value (EV)	EV/Revenue	EV/EBITDA
JMS	Russel Metals	125	0.6x	—
Ryerson Tull	Platinum Equity	1,794	0.3x	7.2x
Novamerican Steel Inc.	Symmetry Holdings	585	0.7x	7.6x
Various Companies*	Reliance Steel & Aluminum	258	0.5x	5.9x
Yarde Metals	Reliance Steel & Aluminum	202	0.5x	—
Earle M. Jorgensen	Reliance Steel & Aluminum	966	0.6x	5.5x
		Average	0.5x	6.6x

*Encore Group, Clayton Metals, Crest Steel and Industrial Metals, EBITDA margin assumed to be 8%

Source: Capital IQ and company reports