

# Conditions Ideal for Service Center Mergers and Acquisitions

Buyers and sellers both have solid reasons to come together and strike a deal.

IF YOU'RE IN YOUR 50s or 60s and you're a shareholder of a service center, it's only natural to question just how long you should hang on before you retire. Would it make sense to sell at a time when you're making a lot of money? Is that when you'll be sure to get the best price? How long do you want to wait?

fair price?

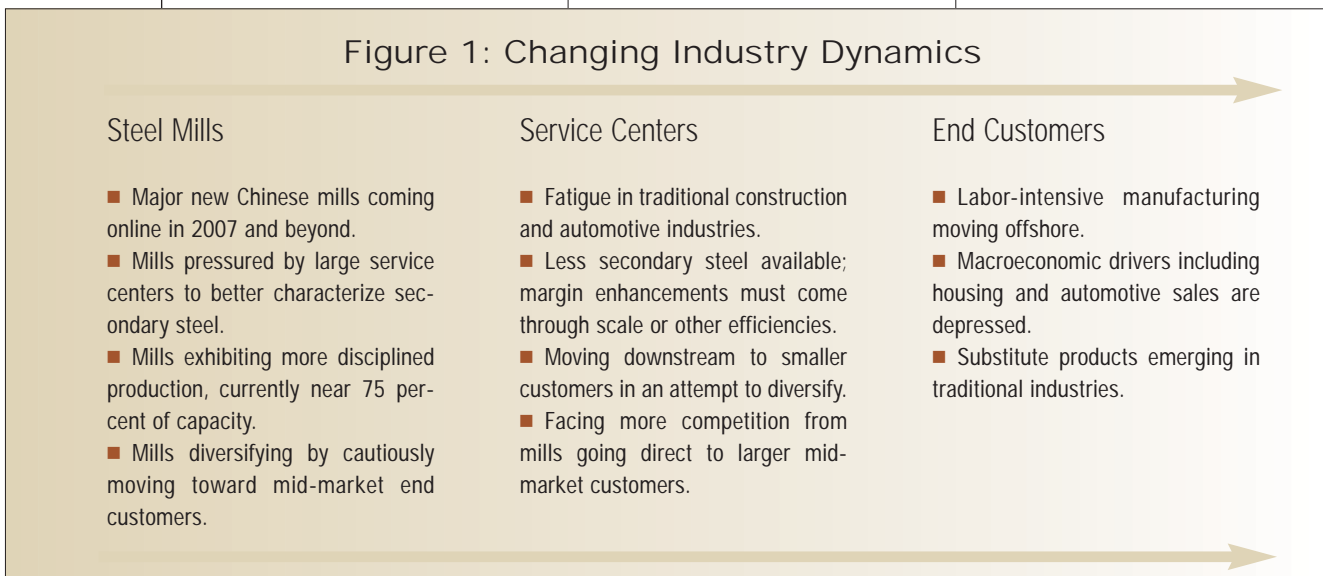
As advisors, we are constantly fielding these types of questions from service center owners. Today, we're telling them this: It's a great time to either buy or sell service centers, for a variety of reasons:

- Changing industry dynamics are giving owners an opportunity to re-think their strategies and

consider a deal.

The enhanced scale and discipline of today's mills is ensuring that their production is better managed, which has the effect of stabilizing prices for service centers and end customers. Mills are also doing a better job of characterizing secondary steel, which reduces the amounts available to mid-market service centers, limiting margin-enhancing opportunities. At the same time, mills are more aggressively marketing to

Figure 1: Changing Industry Dynamics



Similarly, if you are interested in acquiring service centers, it is important to understand whether this is the right time to buy, and, if so, what would be considered a

*John Jazwinski leads Deloitte's Primary Metals Group within the Corporate Finance Advisory practice in Canada. He has advised on a variety of transactions in the service center industry. Based in Toronto, Canada, he can be reached at 416-601-6213 or by e-mail at [jjazwinski@deloitte.ca](mailto:jjazwinski@deloitte.ca).*

become active buyers or sellers.

- Significant liquidity in the service center industry, offering good access to growth capital, is driving a record number of mergers and acquisitions.

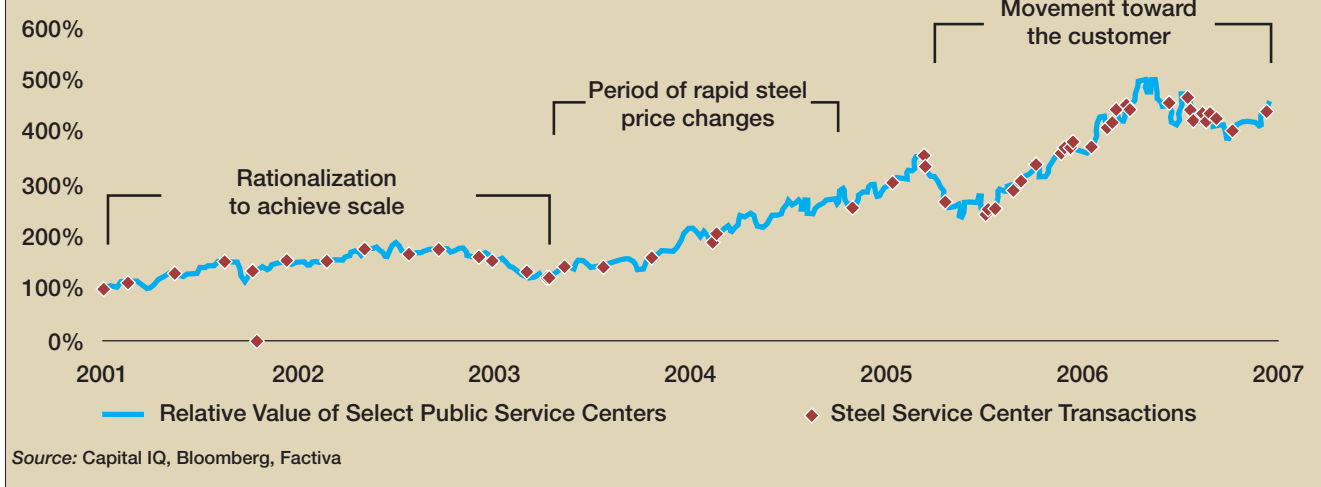
- Valuations of service centers are near the long-term average, which means the expectations of both buyers and sellers are closely aligned.

Shifting market dynamics (Figure 1) within the steel supply chain suggest that this is the right time for buyers or sellers to

larger mid-market customers of service centers.

Only large or very efficient service centers are weathering the current squeeze. With lower levels of secondary steel available, and mills looking to expand their reach into the customer realm of service centers, many in the industry are depressed by these new realities. Under pressure due to challenges in the traditional automotive and consumer goods industries, service center margins are best maintained in the long-term through

Figure 2: Index of Select Public Service Centers  
Service Center Transaction Activity (North America)



volume growth, typically through green-field projects or acquisitions. These dynamics are motivating many to become buyers.

Many service center owners late in their careers have neither the desire nor the patience to manage their companies through the latest phase of industry change. This is creating a wave of moti-

From 2001 to 2003, industry consolidation began as financially healthy service centers acquired the assets of troubled competitors. An increase in the availability of capital for traditional industries at this time facilitated many private leveraged buyouts, including many smaller service centers that were below the radar screens of larger participants. From this

clusters of transactions illustrate, and their activity is best characterized as a movement downstream toward the customer.

Mills, service centers, private equity  
The emergence of large-scale global mills favorably positions them to acquire larger service centers and begin selling

While there has yet to be a major transaction in North America...there is definitely an overt flirtation under way between large mills and North America's largest service center companies.

vated sellers.

While current industry dynamics may frustrate short-term financial performance, capital market indicators such as M&A activity and public company valuations suggest it is an attractive time to look at either growing or selling your service center.

Merger and acquisition activity

Press coverage in the last two years has pointed to an impending wave of mergers and acquisitions in the steel industry. In reality, that activity has been occurring, with relatively little fanfare, for some time now. Looking at data that stretches back five years (Figure 2) clearly shows three distinct waves of consolidation:

1.) Rationalization to achieve scale:

wave of consolidation emerged larger service centers with greater scale.

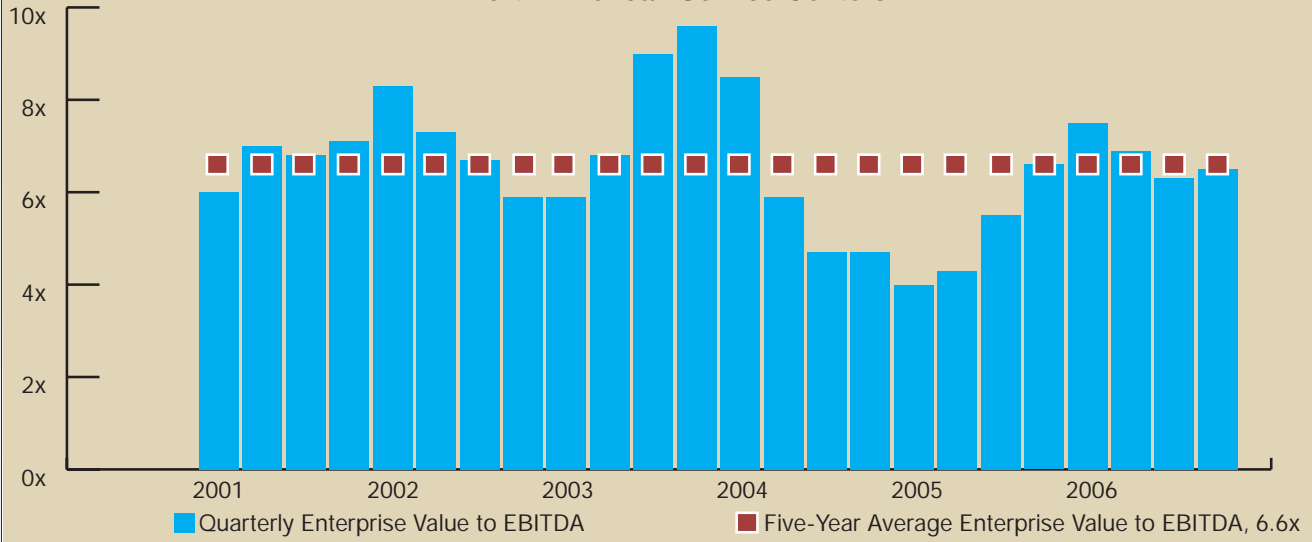
2.) Period of rapid steel price changes: Figure 2 also shows a lack of activity during the turbulent price increases and decreases of 2004 and 2005. This suggests that most in the industry were patient and careful to understand the implications of the dramatic price changes before buying or selling. During this time, steel mill consolidation resulted in the emergence of large, global mills such as Arcelor and Mittal. The business and capital market strategies of these mills set the tone for the next wave of activity.

3.) Movement toward the customer: Leading mills, service centers and private equity firms have now emerged, as the

directly to customers. Smaller mills are also re-defining their niche in an increasingly large-scale world. These mills are looking for service centers with complementary product and geographical footprints to capture their existing customers within a proprietary sales channel. While there has yet to be a major transaction in North America, activity is certainly occurring on a smaller, private scale, and there is definitely an overt flirtation under way between large mills and North America's largest service center companies.

The new realities in the industry are making it increasingly important for service centers to achieve greater scale and a diverse mix of customers. As such, service centers of all shapes and sizes are

Figure 3: Historical Quarterly Enterprise Value to EBITDA  
North American Service Centers



Source: Capital IQ

in acquisition mode. Those with scale are motivated both to increase in size and to diversify away from traditional industries and geographies. Those without scale are diversifying the composition of their cus-

private equity investors in the past two years include Platinum Private Equity's purchase of PNA Group and Metals Supply Co. last year, Ironwood Capital's purchase of Primary Steel LLC in 2005

of those rare times when the value expectations of both buyers and sellers are closely aligned. Current enterprise valuation multiples, which are at 6.9 times EBITDA, are very near the long-term

The current market is one of those rare times when the value expectations of both buyers and sellers are closely aligned.

tomers bases to include smaller customers, reducing their dependence on a relatively small number of big customers.

Private equity is smart capital going after a still non-rationalized industry. The entrance of large private equity firms underscores the liquidity in the market and also suggests that longer-term opportunities to maximize value are available. Private equity investors typically buy into industries with favorable conditions that afford high long-term returns on their capital. They also require an exit from their investment, typically in five or more years. This timing may suggest a potential timetable for a roll-up of the North American service center industry by global mills.

Notable service center acquisitions by

and Apollo Management Inc.'s acquisition of Metals USA Holding Corp., also in 2005. The current level of merger and acquisition activity has created momentum in the marketplace, and this will likely continue. The current valuations of public service centers also suggest that the time is right to transact.

Current valuation observations

When valuing companies, buyers will typically pay a multiple of EBITDA. It is Deloitte's experience that both strategic and private equity buyers typically will look to the long-term valuation average as a proxy for determining the value of a given acquisition. In contrast, a seller's expectations are typically above the long-term average. The current market is one

average of 6.6 times (Figure 3).

In advising its service center clients, Deloitte has learned that premium value is influenced by four drivers: the scale and diversity of the company's customer base (size, industry, geography); consistent and strong margins in rising and declining price environments, which suggests a high level of inventory discipline; the pace of revenue and earnings growth; and the quality of its management team.

Changing industry dynamics, liquidity in the marketplace and the close alignment of buyer and seller expectations make this a good time to transact. Understanding, positioning and negotiating on the basis of these value drivers is the key to a successful deal in today's market. ■