Why Are Private Equity Firms Investing in Ready Mixed Concrete Companies?

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In the summer of 2003, two private equity firms in Austin jointly acquired a Texas-based ready mixed concrete ("RMC") company. In 2004, a private equity firm in Boston acquired a North Carolina-based concrete company and a private equity firm in Minneapolis acquired a Louisiana-based cement and concrete company. Prior to 2003, there has been very little interest in the RMC industry from private equity firms, aside from the creation of U.S. Concrete. So what has changed? Why is the private equity community now focused on the concrete industry as a vehicle for investment?

On the surface, the RMC industry would not appear to have the sizzle and growth outlook to which private equity firms typically migrate. It’s a mundane, cyclical construction business. Peel back the onion, however, and the industry actually has numerous characteristics that make it appealing for private equity investment. Set forth below is a discussion of these characteristics as well as many of the other factors driving investment in the industry, including:

• Current market conditions for private capital;
• Investment criteria for private equity firms;
• Attractive characteristics of the ready mixed concrete industry;
• Key considerations for sale to a private equity firm; and
• Case studies of recent industry transactions.

Now is a time of impending structural change in the ready mixed concrete industry and we believe private equity firms will play a key role in facilitating such structural change. Owners of privately held RMC companies need to be prepared to address and react to these changes. Key to this preparation is developing an understanding of why private equity firms are investing in the industry, what are the investment criteria and what it means to be partners with a private equity firm.

Current Market Conditions for Private Capital

The first step to understanding private equity focus on the RMC industry is to appreciate how much capital is available for investment and that needs to be invested over the next few years. As discussed further below, private equity firms are money managers for large institutions and endowments. A typical investor in a private equity fund is a state pension fund or a university endowment fund. These large funds typically allocate a small percentage of their funds to “alternative investments” such as private equity in an attempt to diversify holdings and increase overall investment returns. Most private equity firms will create discreet limited partnerships with these institutions, setting forth management fees, specific investment criteria and mechanisms for...
sharing investment returns. The partnership agreements also establish time periods over which the capital is to be invested and then investment returns are to be realized. There are obviously exceptions, but typically a partnership will have a 10-year life with a five-year investment period. The implications of these partnership structures are very important to understanding the current market for private equity. Once a private equity firm raises a fund, it has five years within which the capital needs to be invested, or it potentially will be returned to the limited partners. Returning capital to limited partners is a bad economic outcome for a private equity fund as it loses not only the management fees associated with managing the capital but also any potential investment returns associated with investing the capital. As such, once a partnership is created, a private equity firm has very strong incentives for investing all of its capital over the next five years.

The 1998-2001 time period was an unprecedented time for the raising of private equity capital. Investment returns from private equity investing in the mid-to-late ’90s were very attractive, which led to a significant increase in the number of private equity firms and the amount of equity capital that was raised by these firms. Set forth below is a chart of private equity capital raised by year, demonstrating this phenomenon.

Once this capital was raised, however, events of 2001 and the resulting economic slowdown significantly decreased the pace of investment for private equity firms. Much of the capital raised in 1999 and 2000 remained on the sidelines looking for opportunities. While activity has picked up over the last two years, a substantial private equity “overhang” remains for which the clock is ticking. Much of the capital raised in 1999 and 2000 needs to be invested quickly or it may have to be returned to limited partners as discussed above. This overhang has created a frenzy of activity for private equity firms seeking investment opportunities, and has significantly improved valuations and structures for sellers of businesses to private equity firms. Set forth at left is a chart demon-

![Private Equity Overhang Chart](chart)

**Private Equity Overhang ($ in billions)**

Source: Venture Economics
Investment Criteria for Private Equity Firms

To understand why private equity firms have developed an interest in the RMC industry, it’s important to understand how these firms think and what their criteria for investment are. As discussed above, most private equity firms are money managers for large institutions and endowments. As a result, the primary focus for a private equity firm is return on investment. First, most firms are compensated based on investment returns

![Lending Multiple Trend Chart](Image)

Source: Standard & Poor’s / Leveraged Commentary and Data
and these firms typically do not receive much if any compensation (other than management fees) unless certain specified investment returns are achieved. Second, competition for investment by large institutions and endowments is very competitive and a private equity fund is able to raise capital for a new fund only if its historical track record is strong and in the top half or top quartile for comparable private equity firms. Generally speaking, a private equity firm has historically targeted a return on its equity investment in a range of 30-40 percent over a three- to five-year investment horizon, depending on the perceived risk of the investment. When a private equity firm makes an investment, it will develop a detailed and thoughtful point of view as to how it will achieve this targeted return and will assess all of the risks associated with achieving this return. Given the amount of capital looking for acquisitions, our firm has seen these targeted returns move lower in the past 24 months to a range of 20-30 percent as private equity firms have to work harder to find attractive investment opportunities in a very competitive environment.

So what are the key investment criteria to a private equity firm?

• First and foremost, it is the management of the acquired company. As discussed further below, for “platform” acquisitions most private equity firms look to the management of an acquired company to achieve its growth strategies and targets. Without an effective management team, all of the other factors become irrelevant.

• Second, a private equity firm will develop a financial model reflecting its ability to achieve its target investment returns of 20-30 percent. Factors that affect this outlook will be the projected earnings growth of the business, market position and competition, size of the business, the ability to grow through acquisition, potential cost savings and consolidation benefits, capital required to grow the business, the amount of debt that can be placed on the business (thus decreasing the equity requirement to achieve the acquisition) and other strategies that can achieve above-average earnings and cash flow growth for an acquired company. Further below is a more detailed discussion of these criteria in the context of the RMC industry.

• Third, a private equity firm will carefully assess its ability to exit its investment in a three- to five-year time horizon. To earn its compensation on a fund and to develop a track record for the next fund, a private equity firm has to “realize” its investments, in other words turn its equity investments into cash.

Attractive Characteristics of the Ready Mixed Concrete Industry

Notwithstanding its reputation as a boring, low-growth, mundane, weather-sensitive cyclical construction business, the RMC industry has numerous characteristics that are attractive to private equity firms. As discussed further below, the timing is perfect for private equity firms to step in and play a role in the developing consolidation and forward integration of the cement and concrete industries. These attractive characteristics include:

• Strong and stable industry structure;

• Opportunities for growth through acquisition;

• Numerous benefits associated with consolidation;

• and others.
Opportunities for valuation multiple expansion; and
Increasingly visible and attractive exit strategies.

Believe it or not, the structure of the RMC industry is attractive to many private equity firms. First, it’s a business that many firms can understand. Most private equity firms make investments in a myriad of industries and rarely do many of them specialize in a specific industry. None of the firms that have recently invested in the RMC industry are specialists in concrete or even construction. Second, it’s an industry that is strategic to our national economy and it isn’t going anywhere. No private equity investor will wake up one morning and find that the business has been outsourced to China or rendered irrelevant by a new technology. Sure there’s cyclical and weather sensitivity but these are risks that can be understood and addressed through capital structure and valuation. There is little if any risk of a total loss of a private equity firm’s investment in an RMC company.

The next attractive attribute is the ability to grow through acquisition. As everyone in the industry knows, there are thousands of small companies in the RMC industry, many of which are projected to be acquired over the next decade. Furthermore, industry developments should accelerate this pace of consolidation and private equity firms are attracted by the opportunity to help finance, develop and benefit from this consolidation. Growth through acquisition is an active growth strategy that is appealing to many private equity firms, as it is a variable they and their management teams can influence.

The third attractive attribute of the industry is the ability to actually realize benefits from the acquisition and consolidation of small private concrete companies. Some of these benefits include lower materials and vehicle purchasing costs, higher priority access to materials (which is becoming increasingly important given the prevalent cement shortages around the country), lower operating costs per yard of production, lower S, G & A costs as a percent of revenues and greater utilization of trucks and people.

Fourth, investment in the RMC industry provides the potential to create equity value through the expansion of valuation multiples. There is no doubt that larger concrete companies sell for higher multiples than smaller concrete companies. This can be for many reasons, including materials purchasing volumes, diversity of customers and revenues, market position, management depth, ability to withstand market downturns and the amount of debt that can be placed on the business. A typical private equity firm strategy might be to (a.) buy a “platform” company for 5-6 X EBITDA, (b.) make “tuck-in” acquisitions of smaller concrete companies at 4-5 X EBITDA, then (c.) sell the larger consolidated concrete company to a strategic buyer or larger private equity firm for 6-7 X EBITDA (or more). This expansion of valuation multiples is critical to a private equity firm’s belief that it can achieve a 20-30 percent return on its equity investment, given the slow fundamental growth of the industry. The combination of improved profitability through consolidation with higher valuation multiples upon exit is a very compelling investment strategy for many private equity firms.

Last but not least, we believe that the increased interest in the RMC industry by private equity firms is due to the consolida-
tion and forward integration taking place in the cement and concrete industry, and the resulting confidence that a private equity firm has in achieving its exit strategy. One could write an entire separate paper on the subject, but there is no doubt of an increasing interest in the United States for cement companies to forward integrate into ready mixed concrete. One only has to see the Lafarge acquisition of The Concrete Company, Holcim’s acquisition of Aggregate Industries, Cemex’s acquisition of RMC Industries and its recent joint venture with Ready-Mix USA and recently announced ready mixed concrete acquisitions by Rinker, Hanson, Lehigh and Taiheiyo Cement to understand where the industry is headed. Private equity firms can acquire and consolidate smaller concrete companies with confidence knowing that a larger concrete company will be an attractive acquisition candidate for one of the cement producers or international construction materials companies. There is also the possibility of selling a larger concrete company to a larger private equity firm; one of the transactions referred to in this article was sold to a private equity firm despite rumored strong interest from a large industry buyer.

Key Considerations for Sale to a Private Equity Firm

There are numerous considerations for an owner of an RMC company contemplating selling a business to a private equity firm. These considerations fall into three general categories, as follows:

- How the characteristics of the business match up with the investment strategies of private equity firms;
- What forms of sale transactions are available; and
- Life with a private equity firm.

Obviously, the first step is for an owner to assess his or her business and how it matches up with the private equity firm investment criteria set forth earlier in this article. Private equity firm investments can be generally divided into two categories: “platform” investments and “tuck-in (also known as “add-on”) investments. Platform investments typically represent an initial foray into an industry and it is with this platform company (and importantly, its management team) that a private equity firm will attempt to execute its investment strategy in a selected industry. Tuck-in acquisitions are subsequent, typically smaller acquisitions that are consolidated into a platform company. As could be expected, the bar is set much higher for a platform acquisition than for subsequent tuck-in acquisitions. An attractive platform company should generally expect a valuation in the 5-6 X EBITDA range while tuck-in acquisitions should gear expectations to the 4-5 X EBITDA range. These ranges can obviously vary depending on many factors but are good general benchmarks from which to set initial expectations for the owner of an RMC company.

The most important criteria to be a platform company is size. As discussed above, larger companies have many characteristics that make for attractive private equity investments. A good benchmark for a minimum size in terms of trailing 12 months EBITDA is $5 million. Depending on markets and profitability margins, this translates into roughly 600,000-800,000 yards of

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annual concrete production. Companies smaller than this will almost always be evaluated only as potential tuck-in acquisitions. Once the size threshold is achieved, many other factors come into play as discussed above, including capability and depth of the management team, ability to make acquisitions, apparent benefits from consolidation, current and potential leverage with materials suppliers, quality of the equipment base, safety record, business and customer mix and diversity, and several other factors that affect the growth outlook and profitability of an RMC company.

The second step for an owner is to understand and assess the available transaction structures. Generally in this context an owner can pursue either a sale or a recapitalization. Set forth below is a discussion of each of these alternatives.

• A "sale" transaction generally represents the sale of 100 percent of the ownership of the company, with ownership-management possibly but not necessarily staying involved with the company. Typical sale situations include tuck-in acquisitions, divestitures from larger corporate owners or the sale of a family owned business where the family desires to no longer be involved with the business and isn’t critical to managing the business. A sale requires a private equity firm to find a management team, either from within the business or from outside, and then to provide them the incentives to achieve the growth objectives for the business.

• A “recapitalization” (also known as a "recap") transaction involves the reinvestment of a portion of the sale proceeds into continuing ownership in the business by the selling owner/manager of the business. This ownership position is typically 20-30 percent of the equity of the new company. The primary context for a recapitalization is in the establishment of a new platform company in the industry by a private equity firm. There are numerous benefits to a recapitalization for both the acquiring private equity firm and for the selling owner and has become the transaction structure of choice for many private equity firms. The benefits of a recap to a private equity firm are that it keeps an owner/manager involved in running the business and requires that owner/manager to make a significant financial commitment to the ongoing success of the business. The benefits to a selling owner/manager are also very attractive. A recap allows an owner to take a substantial portion of the value of the business off of the table while remaining primarily responsible for running the business. It also develops a partnership with a source of capital and business expertise that can assist the owner in growing the business and executing an acquisition and consolidation strategy. Lastly, it provides a “second bite at the apple” to the owner when the business is sold again in three to five years. The economics of a recap can be very compelling to a selling owner who desires to take advantage of current market conditions to monetize a portion of the value inherent in the business while also continuing to run and grow the business for the next five years.

Lastly, an owner of an RMC company who remains involved in the business post-sale to a private equity firm needs to prepare for life with a private equity firm. Most private equity firms delegate all the day-to-day management decisions and operations of a
platform company to the managers of the business and participate in strategic decisions though board participation. Many selling owners frankly welcome this strategic input and benefit from the experiences of the private equity firm board members. That being said, a selling owner who stays involved should be prepared for additional internal (and potentially external) reporting requirements and will now have to discuss many of his or her business decisions with others who have a stake in the outcome. Not all independent, entrepreneurially driven business owners make this transition easily. While part of the acquisition evaluation for a private equity firm is to assess the capabilities of a management team, a selling owner should also focus on his or her compatibility with the private equity firms interested in buying the business, particularly in the context of a recap. Lastly, while a recap keeps an owner involved in running the business, it is the first step in the ultimate sale of the business. An owner who sells a business through a recap needs to be prepared for an outright sale, probably to an industry buyer, in the next three to five years.

Case Studies of Recent Industry Transactions

In the beginning of this article, I mentioned three recent transactions that highlight the increasing private equity interest in the ready mixed concrete industry. Each of these transactions has its own rationale and can be instructive as to how outside investors are investing in the industry. Set forth below is a brief discussion of each of these recent transactions.

• **Southern Star Concrete.** In the summer of 2003, Texas Growth Fund and Austin Ventures acquired the Dallas-based Texas and Arkansas concrete operations that were acquired by Hanson in its acquisition of Pioneer. Interestingly, these private equity firms had not targeted the RMC industry for investment but rather were able to move quickly to take advantage of an opportunity to acquire this business in partnership with the management team of the business. The buyers’ primary investment thesis was to buy the business inexpensively when conditions were less attractive, take actions to immediately improve the financial position of the business and then wait for market conditions to improve. Thus far the strategy appears to be working, as Southern Star was able to immediately and strongly increase its financial position by selling non-core operations and improving the working capital management of the business. One phenomenon that the buyers may not have anticipated is the increasing focus on the forward integration of the cement business in the United States. At the time this business was sold in 2003, there was reportedly very little if any interest in it from cement producers or importers in Texas, and the buyers were reportedly able to acquire Southern Star at an attractive valuation. While we know of no plans for the current owners to sell the business, when or if they do we would expect several cement producers or international construction companies to have an interest in the business, which should drive valuation higher. Southern Star produces about 5 million yards of concrete per year, which creates a meaningful amount of cement demand for many prospective buyers.

• **Angelle Concrete.** Angelle Concrete executed a recapitalization in late 2004 with Shoreview Industries, a Minneapolis-based private equity firm. Angelle is based in Jennings, LA and the owners of Angelle also own South Louisiana Cement, an independent cement importer. While the financial details are not available, the recapitalization allowed older family members to extricate their value from the business while keeping the current management team in place. The recap also enabled the consolidation of four legal entities (including South Louisiana Cement) into one company. Shoreview stepped into the majority owner's position in the business and is providing the capital for Angelle to pursue its strategy of acquiring rural concrete companies in markets contiguous to its current operations.

• **Ready Mixed Concrete Company.** Ready Mixed Concrete Company (“RMCC”) was sold to Audax, a Boston-based private equity firm, also in late 2004. RMCC is a very profitable business with strong market positions in many of the major metropolitan areas in North Carolina, South Carolina and southern Virginia. RMCC currently produces about 2.3 million yards of concrete and has the business strategy of continuing to
make tuck-in acquisitions of smaller concrete companies in contiguous markets. Audax was attracted to RMCC by its profitability, market position, management team, equipment base and safety record, ability and potential to continue to make acquisitions and its ability to realize the benefits of consolidation. RMCC was reportedly sold for more than 7 X EBITDA, providing an excellent example of the benefits of size, management and growth potential as well as the ability to place a significant amount of debt on larger companies.

Overall, we believe that many factors will continue to bring private equity investment into the ready mixed concrete industry and that private equity firms will play a key role in the consolidation of the United States concrete industry. As discussed above, the industry in the U.S is clearly moving toward a structure of forward integration with the major cement producers and, given the dynamics of the cement industry, access to cement supply will become increasingly important and problematic for smaller RMC companies. Private equity firms will step into the role of acquiring and consolidating smaller concrete companies and building larger companies that, (a.) can develop better and less expensive access to cement supplies, (b.) operate more efficiently, and (c.) will ultimately become attractive acquisition candidates for cement producers seeking additional forward integration. We believe every owner of an independent RMC company in the United States should be monitoring these events closely and be proactive about developing a strategy for his or her business as this industry restructuring unfolds.

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