



The Ups & Downs of Construction Company Valuations

Construction contractors are accustomed to being at the mercy of the U.S. economy. The industry enjoyed strong growth in 2004, and new construction starts in 2005 look promising. But demand is highly cyclical, and revenues and expenses are uneven. Whether the company is a general building, highway or residential contractor, these valuation vagaries add to the challenge of appraising a construction company.

As with any valuation, the higher the risk, the lower the value. With that in mind, there are several key factors to consider when looking at the value of a construction company:

Key employees: Many construction companies are family owned. Depending on the size of the company, it may rely heavily on a few key employees who hold the relationships and reputation integral to the company's success. This is especially true with private sector contracts.

Moreover, the company's welfare may depend on the estimating, scheduling and contracting prowess of just a few individuals — a common situation in the public sector construction arena. Reliance on key employees means more risk.

Key clients: Similarly, the company may rely heavily on contracts from a few recurring clients. What would happen to the value of the company if key clients looked elsewhere? Would clients stick with the company if ownership changed?

Nature of contracts: Because construction companies work on contracts, historical earnings may not be truly indicative

of future income. It's important to look deeply into the contract backlog, the nature of current contracts and their terms. Construction companies also have unique accounting issues which should be taken into consideration. For example, are they using a cash, completed contract or percentage-of-completion method?

Unstable earnings: Companies that engage primarily in new construction tend to thrive in good economic times. Companies handling mostly repairs or renovations tend to do better in more unsteady economies. Contractors with a lot of state-funded contracts may feel a budget crisis more quickly than those doing federally funded work. Federal funding tends to be set aside in larger amounts over longer time periods and is therefore less volatile.

Regional differences: Is the company doing work in a region in growth mode or in decline? Is the area on the "Best Places to Live" list or struggling to attract new business? Contracts go where the population goes.

The Right Approach

For construction companies, the asset approach is sometimes more appropriate than other valuation methods. Equipment value is often high. Margins are typically low. Construction companies are often sold at or near book value. Looking at equipment may provide a more accurate picture of value than does cash flow.

Considering a construction company valuation? Our firm would be happy to discuss these considerations with you in further detail.

Where To Look ...

Business valuation experts rely on many resources for background information, standards and practices. Here are a few resources especially helpful to readers interested in the construction industry:

- **IRS Market Segment Specialization Program Audit Guide:** This provides an overview of the construction industry, types of contracts and accounting methods.
- **Construction Financial Management Association:** CFMA conducts an annual financial survey of construction companies — an excellent resource for benchmarking data.
- **PAS, Inc:** This company publishes *Contractor Compensation Quarterly* and offers salary survey information for construction executives, construction staff and construction craft positions.