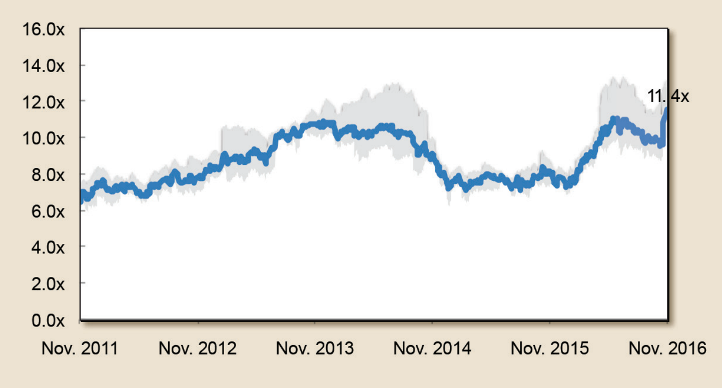
 By John Jazwinski

Conditions Right for M&A

The service center industry and financial markets are strong today, with record valuations and favorable levels of capital liquidity, presenting a compelling opportunity for potential buyers and sellers to explore mergers and acquisitions.

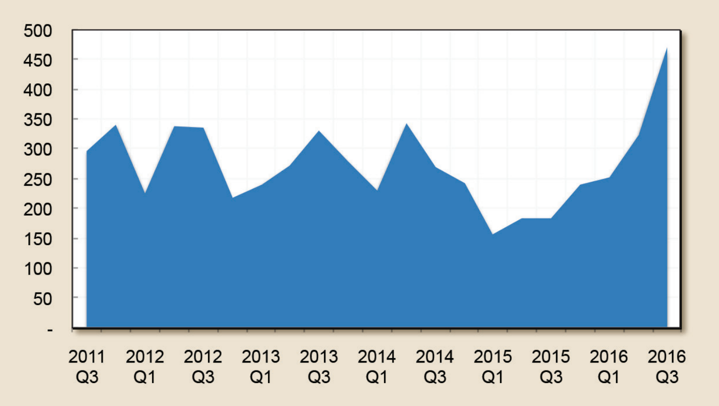
Relative valuation metrics reflect the recent and potential earnings of a company and its industry, as well as overall economic conditions. The most common valuation metric utilized by investors in the service center industry is enterprise value (EV) to trailing 12-month EBITDA (earnings before interest, taxes, depreciation and amortization). The average EV to EBITDA of the three largest and best-performing publicly traded service centers—Reliance Steel and Aluminum, Russel Metals and Worthington Industries—is currently 11.4x, a five-year high and well above the five-year average of 8.4x (see Chart 1). Whenever the current valuation is higher than the long-term average, it suggests investors view a company's prospects as more favorable than recent performance. In this select group of companies, all have higher current averages. Taken together, this suggests that service center industry prospects most likely are favorable, as well.

Chart 1 - **Enterprise Value to Trailing 12-month EBITDA**



▲ *The average EV to EBITDA of the three largest and best-performing publicly traded service centers—Reliance Steel and Aluminum, Russel Metals and Worthington Industries—is currently 11.4x, a five-year high.*

Chart 2 - **Cash on Hand (US$MM)**



◀ *The industry has strong levels of capital liquidity. For the three market leaders, the level of cash on hand is at a five-year high of nearly half a billion dollars.*

The recent increase in valuations may appear to contrast with a decline in revenue and EBITDA at many service centers over the last two years. However, with some exceptions, these declines may be isolated to the negative impact of lower oil prices on the energy and heavy equipment industries, as well as lower metals prices. Most other end industries performed well during this time, offsetting some of these declines, and appear to be continuing to grow.

Many in the industry viewed the decline in oil prices as an opportunity to further prioritize and enhance their diversification strategies, expanding products/services, geographies and industries served. Others pursued opportunities to free up capital, for example, by improving working capital turnover and asset utilization, strengthening their financial performance. Following nearly two years of low oil prices, most service centers have felt the full financial impact of the energy slump and have adjusted to a new, lower-oil-price reality. In other words, there isn't much more downside that

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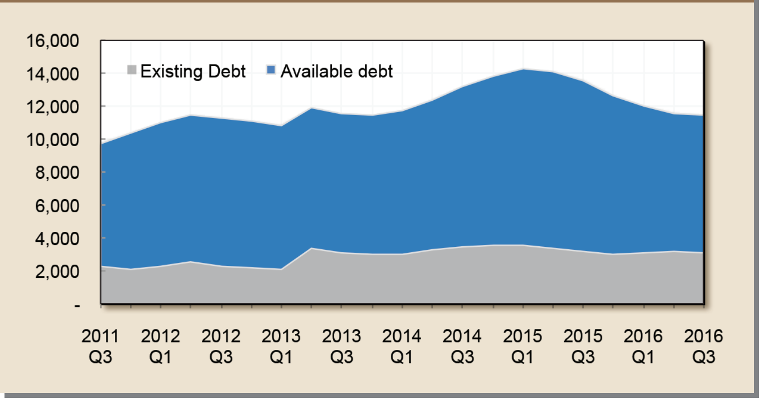
could arise from depressed oil prices.

These observations are evident in the performance of the three select service centers. Each of the companies improved its average EBITDA margin (EBITDA/Revenue) in the last three quarters. At the same time, the industry average improved to nearly 8.0 percent—above the five-year average of 7.5 percent. Working capital turnover also improved, albeit less notably. With better relative profitability, improved working capital turnover and strong prospects in most end industries, the market's solid financial fundamentals present a good opportunity to explore M&A.

Chart 3 - **Existing and Available Debt Capacity (US$B)**



Adding to the available liquidity for acquisitions is ample borrowing power. The three benchmark companies had nearly $5.2 billion in potential debt available at the end of the third quarter. The gray shading shows the level of existing debt and the blue the amount of available debt, assuming a leverage ratio of 2.0x EBITDA.

Strong levels of liquidity

While liquidity may be measured in many ways, some good gauges include the dollar amount of unrestricted cash on hand, as well as available debt capacity. For the select service centers, the level of cash on hand is at a five-year high of nearly $500 million (see Chart 2). Cash levels increased over the last several quarters largely through earnings growth and improved working capital efficiencies. It is also noteworthy that the dividends distributed and shares repurchased increased over this time. These types of market transactions only occur when management of a company is confident there is surplus capital above that required for normal operations and acquisitive growth.

Interest rates remain historically low, giving companies the ability to access high levels of credit. For the select companies, Chart 3 sets out the amount of existing debt (gray) over time and the amount of available debt (blue) by applying a leverage ratio of 2.0x EBITDA, approximating a 60 percent debt to total capital ratio. Given this assumption, there was nearly $5.2 billion in potential debt available to the select service centers at the end of third-quarter 2016. While more debt is available, this analysis does not suggest that a higher level of debt is necessarily appropriate. Rather, it points out that the industry is accessing a lower level of debt (gray) and that companies have the potential to quickly access large amounts of cash and credit in support of large, transformative M&A transactions. The industry has strong levels of capital liquidity.

Despite fewer service center transactions over the last few years, the rationale to grow by M&A remains highly compelling. The impact of low oil prices is fully realized, relative profitability and working capital turnover are above long-term averages, growth prospects in many end industries remain fundamentally strong, and liquidity is favorable. While there is never a perfect time to explore an acquisition or the sale of your company, the market fundamentals indicate that now would be a good time to transact. ■