By John Jazwinski

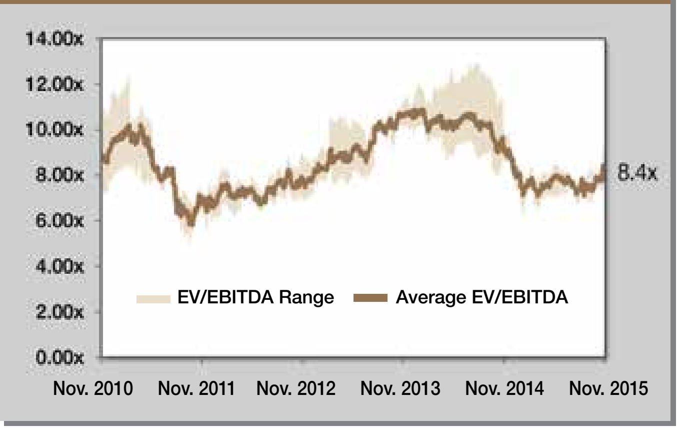
M&A Math Shows **Importance of Benchmarking**

Monitoring the right performance metrics, and comparing them to comparable peers, can help service centers stay on top of their company's valuation.

Both buyers and sellers in the service center industry have been applying greater diligence in their approach to mergers and acquisitions to ensure the highest possible degree of interest alignment. We continue to believe that fewer transactions will be completed going forward—not due to a lack of interested buyers or sellers, but rather to their increasingly disciplined and targeted attitude toward M&A. This more strategic approach involves creating value by acquiring service centers with a strong presence in growing end industries, ones that offer extensive value-added processing and specialize to a greater degree in product areas with less price competition.

The unique themes that characterize the current M&A environment highlight the importance of assessing your company's ability to create shareholder value, whether or not a transaction is on the horizon. Too often, service centers rely on their own historical financial performance as their primary means of measuring success. This is not an incorrect approach, but it considers neither broader mid-term industry change nor the near-term strategic choices of large competitors. A detailed benchmarking of your service center's financial performance relative to industry outperformers will enable this type of review.

Fig.1 - Enterprise Value to Trailing 12-month EBITDA



The enterprise value to trailing 12-month EBITDA for three of the largest, most diversified and best-performing publicly traded service centers—Reliance Steel & Aluminum, Russel Metals and Worthington Industries—has ranged from 6.0x to 11.0x over the last five years, with a current average enterprise value of 8.4x EDITDA approximating the long-term average.

The first step in the benchmarking exercise is to select comparable companies. Because measuring value creation is the primary objective, understanding valuation trends over the longer term is instructive as these reflect company, industry and capital market realities. The primary valuation metric used in the service center industry is enterprise value (EV) to EBITDA (earnings before interest, taxes, depreciation, and amortization). The enterprise value to trailing 12-month EBITDA for three of the largest, most diversified and best-performing publicly traded service centers (Reliance Steel & Aluminum, Russel Metals and Worthington Industries) is set out in Figure 1.

As the graph shows, this select group traded within a close range over the last five years, with the current average enterprise value of 8.4x EBITDA approximating the long-term average. While not conclusive, the close trading range is a good indication that the financial performance of these three service centers will also have a high correlation and will likely provide appropriate average benchmarks when taken together. The average EV/EBITDA is also a good

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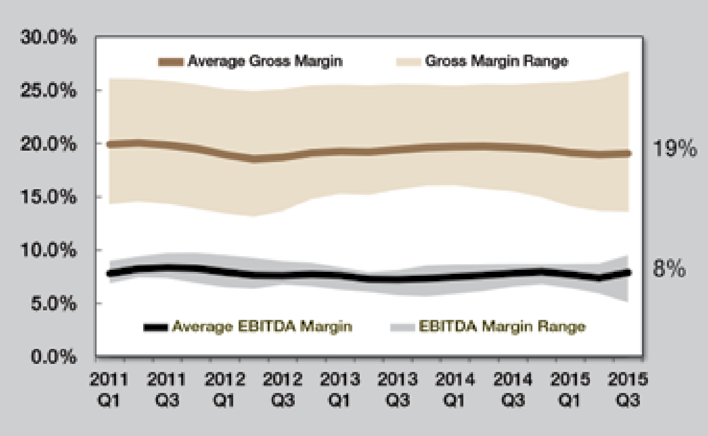
estimate of the ceiling value that a privately held service center may achieve in an M&A transaction, should it have all of the merits of its publicly traded peers. However, the value of most privately held service centers rarely exceeds 6.5x EBITDA.

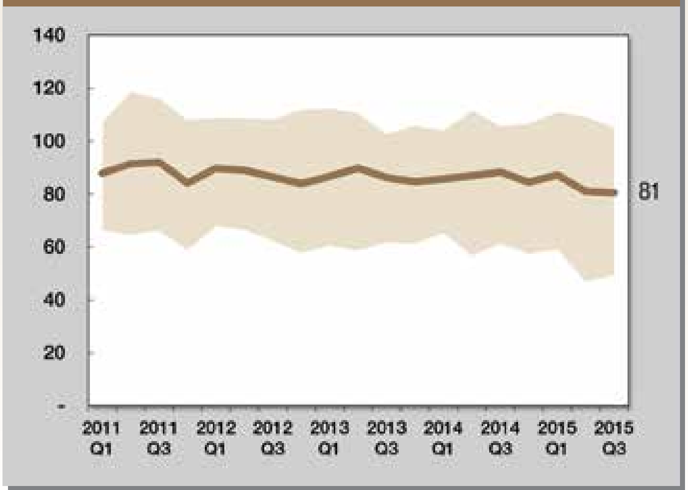
While we believe the selected companies provide good benchmarking insights, it is important to review and possibly normalize the financial results of any chosen companies for unique events. Examples of such impacts include accounting choices, or business characteristics that limit comparability, such as the impact of a one-time or unusual expense, the effect of inventory choices on earnings (i.e. LIFO vs. FIFO), or the influence of unique characteristics such as locations, products, services or end industries. Equally important is that your service center normalize its own historical performance to ensure the highest levels of comparability.

Fig. 2 - Gross and EBITDA Margin



Gross margin measures the ability of a service center to generate profit from the sale of its inventory and services. Data on the selected market leaders—Reliance, Russel and Worthington—shows the consistent nature of their gross margin over the long term. This consistency illustrates the resiliency of these companies in generating similar levels of profit despite changing price and market conditions.

Fig. 3 - Inventory Turnover (Days)



The average inventory turnover for the selected service centers—Reliance, Russel and Worthington—was around 80 days over the long term. An over-achieving service center turns its inventory once every 100 days, and those turning their inventory once every 60 days are among the most efficient in the industry. All else being equal, service centers that turn their inventory quickly command a premium valuation.

Choose the right metrics

Service centers are generally lower-margin, volume-driven and asset-intensive businesses, and it follows that the right financial metrics should provide insight into these realities. While we recommend several, more comprehensive metrics, we selected gross and EBITDA margins, inventory turnover and return on invested capital for purposes of this article.

■ **Gross margin and EBITDA margin**—Gross margin (Gross Profit/Revenue) measures the ability of a service center to generate profit from the sale of its inventory and services after considering the cost of the product, processing and attributable labor and overhead. The clearest observation (Figure 2) is the consistent nature of gross margin over the long term. This consistency illustrates the resiliency of these companies in generating similar levels of profit despite changing price and market conditions. This may be attributed to a number of factors, including scale, strong inventory management policies, pricing discipline, and a general movement away from commoditized products and services, among others. This “maintainability” is highly valued by shareholders and carefully scrutinized in any M&A transaction. It is noteworthy that these particular companies have achieved greater levels of profit growth and resilience through careful and diligent M&A.

Similarly, average EBITDA margin (EBITDA/Revenue) has been consistent over the last five years and most recently was 8 percent. The range of EBITDA margin is narrow and consistent (6-9 percent) over time and relative to gross margin. As EBITDA margin considers profit after all cash expenses except interest and taxes, it provides the best measure for benchmarking profit. Not surprisingly, when compared to EV/EBITDA (Figure 1) over the same time horizon, subtle changes in EBITDA margins affect valuation. All else being equal, service centers that generate consistent profit margins that are similar or higher than the selected service centers would have a premium valuation.

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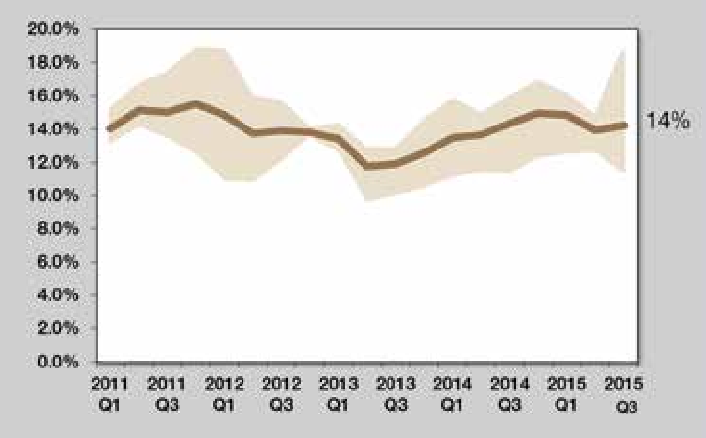
■ **Inventory turnover**—Inventory turnover measured in days is defined as inventory divided by an annual level of cost of goods sold multiplied by 365—it is among the most commonly employed metrics in the industry. A simple measure, it illustrates how efficiently a company turns its inventory and the time that its potential profit is exposed to metals price variability. Many of our clients use monthly industry inventory reports to gain insight into competitive capabilities and to understand the potential of system inventory to influence price. We observe, though, that longer-term inventory benchmarking is not as prevalent.

Figure 3 shows that average inventory turnover for the selected service centers was around 80 days over the long term and fell within a range of approximately 60 days to 100 days. Also, inventory turnover for these companies gradually declined over the same period. It is likely that greater scale enables these businesses to achieve inventory efficiencies over time. An overachieving service center turns its inventory once every 100 days, and those turning their inventory once every 60 days are among the most efficient in the industry. Again, all else being equal, service centers that turn their inventory quickly will command a premium valuation.

■ **Return on invested capital (ROIC)**—Return on invested capital (ROIC) is defined as EBITDA divided by the book value of equity plus debt. This metric provides a good view into the ability of a service center to generate profit relative to the amount of capital invested in fixed assets and net working capital. ROIC also helps to measure the unique, intangible assets of a service center, including the value of its workforce, competitive strengths and customer relationships, among others. The higher the ROIC over the longer term, the greater the propensity to create shareholder value.

The ROIC of the selected companies over the last five years was within a range of 10-19 percent, most recently at an average of 14 percent (Figure 4). An ROIC at this level is attractive to prospective buyers and sellers and is a good benchmark for private service centers.

Fig.4 - Return on Invested Capital



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As with other metrics, accounting decisions may unintentionally influence the ROIC calculation. For example, unique decisions related to depreciation choices may result in a level of fixed assets that is over- or under-depreciated and thereby increase or decrease the ROIC, respectively. One unusual observation is that valuations (Figure 1) were at their highest levels when ROIC was at its lowest. As a case in point, the acquisition of Metals USA at a premium valuation, while not expected, had the effect of temporarily lowering Reliance's ROIC and skewing the average down. However, shareholders viewed this acquisition as highly favorable, resulting in a premium valuation.

This serves as an important reminder that thorough diligence on all benchmark companies is crucial. Benchmarking should be done on a quarterly, or at least annual, basis to keep your business on track and make sure it is well positioned for optimal value in a sale, acquisition or financing transaction. ■