



PRO DEALER

What's a Pro Dealer Worth? Understanding the Drivers of Value

Presentation to the 2005 Pro Dealer Conference

James J. Mulick, Ph.D.
President
Ameridan Resources LLC



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Discussion Overview

- **Understanding earnings multiples**
- **How investment bankers value Pro Dealers**
- **Why I hate to give valuation benchmarks**
- **The real drivers of value: who, what, where, why, & how:**
 - Who will be interested?
 - What is the value proposition?
 - Where is the Pro Dealer located?
 - Why is the business being sold?
 - How is the company being sold?
- **Common contentious issues:**
 - Earnings quality, balance sheet and timing issues
 - Earnings adjustments & divvying up the synergies
- **Conclusions**
- **About Ameridan**

Understanding earnings multiples

Earnings-based valuation:

- In the mergers and acquisitions marketplace, profitable Pro Dealers are valued based on earnings. That is, Pro Dealers are valued based not on the assets they own, but on the income they produce:
 - Exceptions: very small Pro Dealers (i.e., <\$10M in sales) and underperformers.
- Investment bankers and acquirers use very specific measures of earnings, which remove the effects of financial leverage and taxes:
 - EBITDA: Earnings before interest, taxes, depreciation and amortization;
 - To arrive at a business value, EBITDA is multiplied by the appropriate multiple.

Enterprise value:

- Enterprise value is the measure used to indicate the value that the stock market places on a public company. It is the amount an acquirer would have to pay for a public company:
 - Enterprise value= market capitalization plus debt minus excess cash.

Example of an EBITDA-based valuation:

Disguised Builders Supply, Inc. EBITDA & Valuation Calculation	
	LTM through 30-Jun-05
SALES	\$44,109,042
GROSS PROFIT	\$12,512,577
Earnings From Operations	\$ 2,396,769
Other	\$ 14,531
Net Income Before Taxes	\$ 2,411,300
Income Taxes	\$ 792,594
NET INCOME	\$ 1,618,706
Interest Paid	\$ 324,358
Depreciation & Amortization	\$ 327,785
EBITDA	\$ 3,063,443
Adj: Excess Officers Salaries	\$ 488,918
Adjusted EBITDA	\$ 3,552,361
<hr/>	
Value of Disguised Builders Supply, Inc.:	
\$3,552,361 X 5.25:	\$18,649,895

How investment bankers value Pro Dealers

Enterprise Value Summary-2005⁽¹⁾ Building Products

	Enterprise Value/ <u>EBITDA</u> ^{(2) (3)}
<i><u>ProDealers:</u></i>	
BMHC	7.4
Builders FirstSource	7.5
<i><u>Distributors:</u></i>	
Huttig	7.6
BlueLinx	12.3
<i><u>Big Box:</u></i>	
Home Depot	8.5
Lowe's	10.2
Average	8.9

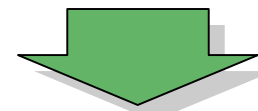
Notes:

1. Based on closing stock prices on 9-16-05.
2. Enterprise value=market capitalization plus debt minus cash.
3. EBITDA and sales based on LTM ending June or July 2005 .

Source: Hoovers Online, company 10Q's, 10K's.

Valuation of publicly-traded building materials distributors/retailers:

- The recent IPO of Builders FirstSource provides an excellent indication of the value the stock market places on Pro Dealers;
- The market places an almost identical value on the two publicly-traded Pro Dealers:
 - ~7.5X EBITDA.
- To adjust for the liquidity premium, privately-held Pro Dealers are valued at a 20-30% discount to their public counterparts.



Information from the public markets suggest that privately-held Pro Dealers should be valued at: 5.2X-6.0X EBITDA.

How investment bankers value Pro Dealers (cont.)

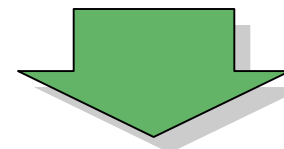
Recent Private Transactions⁽¹⁾:

<u>Pro Dealer Acquired</u>	<u>Acquirer</u>
Leeds Building Products	Hope Lumber & Supply
Holmes Lumber & Building Ctr.	Carter Lumber
Williams Bros. Lumber	The Home Depot
Parker Lumber	Lanoga
Carter Lee Lumber	Lanoga
Northlake Lumber	Strober
East Haven Builders Supply	Stock Building Supply
Central Kansas Truss	Lanoga
J.C. Baldrige Lumber	Stock Building Supply
Adams Building Materials	Stock Building Supply

1. Total consideration and TTM EBITDA were not available for all transactions.

Recent private transactions:

- The Pro Dealer M&A marketplace is currently very strong in terms of number of transactions and valuations;
- Recent transactions show a marked size premium:
 - Transactions for Pro Dealers with over \$100M in sales: 6.0-6.5X EBITDA
 - Transactions involving mid-sized Pro Dealers: 5.0-6.0X EBITDA
 - Smaller Pro Dealers (<\$20M) sold for 4.6-5.0X EBITDA (asset value plus a small premium).



Recent private Pro Dealer transactions range from 4.6X to 6.5X EBITDA

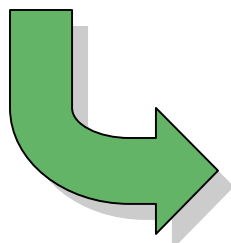
How investment bankers value Pro Dealers (cont.)

Valuation of Public Pro Dealers:

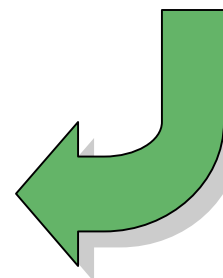
Information from the public markets suggest that privately-held Pro Dealers should be valued at 5.2X-6.0X EBITDA.

Comparable Private Transactions:

Recent private Pro Dealer transactions indicate a range from 4.6X to 6.5X EBITDA



Pro Dealers are currently valued at 4.6X-6.5X EBITDA



Benchmarks:

Very Large Pro Dealers (\$200M+): **6.25X**

Large Pro Dealers (\$75-\$200M): **5.75X**

Mid-sized Pro Dealers (\$20M-\$75M): **5.25X**

Small Pro Dealers (<\$20M): **5.0X**

Why I hate to give “benchmarks”

Reason #1: Sellers assume...

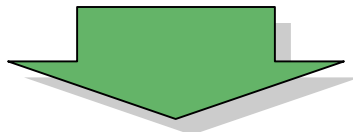
- Their company deserves a value higher than the benchmark;
- Getting a premium over the benchmark is simply a function of being a tough negotiator;
- They can choose the exact point when to sell in a way that maximizes EBITDA and value.

Reason #2: Buyers assume...

- They need to pay less than the benchmark to create value.

Reason #3: Benchmarks ignore...

- Critical aspects of deal structure including indemnifications, escrow amounts, non-compete agreements, contingent payouts, etc.;
- The balance sheet and other aspects of the company that can significantly add to, or subtract from value.



Benchmarks often lead to misconceptions. These misconceptions frequently cause: (1) sellers to pass up excellent offers and (2) unsophisticated buyers to miss great acquisition opportunities.

Who will be interested?

Players in the M&A Marketplace:

Large Consolidators

- Very acquisitive strategic buyers looking to expand nationally in attractive markets;
- Tend to pay higher multiples for platform acquisitions, lower multiples for “fill-in’s”.

Regional Strategic Buyers

- Synergy oriented acquirers that may pay premium multiples in selected situations.

Small Competitors & Local Financial Buyers

- Risk-averse buyers that typically attempt to do deals at discounted asset value.

Private Equity Groups

- Literally hundreds of these firms with billions to spend on acquisitions. PE firms are a limited but growing force in the Pro Dealer M&A marketplace;
- PE firms will pay reasonable multiples for larger Pro Dealers with compelling value propositions.

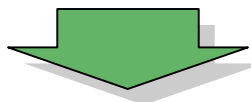
Observations on the Pro Dealer M&A Market:

- Despite the boom times and a seemingly large number of transactions, the number of viable acquirers for any one particular Pro Dealer is relatively small;
- Large, multi-location Pro Dealers with dominant shares in regional markets will draw the attention of the large consolidators as well as certain PE groups;
- Smaller Pro Dealers with strong market positions and/or offering significant synergies are attractive as “add-on” acquisitions to the large consolidators and regional strategic buyers;
- Small, undifferentiated Pro Dealers who are not market share leaders have difficulty finding buyers:
 - Local competitors or local financial buyers are the most likely acquirers. Transactions are difficult to consummate and valuations tend to be asset-based.

What's the value proposition?

What's the value proposition?

- Pro Dealers that offer the most value to their customers have the correspondingly highest values in the M&A marketplace:
 - Key question asked by savvy acquirers: If this Pro Dealer went away, would anyone care?
- Offering excellent service and being in position to “get the last look” are not compelling value propositions;
- High value Pro Dealers are those that offer value added-services such as trusses, framing and door manufacturing;
- Installed sales can boost value if the Pro Dealer has a history of offering these services in a profitable way;
- High market share with the top contractors translates into high value.



Pro Dealers with dominant market shares and deep customer relationships command the highest value.

Where is the Pro Dealer located?

- Pro Dealers located in the “hot” housing markets are valued at a 10-30% premium to those in slow growth markets:
 - In regions where growth is non-existent, it's very difficult to sell a Pro Dealer at a premium to asset value.
- Hot markets are not confined to the West and South:
 - Pockets of robust housing activity exist in the Mid-West and East Coast.
- Extremely robust market conditions are beginning to put downward pressure on earnings multiples:
 - Acquirers are not willing to pay 5.5 times “artificially inflated” EBITDA.
- Pro Dealers in strong markets where the large consolidators lack a presence command the highest values.



Being located in large, hot market increases value, especially if the large consolidators are absent.

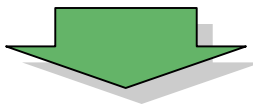
Why is the owner looking to sell...and how?

Owners have many good reasons for considering a sale of the business:

- Most Pro Dealer owners have a large share of their wealth tied up in the value of their businesses. By selling their businesses, they can achieve liquidity and wealth diversification;
- Many owners provide their banks with personal guarantees. Selling the business removes these guarantees thereby reducing risk;
- Owners often reach a point in their lives where they are uncomfortable investing the additional capital required to grow the business.

Reasons that lead to a low valuation:

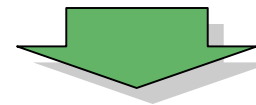
- Estate settlement, financial distress, trying to “cash in” on the only good four quarters the company has ever had.



Selling for the right reason provides the foundation for a solid valuation.

How is the sale process being conducted?

- Acquirers who are active in acquiring Pro Dealers take a very structured, professional approach to making acquisitions;
- Top acquirers recognize that owners need professional assistance in managing the process; as a result, they expect the best acquisition candidates to be represented by a professional merger and acquisition advisor;
- Given the limited number of legitimate acquirers, a quiet, targeted approach usually results in an optimal outcome:
 - But running a “controlled auction” can be appropriate if the Pro Dealer is likely to be attractive to private equity groups.

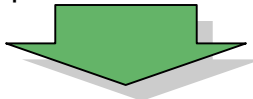


For most Pro Dealers, a quiet, targeted approach yields the highest value. But for the larger players, a broader, controlled auction is sometimes appropriate.

Earnings adjustments and synergies

Adjustments to earnings:

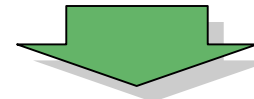
- The measure of earnings used for valuation purposes should be based on financial statements prepared in accordance with GAAP;
- Generally, only three types of “add-backs” are legitimate for valuation purposes:
 - Adjustments for the difference between officer’s salaries before and after the proposed acquisition;
 - Adjustments for transactions with “related parties”;
 - Truly extraordinary expenses (e.g. moving costs, uninsured losses due to a disaster, etc.).
- Some business owners employ a variety of “tax minimization” strategies including dubious expense methodologies and co-mingling of personal affairs:
 - Sellers should not expect to be paid 5 times these expenses.



Some adjustments are legitimate for valuation purposes. Others are not.

Divvying up the synergies:

- Synergies are the incremental earnings that the combined companies generate as the result of an M&A transaction. They are the earnings that the two companies cannot reap alone...they are obtained only through the consummation of the acquisition:
 - Examples: cost savings achieved by overhead consolidation, increased purchasing leverage, rebate arbitrage.
- Acquirers usually argue that they are shouldering the risk associated with realizing the synergies. As a result, they believe they should reap the full value of the synergies;
- Sellers should receive some of the value if the cost savings are being generated through the rationalization of the seller’s overhead structure. Also, rebate arbitrage is low hanging fruit...sellers should reap some of the value.



Synergies should be split based on the source and ease of realization.

Earnings quality, balance sheet and timing issues

Measuring EBITDA: 3-year average, TTM or something else?

- During periods of abnormally high or low industry growth, buyers and sellers tend to disagree regarding the appropriate time periods for calculating EBITDA:
 - In boom times, sellers argue that TTM (trailing twelve months) is the appropriate measure, while acquirers want to look at “normalized” earnings;
 - In recessionary conditions, the arguments flip.
- Investment bankers try to solve the problem by calculating the comparables under a variety of methods and comparing the subject company on an “apples to apples” basis. However:
 - Detailed data on sales of privately-held Pro Dealers is sparse;
 - In periods of rapid growth (or contraction), very up to date information is critical but almost impossible to obtain.

Quality of earnings is important:

- In periods of sharply rising prices for lumber, drywall, and other commodities, Pro Dealers can reap huge inventory profits;
- Sellers want to be paid for all their earnings including inventory profits, but acquirers oftentimes balk:
 - Bottom line: acquirers won't be around long if they pay 5.5X for inventory profits;
 - But acquirers should pay full multiples on increased profits due to volume gains and increased operating leverage.
- Similarly, sellers cannot expect to be paid full multiples on EBITDA associated with non-recurring revenue.

Reconciling an earnings-based valuation with the balance sheet:

- When valuing very profitable and/or relatively asset-poor Pro Dealers, an earnings-based valuation oftentimes results in excessive goodwill;
- It's difficult for any seller to reap more than a 50-70% premium over debt-free book value.

Conclusions

- **Benchmarks can be useful to get a feel for how a Pro Dealer might be valued;**
 - Between 4.6X-6.5X TTM EBITDA;
 - But be careful...benchmarks can lead to troublesome misconceptions.
- **The value of a Pro Dealer is driven by many factors including size, market share, players involved in the process, location, products & services offered and how & why the company is being sold.**
- **Even in very friendly deals (which most are), expect many areas of contention including earnings definition and add-backs, credit for synergies, earnings quality, balance sheet issues and goodwill:**
 - But these issues can be worked through with a professional, well-reasoned approach.

About Ameridan

About Ameridan Resources LLC:

- Ameridan is a specialized merger and acquisition advisory firm;
- Typical business sale advisory engagements involve companies valued at \$15M-\$150M;
- Ameridan was founded in 1998 by James J. Mulick, Ph.D., a leading merger & acquisition advisor to owners of privately-held companies, private equity groups and public corporations;
- Dr. Mulick has completed transactions in a wide variety of industries, including steel, paper products, residential & commercial building products, construction materials, castings, chemicals, fasteners, electronics, software, industrial instrumentation, glass products and telecom.
- Prior to the founding of Ameridan, Dr. Mulick was an executive with PNC Financial Services Group, one of the Country's top bank holding companies. During his fourteen years at PNC, he held a variety of positions, the most recent of which was Director of the Mergers & Acquisitions Advisory Group.

Contact Ameridan:

James J. Mulick, Ph.D.

President

Ameridan Resources LLC

700 River Avenue, Suite 236

Pittsburgh, PA 15212

Phone: **412-323-8622**

Email: **jjm@ameridanres.com**

Website: **www.ameridanres.com**

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