

Service Center Mergers & Acquisitions: Prospects for the Year 2000

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Over the past few years, the steel service center industry has experienced a tremendous amount of merger and acquisition (“M&A”) activity. Many of the transactions have been driven by publicly held consolidators such as Reliance Steel & Aluminum Co. and Metals USA, Inc. Other transactions have been the result of corporate restructuring, such as Ryerson Tull’s purchase of Washington Specialty Metals, or the result of financial distress such as Huntco’s recent sale of its flat roll processing facility in South Carolina to Feralloy Corporation.

As I contemplate future consolidation of the industry, I see several ongoing forces that will continue to spur merger and acquisition activity.

First, like many other distribution-based businesses, steel service centers have begun to experience a significant consolidation of their customer bases. As customers have consolidated, they have reduced the number of service centers with whom they deal. At the same time, these now larger customers tend to have a larger geographic reach and are demanding that their best suppliers provide service to all of their locations. This has put the small, regional service center at a huge disadvantage with these customers.

Second, many customers are also looking to have closer relationships with a smaller number of suppliers in the hope of taking costs out of the system. Increasingly, larger OEM’s are drastically trimming the number of their suppliers; those remaining are expected to offer a broader product line and more sophisticated information systems. Again, this favors larger service centers that can afford to make the necessary investments and can efficiently provide the requisite service levels.

Third, one of the continuing growth opportunities for service centers lies in the steadily increasing trend toward outsourcing of first stage processing. However, to take advantage of the opportunities posed by this trend, service centers need certain volume levels to justify the investment as well as the ability and risk tolerance to finance the increasingly larger price tags associated with state-of-the art processing equipment.

Perhaps just as important as the above issues, small, privately-owned service centers are faced with the challenge of finding, motivating, and retaining good people. This challenge is especially severe at the level of executive management. Large, publicly traded service centers can offer their executive management team stock options, diverse career paths and many other opportunities for professional growth that independent service centers can’t match.

In light of the above forces, I do indeed believe that further consolidation of the industry makes fundamental economic sense. These forces are really only in their infancy and will continue to grow in importance.

This is not to say that an independent service center can't compete in an era of consolidation. In fact, I believe that many independent service centers, with well-conceived strategies and well-defined niches, will do quite well even though they lack the buying power, systems, and the economies of scale enjoyed by the larger companies. As I've seen time and time again, small service centers tend to stay closer to their customers and can outservice their larger rivals. However, almost by their very nature these smaller service centers have limited growth opportunities.

Outlook for the Year 2000

Although fundamental structural issues in the steel service center industry will drive consolidation over the long run, M&A activity in any given year is really a function of: (a) current economic conditions, (b) the availability of debt financing for acquisitions, (c) valuations of service centers in the public equity markets, and (d) the specific circumstances of major acquirers. Looking at the year ahead, I believe that there will be a dynamic mix of conditions which will lead to continued strength in service center M&A.

Market Conditions and Access to Financing

As other articles in this issue point out, underlying economic conditions are likely to be very favorable this year. Demand continues to be solid across almost all product lines and geographic areas with the exception of agricultural related business. Even oil patch related business, which experienced marked weakness early in 1999, has rebounded strongly. As a function of this firm demand and a constriction of offshore supply, pricing is currently firming in many product lines, including carbon flat roll, plate, shapes and structurals. This underlying strength in the market will provide a solid foundation for merger & acquisition activity in 2000.

The availability of debt financing also looks favorable. Credit conditions in the service center industry tightened somewhat in early 1999 due to concerns over falling steel prices and the corresponding drop in collateral values. However, as steel prices have stabilized and have started to rebound, the concern has dissipated. As a result, with the strong balance sheets that accompany long periods of profitability, most larger commercial banks are eager to provide financing for acquisitions and properly structured management buyouts.

Providers of long term debt financing such as insurance companies and pension funds have also been receptive as evidenced by the several private debt placements successfully completed by service centers. With a continuation of solid fundamentals in the service center business, these long-term lenders should be active once again in 2000.

Valuations of Publicly-Traded Service Centers/Processors

Although the fundamental economic outlook is very favorable, valuations of publicly-traded service centers have been mixed. Table 1 shows two key valuation ratios, which together, provide a good, feel for the relative value of the eleven public service centers shown. The first ratio, Enterprise Value (“EV”)/EBITDA gives an indication of the value of a company relative to its earnings. This ratio is conceptually similar to a price earnings ratio but is more representative of a company’s true value because it is not as distorted by capital structure and accounting policies. The ratio’s numerator, enterprise value, is the market value of a company’s stock, plus debt, minus cash. It represents the amount of cash required to own the company free and clear of all obligations. The ratio’s denominator, EBITDA, is defined as earnings before interest, taxes, depreciation and amortization.

As Table 1 shows, average EV/EBITDA for the group is 6.9X. Companies that are above the average include A.M. Castle & Co., Cold Metal Products, Inc., Gibraltar Steel Corporation, Reliance Steel & Aluminum Co., Ryerson Tull, and Worthington Industries, Inc. It can be noted that Huntco is way above the average with an EV/EBITDA of 42.6X. This does not indicate its superior value; Huntco’s high EV/EBITDA is due to its very poor earnings performance over the last year. A more complete understanding of Huntco’s relative value can be gained by also looking at the ratio of market to book value. Huntco has market/book value of 0.23 which is significantly below the average of 0.9.

The service centers that truly have superior valuations are those that significantly exceed the average on both ratios. This group only includes Gibraltar Steel Corporation, Reliance Steel & Aluminum Co., and Worthington Industries.

The valuations of publicly traded service centers have a substantial impact on merger & acquisition activity in the industry. This is because these valuations are the basis for the valuations of privately-held service centers. For example, the value of a privately-owned service center is between 60% and 80% of a comparable public service center. Using the current average EV/EBITDA for publicly held service centers of 6.9X implies a value of between 4.1X and 5.5X for a comparable, privately-held service center. Although this range of value is slightly below the highs achieved in the early to mid 1990’s when many of the service centers in Table 1 went public, it is still well within the range that most would consider to be favorable to sellers. As such, I believe market valuations will generally be supportive of continued strength in service center M&A activity.

**Table 1. Enterprise Value Summary
Steel Processors/Service Centers**

	Enterprise Value/ <u>EBITDA</u>	Market / <u>Book Value</u>
A.M. Castle & Co.	8.9	1.1
Cold Metal Products, Inc.	7.7	0.9
Gibraltar Steel Corporation	7.3	1.8
Huntco Inc.	42.6	0.2
Metals USA, Inc.	5.7	0.9
Olympic Steel, Inc.	6.3	0.3
Reliance Steel & Aluminum	7.1	1.5
Reyerson Tull, Inc.	7.0	0.7
Shiloh Industries, Inc.	6.0	0.7
Steel Technologies Inc.	5.0	0.9
Worthington Industries, Inc.	<u>7.7</u>	<u>1.9</u>
Average(1)	6.9	1.0

Notes:

1. Enterprise value=market capitalization *plus* debt *minus* cash.
2. EV/EBITDA average excludes Huntco, Inc.

Source: Hoovers Online, company 10Q's, 10k's, Ameridan Resources LLC.

Active Acquirers in 2000

As Table 1 demonstrates, not all service centers have strong valuations. The most notable, and the one with the most implications for M&A activity, is Metals USA. As of this writing, Metals USA stock is trading at \$9.00, which is under the original offer price. At the current price, it is very difficult for Metals USA to offer a potential seller a stock for stock transaction without experiencing substantial earnings dilution. Moreover, its EV/EBITDA is 5.8X, which does not leave much room to create value on the difference between the multiple it pays for acquisitions and its own valuation multiple.

Over the last year or so, Metals USA has attempted to address this issue by doing mostly cash transactions. This is a viable funding alternative; however, unlike stock transactions, a company is limited to the number and size of cash acquisitions it can consummate. Moreover, Metals USA is currently working through the strains associated with integrating its numerous past acquisitions. As a result, unless its market value increases sharply, I expect that Metals USA will be a much more selective acquirer in 2000, with a focus on adding very specific capabilities, geographies and product lines.

I expect another very active acquirer, Reliance Steel & Aluminum Co., to remain so. With its solid valuation and reputation for acquiring very strong companies, Reliance is in an excellent position to grow strongly through acquisition in 2000. As in the past several years, I would expect Reliance to complete 2-4 acquisitions this year, with a couple of large transactions (i.e., over \$150 million in sales each) very possible.

Shiloh Industries, Inc., Steel Technologies Inc., Olympic Steel, Inc., Ryerson Tull, Inc., and A.M. Castle & Co. have been active on and off over the past several years. I would characterize these companies as being receptive to acquisition opportunities that offer opportunities to leverage current capabilities and/or customers. As such, they will be active in very selected situations.

The remaining service centers in Table 1 are not expected to be players in service center M&A. These include Gibraltar Steel Corporation which has focused its acquisition program on heat treaters and building products companies; Cold Metal Products which sold two of its service centers in 1999 and has announced its intention of focusing on its core strip converting business; and Huntco which financially, is not in the position to complete an acquisition. Worthington Industries has focused its acquisition efforts in downstream businesses such as pressure cylinder manufacturing while recently completing the divestiture of several non-core businesses. The company is also in the process of a significant management reorganization and has not been actively pursuing service center acquisitions.

In addition to service centers, I believe private equity groups will begin to play a larger role in service center M&A. There are literally hundreds of these equity funds in the business of buying private companies. They have raised billions of dollars from pension plans, private individuals, insurance companies, and other institutional investors. Traditionally, these firms have not been particularly active in acquiring service centers. However, over the past few years, they have become more of a factor, selectively bidding up the prices of service centers with sophisticated processing capabilities and solid track records. This trend should continue to strengthen in 2000.

It should be noted that U.S. firms are not the only major players in service center M&A. European steel companies, most notably Thyssen-Krupp, have been active in past years and are expected to continue to be so in 2000. Further, I believe certain other steel producers in Europe will be looking to acquire a large service center in the U.S. Indeed, some of the publicly owned service centers discussed above as possible acquirers may themselves be acquisition targets in 2000.

Implications and Issues to Watch

Overall, 2000 should be an active year in service center M&A. Market conditions, access to capital, and valuations should all be favorable. However, I believe it will also be a year in which the major acquirers become somewhat more selective. Service centers that meet very specific criteria will be the most highly valued while those that fall short may find few buyers. The criteria which will be used to judge the attractiveness of acquisition

candidates will be the type and quality of customer relationships, value-added capabilities, consistency of profitability, geographic coverage and reputation in the marketplace.

Finally, there will be two interesting issues to watch which will have implications for service center M&A activity in 2000 and beyond. The first will be the evolution of e-commerce. Unlike some other distribution based businesses, service centers may not have to worry about a new, internet based competitor stealing significant market share overnight. Steel is a unique commodity that requires specific assets to process and deliver. However, that does not mean that e-commerce will not have an effect on the competitive dynamics in the industry. For example, certain high value-added products sold by some service centers do travel well and there is an opportunity for well-positioned service centers to increase market share in new geographies through the intelligent use of e-commerce. More importantly, some service centers do very little processing, maintain only minimal inventory and in some cases, act more as brokers than service centers. These companies may see their position in the marketplace eroded by firms such as Metalsite.com, and may find their value in the M&A marketplace greatly diminished.

The second issue to watch involves the evolution of large service centers and the ways in which they go to market. Companies like Ryerson Tull and A.M. Castle & Co are relatively centralized, have large distribution networks, and are thus in a position to aggressively court nationwide contracts. With wide product lines and a menu of processing capabilities, they can also provide a wider slice of each customer's material needs. The service centers with these characteristics are the ones best positioned to profit from the industry trends discussed at the beginning of this article.

However, there are well known costs involved with centralization and it is not clear to what degree and under what circumstances a this model is superior. As a result, service centers have taken a variety of approaches.

For example, the two large consolidators appear to be taking somewhat different strategic paths. Reliance Steel & Aluminum Co is highly decentralized. It believes that the benefits of local autonomy outweigh the benefits of centralization. Metals USA, which started with a very decentralized model, appears to be moving away from local autonomy and more toward product line management as it pursues large contractual business and attempts to trim costs.

Both models are obviously viable. The challenge for Metals USA is to effectively manage its transformation while both maintaining its acquisition program and staying focused on the customer. Reliance's challenge is to maintain the vitality of its organization as the founders of the service centers it has purchased retire over time. How these challenges are addressed and whether they are successful in doing so will have a profound impact on further consolidation of the industry.

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