

Working Through the Construction Cycle: Q&A with Kermit Baker

Lincoln International's Global Building and Construction Group held its annual M&A conference on June 24, 2008 at the New York



Athletic Club in New York City. Kermit Baker was the keynote speaker this year. Mr. Baker is the Chief Economist for the American Institute of Architects ("AIA") and Senior Research Fellow at Harvard University's Joint Center for Housing Studies ("JCHS"). His presentation - "Working Through the Construction Cycle: When Will We See a Rebound, and How Will We Know It's Real?" - provided an overview of the current economic environment and his outlook into the future performance of the economy and the construction industry.

Q: In your view, what are the major factors currently affecting the overall economy?

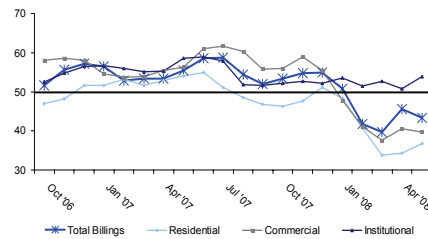
A: Our overall economic environment has weakened recently. At the top of the list is the housing sector; this sector remains in a serious recession. Falling housing prices have lowered home owners' equity value, which has decreased consumer spending. Second, there are many businesses that are cutting payroll which has contributed to rising unemployment figures. About 300,000 jobs have been cut since the beginning of the year. Finally, rising oil prices and a weak dollar have spurred inflation concerns. The combination of these three factors has given the Federal Reserve the unenviable task of trying to prevent both a recession and inflation at the same time.

Q: Kermit, it is understood throughout the building and construction industry that architects have a good sense of industry demand due to the nature of their work. Can you provide us an idea of how the AIA measures this demand and the current state of the market?

A: The AIA uses the Architectural Billings Index to monitor demand in the construction markets; the index measures the change in the number of architectural

billings month-over-month and is a nine to twelve month leading indicator of construction activity (see Chart A).

Chart A: Architectural Billings by Sector
(50 = No Month-Over-Month Change)



Source: AIA Architectural Billings Index

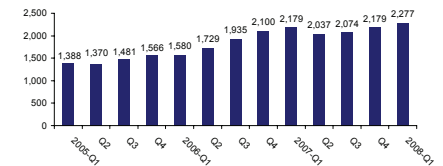
During the first half of 2008, the index displayed sharp declines in total architectural billings. The bulk of the decline occurred between January and March of this year when the billings index dropped fifteen points, from 55.0 to 39.7. The AIA divides total billings into the three construction sectors of residential, commercial and institutional. Similar to total billings, residential and commercial billings have declined. However, institutional billings have remained steady and even shown some growth.

Q: Much has been said about the residential construction industry over the past year. In your opinion, what is the best indicator of the health of the residential construction industry?

A: Looking at the industry from a supply and demand perspective, the inventory of vacant for-sale homes provides us the best view of the industry's condition. The market had excess inventory of approximately 2.3 million vacant for-sale homes in the first quarter of 2008 (see Chart B). This compares to about 1.4 million vacant for-sale homes in the beginning of 2005 when the market was at equilibrium. This means that the market needs to absorb between 800,000 to 900,000 homes before it can return to equilibrium.

Q: Do you foresee growth once the residential market corrects the problem of having an overabundance of unsold homes, and how robust will this growth be?

Chart B: Number of Vacant For-Sale Homes in United States (Homes in Thousands)



Source: U.S. Census Bureau

A: I do foresee us experiencing growth in the residential construction market this decade as long-term trends for household formations are very strong. We at the JCHS, in fact, forecast more robust growth in this decade than in the last. We had approximately 12.5 million new households produced in the U.S. between 1995 and 2005. We predict between 14 and 15 million new households will be produced in the United States between 2005 and 2015. This demographic trend provides a strong foundation for long-term demand in the housing industry, pointing to robust growth in the future. Once the economy is out of the woods, there is reason to hope for a quick recovery for residential construction. In previous cycles, there has been a sharp upturn in residential recovery, with production increasing 15% to 30% in the first quarter of a recovery, based on data from the last 50 years.

Q: The non-residential construction industry has been changing rapidly over the past couple of years. Can you provide us your views on some of the most important factors impacting this sector?

A: The three biggest issues I have seen in the non-residential market are the focus by customers on reducing construction costs, the rise in the prices of commodities used in non-residential buildings and the increased movement toward the construction of green buildings. In today's non-residential market, customers are focused on reducing construction costs in numerous ways, including using simpler designs which require more cost effective building materials. The rising prices of commodities used in non-residential

3 Hottest Issues in Non-residential Construction Markets

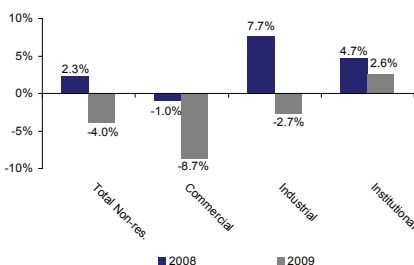
1. Changes in design of non-residential buildings to cut costs
2. Rising costs of building materials
3. Increased movement to green building projects

construction have forced customers to search for ways to cut costs over the life of the building. Since 2004, the Consumer Price Index has increased by 18% while materials costs in the non-residential sector have increased by 37%. The movement towards the construction of green buildings has been driven by a desire for long-term cost reduction. Green building concepts such as using materials that allow for more natural light cost more in the short-term but help save on energy costs in the long-term.


Q: What is your forecast for the non-residential construction sector?

A: Non-residential construction, and commercial and industrial construction in particular, is highly dependent on the health of the overall economy. Businesses usually base their real estate decisions on their financial performance and on their expectations of future growth. The current economic climate has reduced companies' expectations for growth in the near future and, hence, their demand for new office or production space. This cycle, however, has not been marred by the excesses of previous commercial construction booms. This means that the non-residential downturn should be very mild compared to historical standards. We predict a total peak-to-trough decline of about 10% before the recovery in 2010. This decline is especially mild when compared to the peak-to-trough decline of more than 20% in the early 1990s. We predict that the overall non-residential sector will continue to grow through 2008 by approximately 2%, driven

Chart C: Annual Percentage Change in Non-residential Spending (% Change)



Source: AIA Consensus Construction Forecast Survey for 2008 and 2009

by growth in the institutional and industrial sectors (see Chart C). However, we predict a decline of 4% for the total non-residential sector in 2009 as a result of weakness in the commercial sector offset by stable growth in the institutional sector. With an expected recovery in the U.S. economy in mid-2009, a recovery in the non-residential sector is likely by 2010. 

Recap of Lincoln's Annual B&C M&A Conference

Lincoln International hosted their annual Building and Construction M&A Conference in New York City in June, which was co-sponsored by Arthur D. Little. Over 250 industry professionals attended and gained valuable insights on a variety of topics addressed by the keynote speaker and three different panels of industry participants.

The keynote speech was delivered by Kermit Baker, Chief Economist for the American Institute of Architects and Senior Research Fellow at Harvard University's Joint Center for Housing Studies

- Mr. Baker covered several topics including current market conditions for both the residential and non-residential sectors. Mr. Baker also provided an outlook for when the industry will recover. Please refer to the cover story featuring a Q&A with Mr. Baker for more information.

Strategic Buyer Panel

Panelists:

- Ted Hathaway, Chief Executive Officer, Old Castle Glass, Inc.
- Barry Silverman, Former Divisional President, The Home Depot, Inc. and Former CEO, Do+Able Products Inc.
- Peter Dachowski, President and Chief Executive Officer, CertainTeed Corporation
- Frank Feraco, Managing Partner, Great Lakes Equity Partners and Former President, Kohler Company

Topics Addressed:

- Acquisition strategies have changed, focusing on companies providing green and sustainable products and services
- Several sectors have been very affected by the green initiative

- Strategic buyers look to examine how companies perform in a downturn

Private Equity Panel

Panelists:

- Ira Starr, Managing Director, Long Point Capital
- Dan Pansing, Principal and Partner, Merit Capital Partners
- Brian Shortsleeve, Principal, HIG Capital
- Alan Wilkinson, Partner, AEA Investors

Topics Addressed:

- Private equity firms might have some advantages over strategic buyers in the current environment as strategic buyers deal with their own operational issues
- Buyers are focused on acquiring best-in-class companies, but their willingness to sell is low
- Private equity groups tend to either avoid or place a discount on companies with high customer concentration, especially with the big box retailers


Strategies for Successfully Selling a Company in the Cyclical Building and Construction Industry

Panelists:

- Steven Kraus, President and Chief Executive Officer, Skyline Windows LLC
- George A. Pattee, Chief Executive Officer, Parksite, Inc.
- Jean-Rene Hartpence, Managing Director, Lincoln International LLC
- Simon Flax, Manager, Arthur D. Little, Inc.

Topics Addressed:

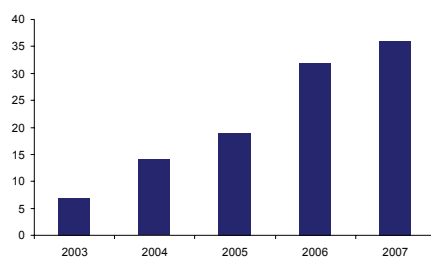
- Potential buyers look at past performance in downturns when making acquisition decisions
- Private equity buyers focus on margin and operational initiatives and prioritize these over revenue growth initiatives
- Installing the right financial and operational systems makes the selling process run smoother
- During downturns companies have the opportunity to take market share, improve efficiencies and remove costs
- Companies should also do their best to strengthen their balance sheet when heading into a downturn

Andrew Bohutinsky, Managing Director and Global Head of Lincoln International's Building and Construction Group, wrapped up the afternoon by sharing results of a delegate survey taken at the 2007 Lincoln International Building and Construction M&A Conference. Participants predicted correctly that residential construction sector would decline over the next 12 months, but they also thought that non-residential activity would also be lower, when it actually rose 13%. While there are a few bright spots within the Building and Construction Industry, the overall industry is intrinsically linked to the state of the broader economy. The conference participants walked away with the underlying message that companies should take steps to weather the downturn and emerge ready to grow in the next cycle. 

Cross Border Acquisitions: Is Now a Good Time to Make Building and Construction Acquisitions in the U.S.?

The two main determinants for cross border acquisition activity are (1) strategic buyers' confidence in their own business prospects and (2) exchange rates. When both of these factors coincide, a strong outlook for domestic business activities increases managers' willingness to take risks in corporate strategy to pursue expansion opportunities via acquisition, and favorable exchange rates make foreign business ventures appear attractive by historical standards. At the present time, both conditions are present in the building products and construction industry, creating a fertile environment for strong activity involving foreign acquirers of U.S. companies. From 2003 to the

Chart D: European Union Acquisitions of U.S.-based Companies

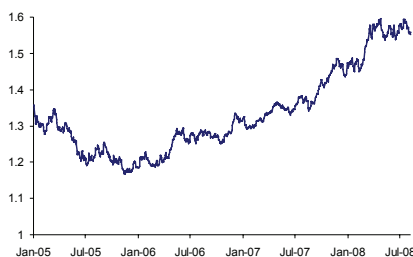


Source: Mergerstat

end of 2007, European acquisitions of U.S. based companies increased significantly (see Chart D).

Over the past two and a half years, the twin deficits and the deceleration of the economy have caused the value of the dollar to decline. Since 2005, the dollar has lost nearly 14% of its value against the Euro (see Chart E). Given the relative exchange rates, European foreign buyers in particular are well suited to make investments in U.S.-based companies. A devalued U.S. currency means that American products have become more competitive in export markets and foreign products have become more expensive domestically. From a traditional valuation perspective, this should not necessarily make American companies more attractive, since the valuation of the target is based on the discounted cash flows of future earnings, which are still denominated in depreciated dollars. Unless the acquirer believes that the dollar is undervalued and will rise in the future, converting those cash flows to Euros or any other currency will not increase its willingness to pay. In fact, acquiring a company only on the expectation of a future revaluation of the currency would amount to no more than currency speculation.

Chart E: Euro to U.S. Dollar Exchange Rate



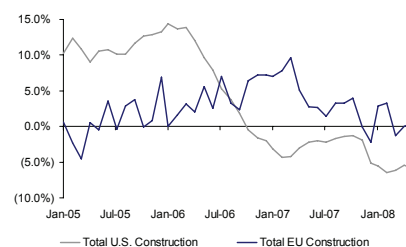
Source: Oanda

However, the acquirer is not only paying for the cash flows. An acquisition implies getting control of the producing assets of the company, including its equipment and workforce. From a comparative perspective, these assets will now be more appealing to any foreign acquirer because they now come at a much lower cost than assets in its home country. Companies that can achieve synergies and better utilize these assets will have even more of an advantage that will translate into higher values. In the building products industry in particular, companies that produce higher value-added products where transportation is a smaller proportion of the overall cost will

attract more strategic interest from foreign acquirers that can better utilize these resources in their home markets and realize synergies from the acquisition.

The construction industry currently has a better outlook in some European countries than it does in the U.S. In the U.S., the grim conditions in the residential housing industry have been the cause for overall construction expenditures to decline. The European construction market, while not at the highs it experienced in early 2007, is faring better than the U.S. and posted its second straight month of year-over-year growth in May, placing European competitors in a better position to expand their business and look for other opportunities (see Chart F).

Chart F: Total U.S. and European Union Construction Levels (Annual % Growth)



Source: U.S. Census Bureau and Eurostat

Structural and cultural reasons also will favor increased participation from European acquirers in the American markets. On the structural side, companies have maintained cleaner balance sheets and are now well positioned to compete for acquisitions. The current conditions in the North American debt markets are also increasing the confidence of European acquirers, who now see a better chance of winning auctions against financial buyers without having to overpay. Culturally, a longer horizon to capture synergies and more patient capital will help foreign strategic buyers weather the current downturn in the industry and encourage these buyers to try to increase their participation in the market at the bottom of the cycle. Along with the above, the U.S. economy offers a large addressable market, healthy secular growth, excellent infrastructure, flexible labor markets and in the case of manufacturing businesses, facilities proximate to these markets.


While the individual characteristics of any transaction remain the most important

factor determining foreign interest, Lincoln International is noticing an increasing interest on the part of European and Asian acquirers to evaluate targets in North America and pursue attractive opportunities. Given the current macro economic conditions, we expect their influence in the market to continue to increase in the second half of 2008 and into 2009. While European companies have increasingly become more active in the U.S. M&A arena, Lincoln has noted that buyers from Asia are also becoming increasingly aggressive bidders in Lincoln's sell-side transactions. In total, approximately 30% of Lincoln's North American based sell-side transactions have been sold to international acquirers during the last 12 months. In the construction and building products arena, many foreign acquirers are actively seeking to expand in the U.S. via acquisitions as opposed to starting organic efforts. For example, the following foreign based diversified building products companies have publicly stated their intentions to grow in the U.S. via acquisition:

- CRH plc – Headquartered in Dublin, Ireland, CRH manufactures and distributes building materials, including cement and concrete products, bricks, tiles, insulation, chemical lime and security gates among others. CRH

currently has operations in over 30 countries and is constantly searching for opportunities to develop its businesses overseas through the acquisition of businesses that can serve as a platform for future growth. It has completed 42 acquisitions since January 2007. As a testament to their commitment to acquire building products companies in the U.S., CRH reached an agreement to acquire Pavestone Group LP in March of this year for \$540 million according to a company press release. Pavestone develops, manufactures and distributes a variety of products including segmental concrete products interlocking concrete paving stones and segmental retaining walls. The company will be folded into CRH's Architectural Products Group and will offer a broader national footprint in concrete landscaping products and bagged stone.

- Saint-Gobain – Headquartered in Les Miroirs, France, Saint-Gobain designs, manufactures and distributes functional materials, such as glass, ceramics, plastics and cast iron worldwide. It operates through five segments: Building Distribution (44% of 2007 revenue), Construction Products (25%), Flat Glass (12%),

High-Performance Materials (11%) and Packaging (8%). The Building Distribution segment distributes building materials, ceramic tiles, fitted kitchens, fitted bathrooms, interior fittings and exterior carpentry. Saint-Gobain's U.S. subsidiary, CertainTeed Corporation, manufactures and distributes building materials in North America. The Company offers residential and commercial roofing; vinyl and fiber cement siding; vinyl and composite decking, railing and fencing; vinyl windows and patio doors; residential, commercial and mechanical insulation; and pipe and foundations, as well as millwork, walls and ceilings. Saint-Gobain is highly acquisitive, having completed 70 acquisitions in 2007 and is aggressively pursuing acquisitions of distribution companies in the U.S. Saint-Gobain's Building Distribution group carried out 53 acquisitions in 2007 adding 291 new outlets to a network that now boasts more than 4,000. The largest acquisition was Norandex, a manufacturer and distributor of vinyl sidings in the U.S., for \$343 million according to a company press release. 

About Lincoln International

Lincoln International specializes in merger and acquisition services, private capital raising, UK pension advisory services and providing fairness opinions and valuations for leading organizations involved in mid-market transactions. With offices in Chicago, Frankfurt, London, Los Angeles, Madrid, New York, Paris, Tokyo and Vienna, and strategic partnerships with China Everbright in China and ICICI Securities, Inc. in India, Lincoln International has strong local knowledge and contacts in the key global economies. The organization provides clients with senior-level attention, in-depth industry expertise and integrated resources. By being focused and independent, Lincoln International serves its clients without conflicts of interest. More information about Lincoln International can be obtained at www.lincolninternational.com.



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