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Collins Forensic and Valuation Services

3600 American River Drive, Suite 147, Sacramento, CA 95864 Phone 916.756.5622

Valuing Construction and Contracting Companies

OVERVIEW

Valuing construction companies is challenging because the “boom and bust” nature of the construction industry makes it difficult to project their future earnings. The external construction environment and the company’s internal characteristics create these volatile operating cycles.

EXTERNAL ENVIRONMENT

A positive external environment including a healthy local economy, low interest rates, favorable government regulations and a favorable lending environment is crucial for the success of a construction company. Unfortunately, these factors are beyond management’s control.

INTERNAL FACTORS

Construction and contracting companies are usually capital intensive and rely on their owners’ ability to forecast growth and control costs. A healthy, growing and diversified customer base is also critical.

CAPITAL INTENSIVE INVESTMENTS

These companies often invest heavily in real estate, vehicles and equipment. These investments often represent a large portion of the value of small to midsize construction companies. When the investments are being utilized they are great profit centers. However, when the investments are not being utilized they still contribute to a company’s overhead expenses.

MANAGEMENT DEPTH

Construction companies are often largely dependent on their owners’ management skills for obtaining new work and managing projects. Companies with skilled and experienced management teams, capable of operating the company in the owner’s absence, are more valuable because it is easier to insert a new owner into a well managed company without upsetting a company’s profitable operations.

CUSTOMER BASE

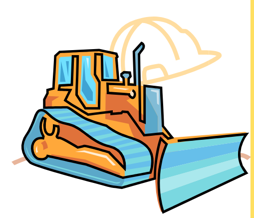
A diversified customer base allows a construction company to rotate servicing customers in different industries as each industry experiences growth. Long term construction contracts and a backlog of contracts can reduce a company’s earnings volatility. However, construction companies with too much work risk overextending themselves and losing control of their projects which can lead to devastating cost overruns and losses.

FINANCIAL FACTORS

Construction companies often make significant estimates in determining their revenues, costs and the value of the work they have completed to date (work in progress). In addition, it is important to know if a company is using the accrual or cash method of accounting. It is prudent to thoroughly analyze management’s accounting of construction projects because management may make estimates and choose accounting methods favorable to their reporting goals.

AVERAGING EARNINGS

Averaging a construction company’s annual earnings over a full construction cycle can be helpful in projecting a company’s future earnings. By averaging earnings, appraisers can see the big picture even when volatile annual earnings and accounting estimates occur between years.



GOODWILL

Construction companies often have less goodwill than companies in other industries with similar revenues, earnings and assets. Less goodwill is attributed to these companies because of their volatile earnings and frequent dependence on their owners’ unique abilities.

QUESTIONS OR COMMENTS

Please call me with your comments at 916.756.5622.

— Thomas Collins, CPA / ABV, CFA