

## Mergers and Acquisition Project

# Client: Aggregate Industries PLC

## Client Report: Acquisition target analysis

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### **\*SUBJECT TO ANY CHANGES MADE TO DOCUMENT\***

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## 1 DESCRIPTION OF AI'S GROWTH BY ACQUISITION STRATEGY

The growth of Aggregate Industries (AI) can be seen to have been fuelled by a policy of adding bolt-on acquisitions to the core business, with 100 companies being acquired between September 1997 and May 2004<sup>1</sup>. This aspect is detailed more fully in the group's earlier Ranking Document,

An analysis of the 31 principal deals itemised in the Thomson Financial Extel Company Report reveal<sup>2</sup>:

- a) No plc's have been acquired by AI.
- b) Only one plc division has been acquired.
- c) 30 private companies have been acquired.
- d) The average purchase price for acquisitions over £1/2m is £20m.
- e) Eight of the acquisitions have been in the US, with the remainder in the UK and the Channel Islands.
- f) The majority of these recent acquisitions have been aggregate? asphalt? rmc? mixture??

AI focuses its acquisition strategy almost exclusively on privately owned companies with an average acquisition value of £20m. The largest acquisition to date has been the purchase of Frehner Construction in the US for an enterprise value of £60m.

In the UK, AI has integrated each acquisition by generally not imposing the parent company name on the acquired company in a dominant manner, and allowing it to continue to be run relatively independently. This allows the individual companies to benefit from entrepreneurial flair and owner motivation whilst enjoying a plc support network. This integration strategy has led to a regional set-up with a national overlaying structure and a very flat managerial structure, where each group director has overall responsibility for a group-wide function including, inter alia, Transport & Logistics and Commercial Policy.

However, in the US, AI has tended to trade using the AI name in most regions, although in the more recently acquired facilities in Nevada, using the original company names ie. continuing to do business in Nevada as Frehner construction, **Southern Nevada Paving**, etc. Given that the Nevada business was acquired within the last 12 months, in an area where AI had no previous presence, using the existing well known/respected company names, at least for some period of time, is a sensible move. In terms of management organisation, as in the UK, the approach in the US is still to "tuck-in" acquisitions under the overall flat managerial structure, described in the previous paragraph.

Given the fairly open brief to identify and recommend a suitable future acquisition target for AI, it would not have been appropriate for the group to merely recommend acquiring a similar company to those that AI has so successfully acquired in the past but in order to provide a fresh approach the group sought to recommend a more significant acquisition target in both strategic and value terms, operating in locations with some synergistic fit to current AI operations, but also providing major expansion opportunities and spreading the risk of operations, by some vertical integration into added value products. Given the strength of the £ against the US \$ at present, plus the relatively unconsolidated market in the US (compared to UK), it is expected that a US company would provide the most attractive target.

## 2 EXAMINATION OF TARGET COMPANY FIT WITH AI

### 2.1 Company background

US Concrete (USC) is the largest independent producer of ready-mix concrete in the United States and one of the top 10 US producers. The company was formed in 1999 with its company HQ in Houston Texas and is listed on the Nasdaq as RMIX.

### 2.2 Operations

USC has a wide spread of operations, with 89 fixed and 8 portable ready-mix plants, plus 3 concrete block production facilities, with almost 1000 mixer trucks owned or leased. US Concrete operates across a good spread of markets comprising: residential (46% of concrete sales in 2003); commercial/industrial (32%); street/highways (7%); other public (7%). The main differentiation of USC comes from the addition of knowledge based value to its concrete products. AI's US operation currently comprises ----% ready mix concrete, which would increase to ----% following the merger, so providing new opportunities to drive additional AI product sales.

### 2.3 Financial performance

In terms of USC's finances, after some good growth in revenue from \$167 million YE 99 to \$473 million YE 03, this was followed by a fall of 4% from 2001-2003, principally due to unusually poor demand in California. This aspect is discussed previously in the group's Ranking Document. USC believes that this fall has now been arrested, with 2003 quarterly sales comparisons showing an improving trend towards the end of the year. This improving trend is further highlighted in the interim results for June 2004, where revenues in the second quarter of 2004 increased by 11.2% to \$138.6 million compared to \$124.6 million in the second quarter of 2003. The revenue increase was driven by a 6.1% increase in volume and a 3.7% increase in price in the company's ready-mixed concrete operations. The Company now expects full year 2004 revenues in the range of \$490 million to \$505 million. A total of 48% of US Concrete's shares are held by institutional and mutual fund holders suggesting that despite its failure to deliver any dividend since its inception, it is still viewed as a well run company by investment markets. Indeed, analyst reports expect revenue for YE 05 to be up 5% on YE 04 at \$515 million. For the second quarter of 2004 net income rose to \$6 million compared to \$3.5 million in the second quarter of 2003. For the six months to June 2004 gross profit rose by 12.7% compared to last year, with gross profit of \$38 million up from \$33.7 million. Revenue rose for the full half year from \$210 million to \$229 million.

#### Market geography

Despite its Texas base, 44% of turnover in 2003 came from California, a sunshine state with high demographics and significant construction activity. Indeed, despite recent budget deficits and other financial issues that ultimately led to the State Governor (Grey Davis) being recalled in 2003, growth in California has matched that of the rest of the US, with GDP growth of 3% in 2003, expected to rise to at least 4% in 2004(new ref AA). The new governor (Arnold Schwarzenegger) has announced high spending on several major, state funded construction programmes starting in 2004(new ref BB). USC's second most important region (17% of 2003 sales) is New Jersey and surrounding area, which suffers relatively modest winter downturns due to weather and again is a region with high population, good growth and significant construction activity.

In the Southwest US, USC is principally located around the San Francisco Bay area. AI does not currently have any operations in California, but operates 2 quarries <200 miles

away in Reno & Carson City Nevada, plus has extensive operations and quarries located some 500 miles away in Las Vegas. Some access to these AI owned quarry facilities by US Concrete operations may be feasible, given that research shows that there are excellent freight rail links between Western Nevada and California (see section 3). Moreover, access for AI to this huge construction industry activities in California, with an establish company (US Concrete) is seen as a major expansion activity, necessary for AI to compete in the consolidating US market.

On the East Coast of the US, AI has many operations based throughout Maryland and Washington DC, including a rail link between Washington and AI quarries in each of Millville and King George County. US Concrete has 3 Maryland facilities just outside Washington, which are within 10 miles of AI's rail link and many other AI facilities. In addition, US Concrete's major operations in New Jersey (including its own quarry with 44 million tons of reserves) are well linked to this by both rail and road. Finally, US Concrete has several operations within 100 miles in Delaware, which are well served to allow movement of AI aggregates etc to USC facilities by sea, rail and road connections from the Washington area.

A detailed evaluation of the above geographic synergies is covered in section 3.

## **2.4 Leadership and structure**

The CEO of US Concrete has over 30 years of experience in the concrete industry and has formed an entrepreneurial management team that fits extremely well with AI culture. Even though US Concrete is a public company, it has a flat structure, with delivery focus, and so again fits extremely well with AI culture. USC share AI's methods of achieving growth by the process of purchasing smaller bolt on acquisitions. In terms of integration, it is expected that USC could be comfortably bolted on to AI and allowed to run predominantly as it is now, with synergistic gains above and beyond those of market location, as discussed in section 3. In addition, with the CEO being 64 years old and some other key board members in their 60s, joining USC with a larger company may be particularly attractive to such board members ie. one last big deal before retiring.

### Order of cost

As detailed from the initial Ranking Document analysis, it was expected that AI could purchase US Concrete at a price of the order of £140 million, with a further £40 million required to reduce debt to acceptable levels, giving a total cash requirement of £180 million, which fits with the acquisition price range noted in the Times Newspaper review of AI's results for 2<sup>nd</sup> quarter 2004 ie. "At least £150m of free cash available per year for acquisition and still be conservatively geared" !!!!! guess we should delete the last bit of this quote then!!!!!

### Contribution to the creation of a balanced portfolio

Ready mix concrete (RMC) sales demand is expected to show an increased trend-line into the medium term as a result of the general US economic upturn. RMC sales can be demonstrated to be closely tied to economic activity and therefore to react quickly and more positively than other market sub-sectors to any economic and spending changes. The RMC sub-sector is expected to outperform other sub-sectors of the construction products market in this short to medium term, and contribute positively to the cash generating potential of the merged business. As a result, the acquisition of USC will be a positive addition to the mixed portfolio of the company's activities in conjunction with some of its longer term lower margin products. Whilst being a fast reactor to the economy, USC's added value differentiation basis will provide some insulation to any

future downturn, in comparison to generally more commodity based RMC competitors. This element of synergy from the merger is deemed to be of strategic rather than direct financial benefit.

## 2.5 Summary

In summary, USC is considered to be a particularly opportune acquisition target for AI for the following reasons of fit and timing;

- USC's recently developing financial performance
- Complimentary geographic coverage
- Compatible market coverage and expansion opportunity/necessity
- Strength of USC's Added Value Products (innovative concrete solutions etc)
- Compatible aspects of strategy and corporate culture
- Lean board structure allowing greater restructuring flexibility
- Compatibility of anticipated purchase price with AI cash availability
- Positive US economic trend
- Low interest rates
- Weak \$ vs £ giving greater value for money

### 3 EVALUATION OF ACQUISITION SYNERGIES

An analysis of the overall strategic fit of AI and USC, as well as the value chains of their US operations highlights a number of areas of potential synergy.

In terms of the assessment of these synergies on the combined company's predicted performance, a cautious approach has been taken, with only those supportable synergies which are likely to arise with a fair degree of certainty, having been utilised in the subsequent valuation assessment and in the consideration of an appropriate level of acquisition premium.

#### 3.1 Factors generating increase in sales and market

Some increases in AI's US sales will result due to new sales of AI products. These areas of new sales will be two-fold;

##### New 'internal' sales of AI primary products to USC

AIUS have reasonably well placed aggregate quarries with the potential to service some of USC's requirement for ready-mix aggregate where geographic proximity exists. The acquisition will therefore bring about some direct vertical integration benefits with crushed aggregate being utilised directly in USC concrete production. Figure ZZZZ shows a summary of AI and USC operations in the US

[Insert overall US map picture here](#)

Clear synergy exists in USC's Atlantic region, where the company has 11 ready-mix plants in the states of Delaware and Maryland, with one aggregate quarry to the north east of the assemblage. AIUS have 7 aggregate quarries spread throughout the area covered by this assemblage, with a particular focus on the highly developed Washington DC area.

Similarly in USC's Southern California/Arizona region, there are aggregate supply synergies with AI's Nevada operations in Reno/Carson city and even Las Vegas, via a major railroads operating 158 ton wagons and routing throughout the populated areas of the region.

These rail routes are run by Union Pacific, with the track capacities set at the maximum allowed of 158 tons, as shown in Figure XXXX. These are well established routes and are noted in the California State Railroad Plan 2001-2010<sup>4</sup> as having major recent investment to sustain/improve operations.

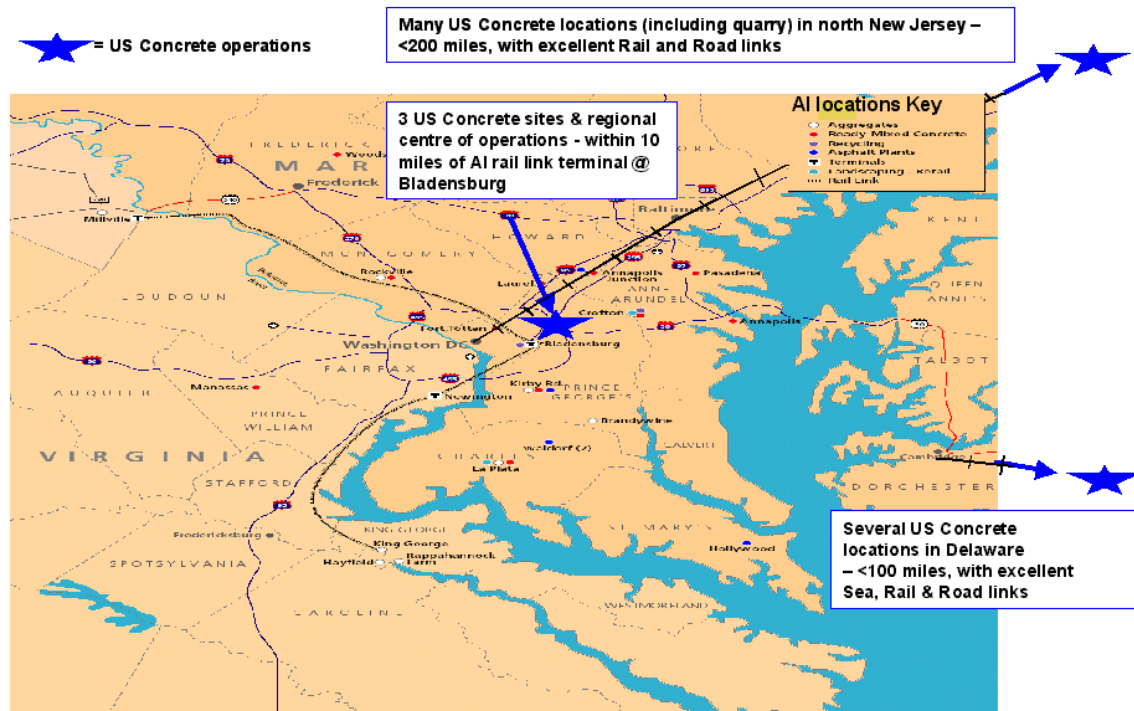


*'Las Vegas: With full ownership of the Sloan Mountain Quarry and over \$200m of invested capital in this new region what is the strategy going forward. Ready mixed concrete in this market is effectively consolidated and therefore aggregates and asphalt are the primary product routes to market. Should we expect asphalt acquisitions or is the focus on developing the rail potential as rapidly as possible to develop aggregate sales in California or elsewhere?'*

AI and USC both have activities in close proximity in Michigan (AI sand and gravel, quarries, asphalt, paving and concrete products; USC 14 RM and concrete block plants). With this region supplying some 11% of USC's revenues, access by USC activities to AI's nearby sand and gravel resources would have some synergistic benefits in an area where USC's growth has been the strongest in the last couple of years (USC Annual Report 2003).

On the East Coast of the US, similar possibilities exist. AI has many operations based throughout Maryland and Washington DC, including a rail link between Washington and AI quarries in each of Millville and King George County. As can be seen from Figure YYYY, showing AI operations in this area, US Concrete has 3 Maryland facilities just outside Washington, which are within 10 miles of AI's rail link and many other AI facilities. In addition, US Concrete's major operations in New Jersey (including its own quarry with 44 million tons of reserves) are well linked to this by both rail and road. Finally, US Concrete has several operations within 100 miles in Delaware, which are well served by sea, rail and road connections to the Washington area.

Figure XXXX  
**Map showing synergies of AI locations in Virginia & Maryland versus US concrete locations**



This use by USC of a new ‘in-house’ stone source for some of its concrete production would allow increased company profitability or competitiveness. We have assumed that all of the benefits will be taken in the form of enhanced profit via increased AI turnover, estimated as follows for year 3 post acquisition and beyond;

USC annual cost of sales ('03)	\$303m
Est. proportion of CoS attributable to raw materials, say	70%
USC expenditure on raw materials	\$212.1m
Est. replacement of USC exist. agg. suppliers by AI (for yr 3)	30%
Giving increased AI turnover of	\$ 63.6m
Equals	£ 35.9m

### 3.2 Need review and reduction

Benefit delivery has been based on a gradual transfer of supply from USC’s existing suppliers to AI, based on 10% in fin. yr end 2006, 20% in 2007 and 30% thereafter as in the demonstration above.

These figures have been taken as a firm, likely achievable synergy benefit, improving the DCF’s flowing to AI and yielding an improvement in their NPV of \$73m.

#### Cross selling of AI products to USC's existing customers

In the UK, AI do not carry out overt cross selling of their products at the local level because of the perceived benefit to the customer of purchasing from a local supplier rather than a national company. This is to the extent that AI operations in the UK usually

retain a local operating name. Whilst this on occasion retains some importance in the US, and whilst local relationships remain equally important, the cultural fear of a national brand and the perceived greater expense of their products is less so.

As a result, due to the complementary relationship of USC's and AI's products, it is considered that in USC's south west California/ Arizona region, Michigan and Atlantic regions, significant cross selling opportunities exist for AI to sell their stone and finished paving products through USC's existing customer base. USC currently trade in fairly focussed product mix of concrete, associated technical advice and contracting, but also involving some (lesser) pre-cast concrete, asphalt and direct aggregate sales. These are targeted to contractors, developers and home-builders through an established local sales force, which with basic training on the new product opportunities could rapidly expand their remit and the potential for resulting volume increases to the AI side of the merged company.

Whilst a potentially significant increase in AI's US turnover could be expected to result from new sales of AI products to existing USC customers, this would be dependant upon assumed cultural values of the customer base and necessary changes in the company's sales and marketing regime, which would be required to be introduced with the support of the workforce. An additional contribution of say 2% on AI's current US turnover could potentially be expected to result within 3 years, with an additional 2% by year 5 post-merger. On the basis of uncertainty however, no financial benefit from this aspect of potential synergy has been taken forward into the calculation of financial benefits arising.

#### Cross selling of USC products to AI's existing customers

Because ready-mix sales are generally workable within only a small sales radius of 25 miles between production plant and customer, speculative establishment of new production sites is high risk and therefore usually limited to very high growth areas with a demonstrable market demand. As AI have existing strong customer bases in geographic areas where USC do not currently have a presence, this allows the more differentiated USC concrete products to be cross-sold. Benefiting from the stronger brand name of USC may also slightly reduce the threshold at which new sites will become viable opportunities to expand geographic coverage in and around AI territory.

It is expected that any benefit from this would be small in financial terms, slow to materialise and difficult to quantify. Following the principle of supportability and robustness no financial benefit from this aspect of potential synergy has been taken forward into the calculation of financial benefits arising.

#### Greater brand awareness and image

There will be a further consequence of the increase in market coverage of the AI/USC brands. The increased size and greater national 'presence' of the business will make it more of a household name to those involved in the use of ready mix and construction contracting. The USC brand will in general be made to adopt the UK approach, in accrediting it as an Aggregate Industries company within its logo, whilst also fundamentally continuing to retain its own strong identity. Thus, the best of both worlds will be gained. This is particularly the case with USC's current core product and service where the established brand name of USC to be seen to have a stronger foothold within the concrete market than AI. Indeed, it is recommended that AI's concrete products will over time adopt the USC brand identity towards following USC's existing policy of attaining a national coverage and a visible on the ground promotion.

**Figure ????**

Existing AI and US Concrete logos

Potential future logo's for AIUS Concrete products, giving optimum potential for synergy benefits



This approach will not only increase the general awareness of the AI and USC brands, but will also be of perceived benefit to those major US nationals who see efficiency and other benefits in minimising the number of suppliers with whom they trade. USC currently have strategic aspirations of a national presence and the merger will assist towards the achievement this long term aim.

The level of anticipated value to the combined company as a result of this enhanced brand awareness could be factored in at an increased turnover of around 0.2% per year for the five years post merger, and 0.1% per year thereafter. However, again this cannot be readily quantified with any degree of accuracy or certainty, and has not been factored in to the calculation of financial benefits arising.

New product opportunities

One step on from the inter-company cross selling of existing products, are the possibilities to introduce specialist products from within the existing stables of the acquiring and target companies, into each others markets. This will include the potential to allow each company to utilise each others trademarks and licenses as well as confidential operating techniques. This has strong future potential to generate new sales and margins, as well as enhanced operational efficiencies.

For example Bardon Concrete in particular has a number of innovative products and services such as Diamondcrete, Bardon Highflow, Hydracrete, Compactacrete etc, which may readily transfer in terms of saleability and value earning potential through USC's customers. Similarly, operating skills and knowledge such as USC's innovative GPS based delivery tracking system could flow back.

This is perceived to be a major long term value enhancer to the merged company, albeit this value creation is likely to come on stream relatively slowly and none can be guaranteed. It is anticipated that enhancement to the combined sales of the merged company could amount to 0.5% per year during years 3-5 post merger, and average 2% per year between years 6-10. Similarly, operating cost reductions between years 4-10 are expected to be at a rate of 0.75% of merged company operating costs per annum. Continuing to follow the robustness principle however, synergy values in financial terms have not been taken forward from this into the post merger valuation of the company.



### 3.3 Factors generating a decrease in operating costs

These savings will generally result from enhancement of efficiencies in scale and scope of the combined company's operation, including the benefits of new knowledge.

#### Purchasing power

As a result of a merger of USC and AI, benefits to both will accrue through scale efficiencies by way of an overall increase in purchasing power. Typical benefits will accrue in materials acquisition, vehicle and equipment acquisitions, maintenance contracts, insurances, pensions etc. In addition, general scale economies will arise in aspects such as USC's involvement and negotiations with a number of strategic alliances in which it is involved, such as national speciality admixture and engineering software companies.

The direct costs of USC represent 63% of sales. The merged company will deliver reduced costs of sales at this level, so assuming 2% cost savings, these savings have been taken through into the financial valuations of the merged company at a level equivalent to  $0.63 \times 2\% = 1.25\%$  of sales. Thus in year 3 post-merger, this will amount to reduced costs of around £-----.

#### Common procedures

It is known that AI already have a number of common policies and procedures in place applicable to both their US and UK operations, and their goal is to increase such common approaches where this is practical. Benefits from the development of such single systems, to cover USC as well as AI, will strip out the need for duplication of such overheads. Areas where this will be applicable will include; some combined management and operating programmes and policies, some combined and reduced operating costs, some combined SG&A costs.

An average reduction in combined SG & A costs in the order of \$600,000 per annum could be assumed for each of years 3-8 post merger, however due to the risk and the inability to accurately substantiate this estimated figure this has not been taken forward into the post merger valuation of the company.

#### Operating economies

Such benefits are likely only where AI and USC currently operate in close proximity to each other; that is in the Atlantic region around Delaware, Maryland and New York etc. In such areas, the close proximity of sites and plant gives for example, the opportunity for shared use of mixer trucks and other facilities. USC currently renew trucks to the value of \$10m each year, and at \$130,000 per truck some significant savings will be possible even if only applicable in some parts of the Atlantic region. Due to the likely limited size of these potential synergy savings and the inability to accurately generate a figure for this, no cost savings from this have been taken forward into the post merger valuation of the company.

It may be the case that certain AI and USC plants in very close proximity to each other currently cannibalise each others sales. Early recognition of this may allow the closure of specific concrete production plants, whilst retaining sales at near current levels at the retained plant site. This will allow synergies from the reduction in operating costs of these plants. As the precise geographic effects of plant sales on each other can only be a function of future detailed evaluation, no financial benefit from this has been considered at the present time.

### Combined support

It is proposed that a review of head office structure be carried out to ascertain the potential benefits of combining some of the administrative functions of the USC head office in Houston Texas with that of AI in --. USC have 421 salaried employees including executive officers, management, sales, technical, admin and clerical staff, whilst AI have a total staff of 3554 in the US, of which we assume x% or – relate to indirect costs. Potential synergies in the different organisational functions are as follows; Operations, Strategy, Finance, Marketing, HR & training, Design/ R&D, Procurement, Technology and communications. Ignoring the potential for the wholesale merger of AI's and USC's west coast administrative functions into a single admin facility, the proposed merger may reasonably allow the elimination of 20% of USC management and administrative support jobs. **This equates (by approximation) to 30% of total indirect wage costs overhead. with a potential saving, after taking into account any redundancy costs, of say \$400,000 per annum for each of years 2-6. NOT CLEAR - NEEDS MORE INPUT. Number of jobs?**

### R&D sharing

Where information is available to allow indirect support costs to be ascertained on a specific basis, this has been done, with a case in point being in the calculation of R & D spend. This synergy has been calculated separately to the above general Combined support cost savings (above) in order to avoid any duplication in the accounting of these figures.

Although no figures for R&D spend can be gleaned from available information of the target or acquirer, based on Lafarge's spend of 1% of sales on R&D (the Economist Sep 4th 2003), synergy benefits in this area will be small but realisable. 1% of USC's sales equates to \$4.1m for 2003. Typical activities where benefits will accrue will be in the initial sharing of information between the two organisations and in future cost savings through shared research. Such shared research opportunities will in particular be likely in areas involving changing legislation compliance requirements, recycling, energy efficiency and sustainability, research on production processes especially for added value products, new technology and other systems research, and research into quarry exploration techniques.

The financial benefits of R&D sharing are predicted to be 25% of USC's estimated R&D spend, therefore equating quickly to around £700,000 annually. Benefit delivery has been based on a 1% of sales saving for 2005, and 0.75% annually thereafter.

## **3.4 Non-operating cost reductions and other synergies**

### Reduced cost of capital

Reduced costs of servicing long term debt (in particular that of USC) will arise following any future debt restructuring, primarily as a result of the stronger financial position of the merged company giving scale economies and stronger buying power. As the merger will, for the benefit of the whole organisation, retain USC's recently structured cheap US borrowing this element will be cost neutral in the short term.



### Single market listing

As a result of the acquisition, US Concrete will become a wholly owned subsidiary of Aggregate Industries. Any possible benefits of maintaining US Concrete's current stock market listing are outweighed by the potential financial saving from the single listing of the merged companies. This will result in a direct annual saving of around \$0.5m per annum off USC's SG&A costs from year 2005 (Source - Merrill Lynch).

### Increased market valuation

#### Counters threat from market consolidation

As the merger will give the company an increased market share and greater geographic coverage, elevating the company's position in the concrete sector from #6 to #??, the benefits of the merger will give the company's concrete division greater robustness to withstand potential future competition from the other large players in the sector.

#### Balancing of risk and earnings generating ability

As mentioned previously in section 2 of the report, the merger will bring about a synergistic benefit to the performance of the merged company through its contribution to the creation of a more balanced portfolio; USC's predominant market sector being a good cash generator in buoyant economic conditions and a quick responder to economic change. This element of synergy from the merger is deemed to be of strategic rather than direct financial benefit.

#### Taxation

No taxation based synergies are considered to exist as a result of the proposed acquisition.

## 4 EVALUATION OF ACQUISITION RISKS

In the evaluation of risks inherent in, or emanating from, the acquisition, only the main applicable risks have been considered. Lesser risks are considered to have been accommodated by sticking within the range of premium recommended as being acceptable.

### 4.1 Strategic

#### Macro economic changes

A major risk to the successful outcome of the acquisition lies in the general economic climate. The current positive environment has previously been covered in this and the fore-runner ranking report. The main threats to this are from terrorism, oil costs, or a resultant combination. Concrete prices are particularly sensitive to fuel costs due to the energy input necessary in cement manufacture as well as raw material and product transportation. As previously mentioned, the concrete market is reactive more than most to economic change, although the markets and analysts generally have an overall upbeat outlook to the macro-economic picture for future.

#### Competitor reaction

Whilst the market is currently consolidating, excessively aggressive competition or a price war is not considered likely. USC's differentiated approach in the form of specialist concrete products and added value services will indeed help to reduce AI's existing risk in this respect from their more commoditised approach to concrete production as occurs in the more general market.

#### Customer reaction

By retaining the strong AI brand name, customer facing staff, as well as operational continuity in at least the short term, loss of custom in significant numbers is unlikely. This represents AI's normal conservative approach in undertaking bolt on acquisitions and on the basis of this track record a high level of confidence can be attributed to this position. Any alternative approach to that being taken in terms of major shifts in branding, strategy or staff know-how would bring significant risks of adverse customer response and loss of sales.

#### Wrong 'fit'

Under the heading of financial risks, below, the issue of failure of the perceived merger synergies and benefits arising has been considered within the basis of the calculation of the premium that should be offered. This evaluation having taken place in the formulation of the views given in sections 2 and 3 of this report should further mitigate the risk that anticipated synergies do not exist, whilst due diligence at the more detailed level should further hone in on the potential for perceived synergy benefits to be absent.

### 4.2 Legal / employment

### General due diligence liabilities

Risks clearly exist in a range of areas when it gets down to the detailed level of USC's operations. It is recommended that the fullest practical due diligence checks be carried out covering all the usual areas of finance, litigation, environmental issues etc.

### Key contracts

An important issue in the acquisition of USC, given the recommendation to run the company as a bolt on, is the ability to retain and maintain the services of key board and management members and as a consequence maintain also key sales contracts and other important business relationships. This risk should be addressed by looking carefully at employee remuneration and incentive packages and having suitable proposals in place before the acquisition takes place. Specifically ----- USC guy will be offered a place on the AI board along with -----the existing AI chief operating officer for both UK and US ceding his US role, whilst retaining his UK role and at the same time being promoted to -----,

### Employment relations

Generally predictable levels of restructuring and redundancy costs have been factored in to the valuation for USC and the recommended premium for the company. It is potentially possible that these could prove higher than expected in the short term, although any increases in such costs above those currently predicted would be likely to result in higher savings than those predicted, in the longer term.

An important consideration to bear in mind in any US-UK acquisition or merger, is the subject of pay parity. The differential has been known in the past to result in employee relations difficulties as a result of the pay disparity between the continents. In view of the discrete levels of intercontinental interaction however within the company, this is not anticipated to be a significant adverse risk.

## **4.3 Financial**

### Accuracy of valuation and assessment of acquisition benefits

Clearly the accuracy of the target valuation and the assumptions forming the basis of the assessment of the synergies leading to it are fundamental to the realisation of benefits and overall success from the acquisition and form the single biggest aspect of acquisition risk. As a result, a conservative and cautious approach has been taken and the following clarifications are reinforcements of this point are made;

UNH forecast the AI numbers from first principals to arrive at a detailed PL, CF and BS. The sales forecasts are low risk as they are average brokers forecasts (quote names). The resultant retained profit (again quote names and copy and paste the comparison) is very similar to brokers forecasts and is therefore low risk. Hence happy with forecast and also with model logic.

WACC for AI was calculated using first principals, taking average betas from three brokers and calculating the debt cost after tax. The WACC of 8.13% is very close to Morgan Stanley figures of 8.1%, hence low risk.

The net present value of the cash flows from the model shows that AI is undervalued by 26%. Historical multiples from 2000 to date have been tracked, and in combination with the DCF show that AI is undervalued by at least 11% and as much as 26%. This is congruent with MS who have a price target of 104pps. 11% is 98pps and 26% is 111pps. Again, the DCF model from MS had a price target of 110pps and was only performed over a 20 year horizon. The valuation multiples and DCF rational are therefore low risk.

The same logic for the AI model has been used for the USC model. The earnings per share for the UNH forecast are congruent with two brokers reports, quote names and difference, and are prudent and supportable and are low risk.

The WACC has been calculated with the supportable AI logic and the DCF gives a valuation today that is equal to today's market value. Important point.

A range of sanity check multiples have been used in conjunction with the DCF valuation to give a certainty range. (Again copy and past the table)

The worst case scenario assumes NO SYNERGIES and discounts at the AI WACC, this gives a recommended break even acquisition premium range of between 9% and 34%, the DCF is 22%. This range carries strong certainty and is the worse case scenario range.

#### No take up of bid offer

The group has made clear recommendations on the parameters of premium within which a deal can be recommended. Significant flexibility exists between the recommended initial offer of a 17% premium, up to the proposed 30% ceiling. This represents a difference in cash terms of £------. Even up to this 34% figure, an upwardly revised bid is still considered to be of benefit to AI on a conservatively estimated basis.

In the event of the offer not being accepted by USC shareholders at the ceiling bid level, this represents a risk of abortive costs to AI up to this point of rejection of £-----.

#### Adverse shareholder reaction

The all cash offer recommended risks a negative response from the markets as a result of the impact on AI's resultant gearing as a result of its increased debt levels. Analysts forecast that AI will generate £151m in H2,2004E. Applying all of this cash to the acquisition will have an adverse impact on AI's capital structure, which the company have always striven strongly to defend. The AI WACC will go up, as will the market's perception of risk in AI, and its Ra will also change.

To get around this.....

#### Exchange rate fluctuation

Clearly, the value of the deal to AI is particularly favourable at the present time due to the strong value of the £ against the US\$. A careful eye should be maintained on this exchange rate, as the proposed premium to AI is based on a given exchange rate of \$1.70??. In addition to this, the dollar rate has been fixed for 3 months to avoid exchange risk at 1.7702.

#### 4.4 Operational

**Cultural acceptance of merger**

**Restructuring difficulties**

**Adequacy of resources**

Reputation

Refs

1. Source: Thomson Financial Extel Company Report
2. See Appendix E, Deal Analysis of UNH Consulting, Ranking Document
3. JP Morgan report, Construction & Building Materials sector, London, Feb 2004
4. California State Railroad Plan 2001.02 to 2010.11, California Department of Transportation, Division of Rail, available as pdf file from [www.dot.ca.gov](http://www.dot.ca.gov) (document [www.dot.ca.gov/hq/rail/railplan/csrp2002.pdf](http://www.dot.ca.gov/hq/rail/railplan/csrp2002.pdf))
5. Source: Times Newspaper 27.07.04, pp22.

New Ref AA: California Chamber of Commerce, "California Economic Outlook Favourable" Dec 2003, available as pdf file from [www.dot.ca.gov](http://www.dot.ca.gov)

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