

Customer & Market Due Diligence Of Municipal/Utility Services Company: Deciphering A Niche Market To Validate Target's Growth Plan

The Challenge: Our client, a middle-market PE firm, was in exclusive negotiations to acquire a wastewater services company that included a rapidly growing division providing wastewater infrastructure services to municipalities and utilities. The division was projected to grow at >30% CAGR over the investment timeframe from both growth in existing geographies and expansion in new geographies. Our client was attracted by this growth potential, but needed confidence that it could be sustained. The client engaged Gotham to conduct a 4-week customer & market due diligence of the target with the following objectives: (1) establish municipal budget outlook; (2) establish market size and growth outlook; and (3) understand the target's competitive positioning.

Fact-Based Analysis of a Niche Inspection, Cleaning, and Repair Services Market: Given the extreme data limitations and very "local" municipal and utility end-markets, Gotham focused the effort on 5 geographies, covering about two-thirds of existing revenue and projected growth. For each of these geographies, Gotham undertook a comprehensive fact-based approach, including:

- **Extensive Primary Research:** We interviewed 124 municipal operations, engineering, and finance officials, utility company executives, and municipal and utility contractors to understand drivers of these services, funding/program dynamics, outsourcing dynamics, the buying process, and the target's reputation and positioning.
- **In-Depth Research of Regulations:** Gotham conducted an in-depth review of both federal regulations (e.g., Clean Water Act) and state-level environmental regulations related to wastewater systems. We also analyzed the funding mechanism and utilization of Clean Water State Resolving Funds (CWSRF), partially used to fund projects requiring these services.
- **Top-Down/Bottom-Up Municipal Budget Analysis:** Gotham's top-down analysis leveraged state-level municipal spend data to understand overall trends in wastewater infrastructure spending. For our bottom-up effort, we developed a detailed database of 10-year budget history and projected budgets for 25 representative municipalities in all 5 focus geographies. We reconciled and extrapolated bottom-up municipal data with top-down state-level data to create a reliable picture of municipal budget dynamics.
- **Bottom-Up Market Sizing:** We developed 3 market sizing models to estimate the size and growth for each service line in each focus geography: (1) Municipal Infrastructure Maintenance Services leveraging the system size, service frequency, and price data gathered from municipal maintenance plans, RFPs, and interviews; (2) Municipal Infrastructure Rehabilitation Services leveraging the municipal budget analysis and RFPs to establish the portion of capital outlay used in these types of services; and (3) Utility Inspection Services based on inspection and pipeline replacement plans of all major utilities in target's geographies from our interviews with key utility executives and review of utility rate filings.

Municipal Infrastructure Maintenance Services Funded By Stable O&M Budgets While Rehabilitation Services Funded By Moderately Growing Capital Outlay Budgets

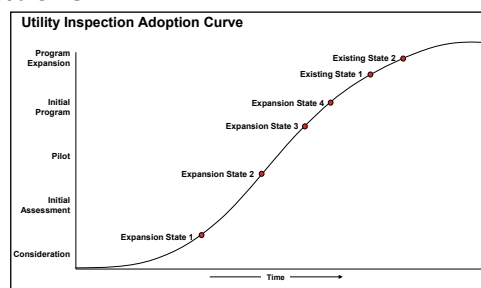
From our analysis and interviews, we established that O&M budgets are the primary source of Maintenance Services and these budgets are fairly recession-proof because they are self-funded through user fees. Rehabilitation Services are primarily funded by Capital Outlay budgets that mostly consist of funds from municipal bonds and the CWSRF. While there is a small recessionary risk associated with this spend, most municipalities predict growth of >3% in Capital Outlay budgets over the next 5 years due to the significant project backlog and urgency of performing rehabilitation to avoid significant penalties under clean water regulations.

Municipal Market Growth Projected To Shift To Rehabilitation Services Driven By Regulatory And Outsourcing Dynamics

As EPA stepped up enforcement about 10 years ago, state regulators developed model inspection programs to meet environmental regulations. These programs resulted in rapid growth in demand for the Maintenance Services as municipalities lacked in-house capacity to inspect their infrastructure in prescribed timeframe. We established that municipalities' demand for outsourcing these services will slow as they finish their initial inspections and conduct ongoing inspections at a slower pace. While the market for Maintenance Services is expected to slow to 1.1% CGAR, the market for Rehabilitation Services is expected to grow at 8.6% CAGR driven by the need to address issues identified by inspections and municipalities almost always outsourcing these services.

Utility Inspection Services, An Emerging Market, Projected To Grow At A 26% CAGR

Utilities have been required to submit DIMPs (Distribution Integrity Management Programs) to address threats to the integrity of their pipeline systems. This requirement along with some accidents raised awareness of potential issues with existing infrastructure which led to a need for target's Utility Inspection Services. Gotham established an adoption curve of growing use of services to address a threat once discovered. Moreover, the expansion geographies were either at the pilot stage or not yet started. By mapping plans of utilities representing the vast majority of the systems in focus geographies, we developed the target's revenue projections from Utility Inspection Services over the next 3 years with a high degree of confidence.



Target Well Positioned To Reach Growth Targets In Expansion Locations

Given that the vast majority of the target's projected growth is from expansion into new geographies, we performed a robust competitive analysis within these new geographies. We found that these geographies exhibit similar competitive dynamics as existing branch locations. Players in both existing and expansion geographies are similarly segmented, with many of the target's major competitors in existing geographies also having a presence in the expansion markets. The target, however, has an advantage in these expansion geographies via already-established relationships with key contractors for both municipal and utility work.

The Outcome: Gotham's comprehensive, fact-based approach verified that the target's aggressive growth plans were realistic and the target had established a strong reputation with its customers. This allowed our PE client to gain confidence in the target's ability to meet its revenue plan and move forward with the acquisition.