AIA Practice Management Knowledge Community

A/E Industry Consolidation

Webinar
December 8, 2011

Presented by:

David S. Cohen, Esq., ASA
Matheson Financial Advisors, Inc.
(508) 655-9700
dcohen@mathesonadvisors.com

Overview and Learning Goals

- Overview of Current M&A Environment
- Nuances of Getting Deals Done
- Valuation Issues
- Transaction Structures
- Deal Consideration

M&A Drivers

&

A/E Market

Overview

The AEC M&A Market

- **Hot** from 2004-2007
- **Warm** from late 2007 to early 2008
- **Cooling** fast from early 2008 – Q3 2008
- **Frigid** from Q4 2008 – Q3 2009
- **Thawing** in Q4 2009
- **Warm - Hot** from early 2010 to present (Jacobs – KlingStubbins, Long Point Capital – EYP Architecture & Engineering, Stantec – Burt Hill)

What's Changed?

- The World
- Capital markets volatile
- Credit markets still frozen
- Firms & Households De-leveraging
- Cash is no longer king…Cash is…g_d
- Valuations down primarily b/c earnings are down – multiples have remained fairly stable

What's Changed?

- Once HOT markets like CA, FL, AZ, NV are now in trouble
- From a Seller's market to Buyer's Market
- Still driven by:
  - Interest rates low, if you can get the debt
  - Low capital gains tax rate *(for now)*
  - Nature of our industry – fragmented with low barriers to entry
    - Attracting private equity – but financing constraints and 'turn-around' limitations (risk)

What's Changed?

- Infrastructure Focus vs. Private
  - W/WW, Transportation, Energy, Environmental
  - But, local funding issues present problems
  - Increased competition for smaller projects
  - Even lower fees w/ price competition
  - Health Care and Education still desired
- Tremendous opportunities still here for foreign firms (Stantec, Arcadis, Bureau Veritas, Dar Al Handasah, WPP Group, Worley, SNC-Lavalin, Cardno, GHD, WS Atkins, Balfour Beatty, IBI Grp…)
  - Weakened Dollar
  - Big spenders in power

What's Changed?

- Lower profits and growth prospects mean increased difficulty to complete internal transitions
  - leadership and financial capacity constraints
- Alternative to Cold Starts
- Industry is not minting entrepreneurs & capitalists, let alone architects and engineers
- Expect more mergers and more buyer stock as consideration

The Current M&A Market

- For *Sellers* – Maximum value & new opportunities
  - Recognition that capital and larger platforms are critical – everyone things they are a "tweener"
  - Adjusting to new valuations?
- For *Buyers* - GROWTH remains critical
  - Higher revenues & earnings = higher value
  - Embedded overhead to cover
  - Conserving cash

Historical A/E Deal Activity

- Just where you expect:
  - Frequent Buyers are on the top of the *ENR Top 500*
    - *They have financial resources & balance sheets*
    - *"Growth" mindset vs. "Dividend" mindset*
    - *Ability to use stock and tap equity markets*
  - Typical Targets are 30-100 person firms
    - *They run out of human resources*
    - *Next tier unable to buy out the founders*

A/E Deal Activity

- $10mm (100-person) Buyers target
  - $1-3mm (10-30 person) sellers
- $20mm (200-person) Buyers target
  - $2-6mm (20-60 person) sellers
- $50mm (500-person) Buyers target
  - $5-20 million (50-150 person) sellers
- Obvious exceptions - like Arcadis & Malcolm Pirnie, Balfour Beatty & PB, and WS Atkins & PBSJ

Ownership Transition Realities

- Nationally, approx. 1 out of 3 firms found to survive a transition to 2nd generation
- About 10% will survive to 3rd generation

Sellers' Transition Options

- Liquidate the firm (Minimum/Floor Value)
- Give it to next generation leaders or family members (Low Valuation)
- Internal Management Buy-Out (discounted Fair Value)
- ESOP (A Financial Buyer) (Fair Market Value)
- Sale to Third Party (Strategic Buyer or Financial Buyer-Private Equity) (Market Value)
- IPO (Hill Int'l, Willdan Grp., AECOM) (Pay Day?)

From the Seller's Perspective

- Firm owners want to maximize value
- Firm owners are tired of running the business
- Internal transition may not be feasible from financial perspective (too much risk)
- Next generation of leaders/managers do not have the capital to invest
- Selling firm may not have developed leadership depth (bench strength) to run the firm
- Larger firm may provide additional opportunities for staff and leaders
- A larger firm may help selling firm compete and win bigger/better projects and clients
- Rescue a sinking ship

What Buyers Want

- To grow their firm's value through higher revenues and earnings
- To execute their strategic plans for their stakeholders
- Deals that provide access to seller's clients, geographic markets, services, backlog, processes/technology/experience, market reputation, design excellence…
- Qualified people – talent at project and leadership levels (alternative to recruiting)
- Possible lower cost than cold starts

Doing Deals Successfully

- Like the game of golf, the less you play, the less likely you will get good at it
- So, firms that do more deals tend to be better at doing them
  - They consistently close with high probability of success b/c they are pro-active and constantly in the market
- Successful acquirers stick to digestible-sized deals that reinforce their core businesses
- Financial yardstick for measuring success is producing higher total return on investment than firm’s cost of equity

Advice

To

Sellers

Transaction Ready Sellers

- Be pro-active not reactive
- Get your house in order
  - Stable leadership/management that <u>stays</u>
  - Accrual (GAAP) financials by outside CPA
  - Steady earnings
  - Accurate backlog report
  - Excellent project accounting
  - Clean up inter-personal/company affairs
  - Clean balance sheet (A/R and WIP)
  - Adequate capitalization

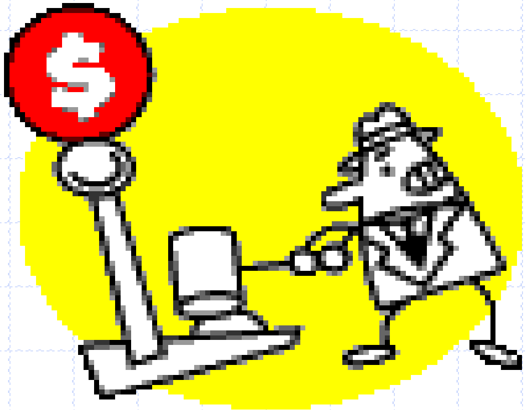
Transaction Ready Sellers

- Selling owners typically think their firms are worth more than they are
- Get an independent sense of value early
- Make sure systems are in place to reward or keep key people that may not get much out of the deal
- EARNINGS, EARNINGS, EARNINGS
  - Steady historic trend and reasonable/attainable future projections

Connecting Profits with Project Management

- Profits begin with successfully managed projects in the Design business

- The typical metrics tracked are:
  - Utilization Rates (By Hours and Dollars)
  - Net Labor Multipliers
  - Revenue Factor
  - Overhead Rates



Other Earnings Measures

- EBIT = Earnings Before Interest & Taxes (after normalized bonuses)
- EBITDA = EBIT, Depreciation & Amortization (Cash Flow measure) – typically 8 -12% median on NSR
- Free Cash Flow (Net Income after taxes, plus non-cash expenses and after reinvesting)

Balance Sheet Delivered

- M&A Experience would suggest target normalized equity level of 20% of Fee Revenue (NSR)
  - Impacted by performance metrics
  - Impacted by A/R & WIP periods

Bottom Line in Managing a Successful Group or Business

- Grow wisely – target markets
- Strategic Business Planning - focus
- Increase profits and maximize profit margins
  - Net labor multiplier (above 3.00)
  - $$ Utilization (above 64%)
  - Overhead control (below 150%, Upper-Q is 137%)
- Bill and collect your money quickly
- Reinvest prudently in your growth
- Maintain strong balance sheet
- Provide shareholder value & opportunity for A-Players

Typical Firm Sale Process

- Define goals and objectives
- Establish valuation expectations
- Develop Offering Memorandum
- Market research – identify target buyers and prioritize
- Contact through letter and phone & begin "dating ritual"
  - Confidentiality & Non-Disclosure Agreement
- Participate in initial meetings – first dates
- Negotiate Letter of Intent/Term Sheet
- Due Diligence
- Legal Documents (Definitive Agreements)
- Integration
- Create Value

Advice

To

Buyers

Buying Firm Considerations

- Have a Strategic Plan
- Develop M&A goals to fit
- Shore up financial performance and conditions
- Develop leadership in-house to help assimilate/integrate
- Evaluate your own internal stock formula – too low a value vs. market can hinder getting deals done
- Be ready to pay to play

Doing Deals Successfully

- De disciplined in:
  - Picking targets
    - Develop investment thesis/goals
  - What deals you actually close
    - Focus Due Diligence on where it matters
  - Where and how you integrate the target
    - Leaders, Projects, Service Lines, Back-office, Culture
  - Developing a back-up plan when set-backs or headaches arise
    - Lost leader, major client, significant project issue

Typical M&A Process

- Define Goals and parameters
- Market research – identify targets
- Screen targets
- Develop profiles of targets and prioritize
- Contact & begin "dating ritual"
  - Confidentiality & Non-Disclosure Agreement
- Negotiate Letter of Intent/Term Sheet
- Due Diligence
- Legal Documents (Definitive Agreements)
- Integration
- Create Value

Valuation

Valuation Concept 1:

Stock

vs.

Enterprise (or Total Invested Capital)

TIC = Stock Value + Funded Debt

Stock Value = TIC - Funded Debt

Hint: Think of your home less its mortgage

Valuing an A/E Firm

- The value of a business is based on the present value of future expected cash flows discounted at an appropriate risk adjusted rate of return
- Therefore, one must be able to forecast earnings
- And, determine an appropriate discount rate to measure "risk" of those cash flows not occurring
- Relationship between rate of return and "multiples"

Firm Value is About

- *Expected* EARNINGS
- Volatility of Earnings (i.e.., perceived riskiness of achieving projected earnings)
- Adequate capital underlying the business
- Caution with reliance on Net Revenue – it's only one factor

Structuring the Transaction

Transaction Structures

- **Asset Purchase**
  - Over 2/3 of transactions (though changing and more stock sales for larger firms)
  - Cherry pick assets and liabilities
  - Avoid certain liabilities
  - Step-up tax basis of hard assets
  - Contract novation
  - Transfer of title to assets
  - Double tax for C-Corp. owners; Single layer for pass-through S-Corps
  - Target company continues to exist
  - Buyer may need to pay-up to mitigate tax hit to seller

Transaction Structures

- **Stock Purchase**
  - Target owners sell stock to Buyer corp.
  - Target becomes subsidiary of Buyer and continues to operate its assets
  - No cherry picking assets and liabilities
  - Buyer assumes all liabilities
  - To be tax free – 100% stock for stock
  - Low Capital Gains Tax to Target owners
  - Buyer may offer less to assume risks

Transaction Structures

- **Merger**
  - A combination of 2 firms where one firm survives and is successor to all assets & liabilities of other
  - Two firms become one
  - Consolidation – a whole new firm is formed
  - Continuity of ownership by target shareholders
    - At least 50% stock in combined firm
  - No tax on stock exchange
  - All risks and liabilities convey

What to Expect in a Transaction

- Buyers want to Purchase Assets
- Sellers want to Sell Stock
- Typical consideration:
  - Cash
  - Seller financed note
  - Buyer stock

What to Expect in a Transaction

- Buyers will want current management team (or next tier) in place and tied to the deal
  - Employment Agreements
  - Non-Compete & Non-Solicitation Clauses
  - Earn-Outs
  - Stay Bonuses
- The dating ritual and process takes longer than you think
- Buyers want to limit the Goodwill they put on books

What to Expect in a Transaction

- Under-capitalized firms likely to receive lower valuation
  - Buyer will have to reinvest
- Due diligence is critical (2-way)
- Is there a cultural fit

Questions & Answers

- What else can I tell you?

Contact Information

David Cohen, Esq., ASA, Managing Director
Matheson Financial Advisors, Inc.
4 Mechanic Street, Suite 211
Natick, MA 01760
ph. (508) 655-9700 e-fx. (508) 861-0450
cel. (774) 217-3380
dcohen@mathesonadvisors.com
www.mathesonadvisors.com

BIOGRAPHICAL INFORMATION
DAVID S. COHEN, Esq., ASA

Matheson Financial Advisors, Inc. ("Matheson Advisors") is a boutique corporate financial advisory services firm providing M&A advisory services, internal ownership transition and management buy-out consultation, Employee Stock Ownership Plan (ESOP) solutions, and business valuations for a variety of purposes. Our clientele includes firms in the engineering, architectural, environmental consulting, construction, and government contracting industries, as well as other professional service firms.

David brings over a decade of experience in consulting clients on ownership transition, business valuation, financial management, and mergers and acquisitions. Prior to becoming a Managing Director at Matheson Financial Advisors, he was Managing Principal of Exit Strategy Management, a consulting firm he founded to provide financial advisory services to the design industry. David assumed the position of Principal at Matheson Financial Advisors in 2006 when Exit Strategy Management and Matheson Financial Advisors merged. Mr. Cohen presents regularly at AEC industry association conferences.

Prior to founding Exit Strategy Management, David was a shareholder with another industry consulting firm, where he headed up the ownership transition planning unit within the Financial Advisory Services group. He also holds a Law Degree and has practiced law in the areas of class action litigation, commercial proceedings, and civil actions. David graduated from the University of Miami (FL) and earned a Bachelor of Business Administration degree with a major in Accounting. He also earned his Juris Doctorate from the University of Miami School of Law and is licensed to practice law in Florida and Massachusetts. In addition to being a member of the American Society of Appraisers, David received the coveted Accredited Senior Appraiser (ASA) designation with a specialization in business valuations.

Contact David Cohen at 508.655.9700 or dcohen@mathesonadvisors.com