PSMJ | Resources, Inc.

M&A Trends and Practices in the A/E/C Industry

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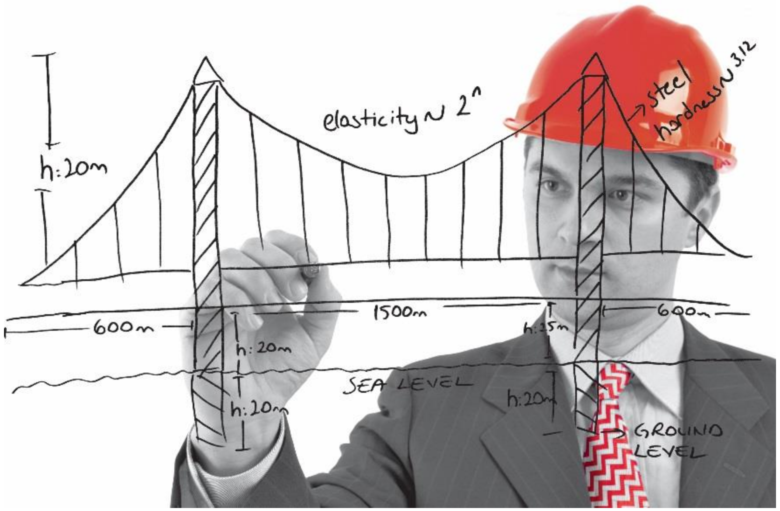

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Technology

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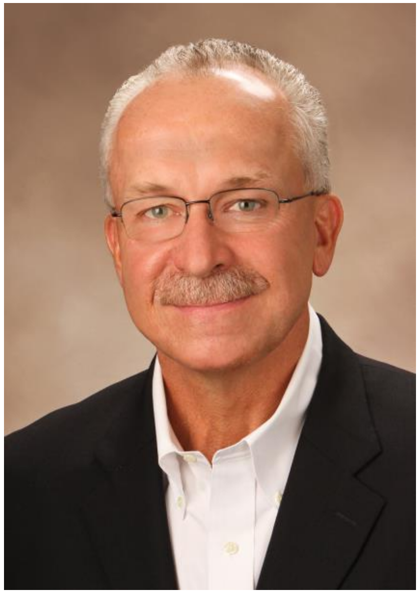
About PSMJ Resources, Inc.

- Established in 1974, PSMJ Resources, Inc. is the world's leading authority on the effective management of architecture, engineering, and construction firms.
- With offices in the United States and Australia, PSMJ offers over 150 titles in book, audio, and video format.
- **Education & Training:** We publish three monthly periodicals and deliver hundreds of seminars, roundtables, conferences, webinars, and in-house training sessions every year for A/E/C professionals around the world. Our survey reports provide benchmarking in many areas including financial performance and compensation.
- **Advisory Services:** PSMJ's sought-after expertise covers a range of critical business areas such as strategic planning, mergers & acquisitions, project management, valuation, and internal ownership transfer.

Agenda

- Introduction & Overview
- Overview of Current M&A Market
- Valuation & Deal Structure
- Perspectives for Sellers
  - Evaluating internal vs. external options
  - Preparing for a sale
- Perspectives for Buyers
  - Acquisition as a growth strategy
  - Managing the process
- Questions & Discussion

Karl Wohler – M&A Advisory Practice

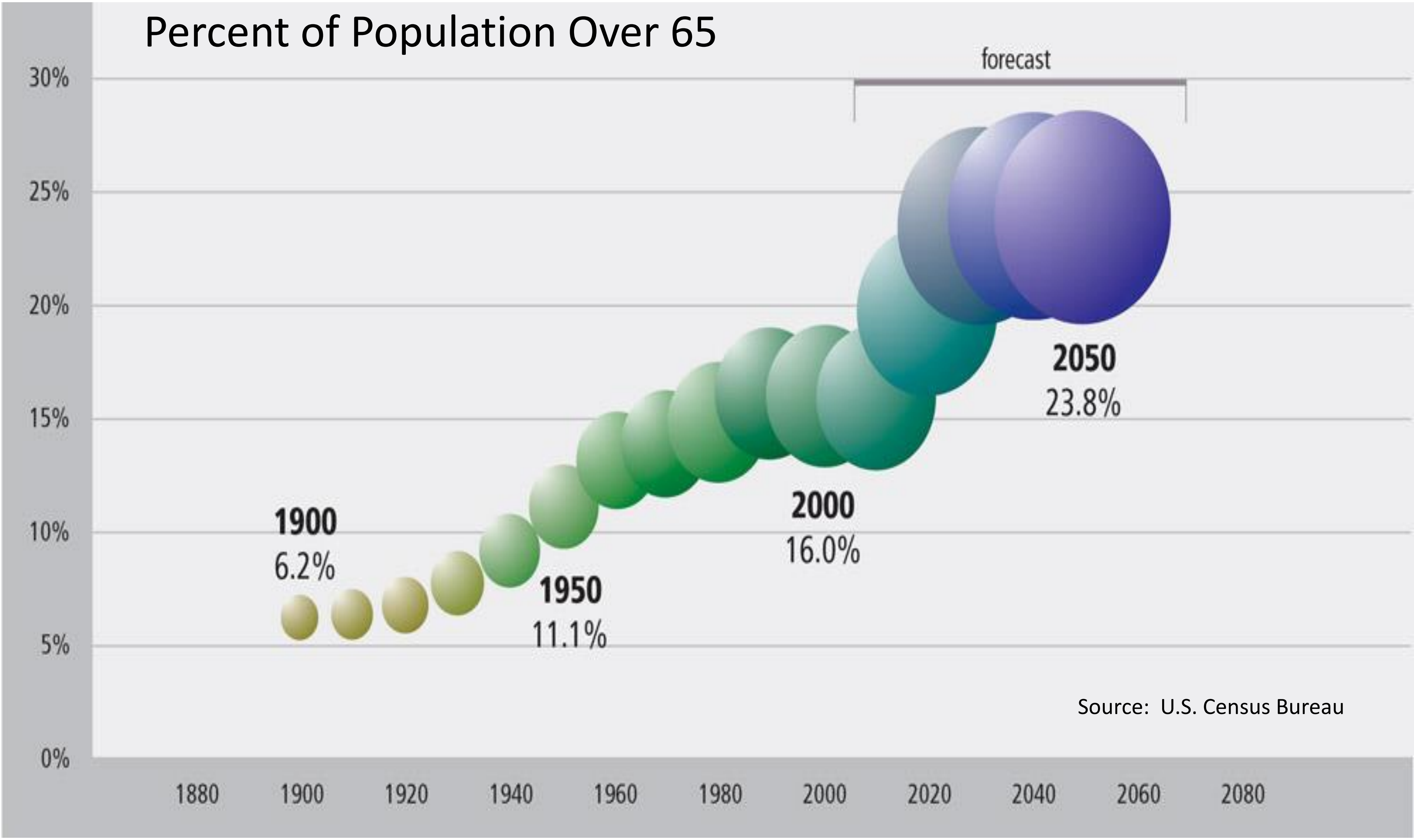


- Education:
  - BS Chemical Engineering,
    University of Massachusetts, Amherst
  - MBA Finance, Babson College
- Experience:
  - Polaroid Corporation - Process engineering,
    R&D, manufacturing
  - Owner/CEO of a $16M commercial printing company
  - M&A investment banking advisory
    - Clients include DuPont, Chargeurs, Philips Electronics, Kodak, private equity firms
    - Lower middle market deal work in manufacturing, printing, consulting services
  - Head of M&A for Bowne & Co. ($1B financial printing company)
  - Joined PSMJ M&A advisory practice in early 2016

Overview of Current M&A Market

- The A/E/C M&A market is very strong with active buyers and sellers across all disciplines.
- Valuations trending up, but seeing a wide range in valuations depending on the situation and market segment.
- Internal ownership transition market very active, but we are seeing some shift to external sale due to weak interest among next generation leaders.
- Shortage of talent is driving some M&A activity with M&A used as a talent acquisition tool.

The Retirement Wave is Coming!



Valuation & Deal Structure

- Business valuation methods:
  - Asset Value: Net market value of assets (liquidation value)
  - Market/Cash Flow Value: Value as a going concern based on recent profitability performance & market comps.
  - Projected Income Value: Value based on Net Present Value of projected earnings.
- The objective for buyers:
  - <u>Sustainability</u> and growth of profitability after the closing.

Conventional M&A Valuation Approach – The Black Box Model

Blood
Sweat
Tears
$$$$

→ **Business** →

Free Cash Flow
as measured by
Adjusted EBITDA

Value = Adjusted EBITDA X Market Multiple

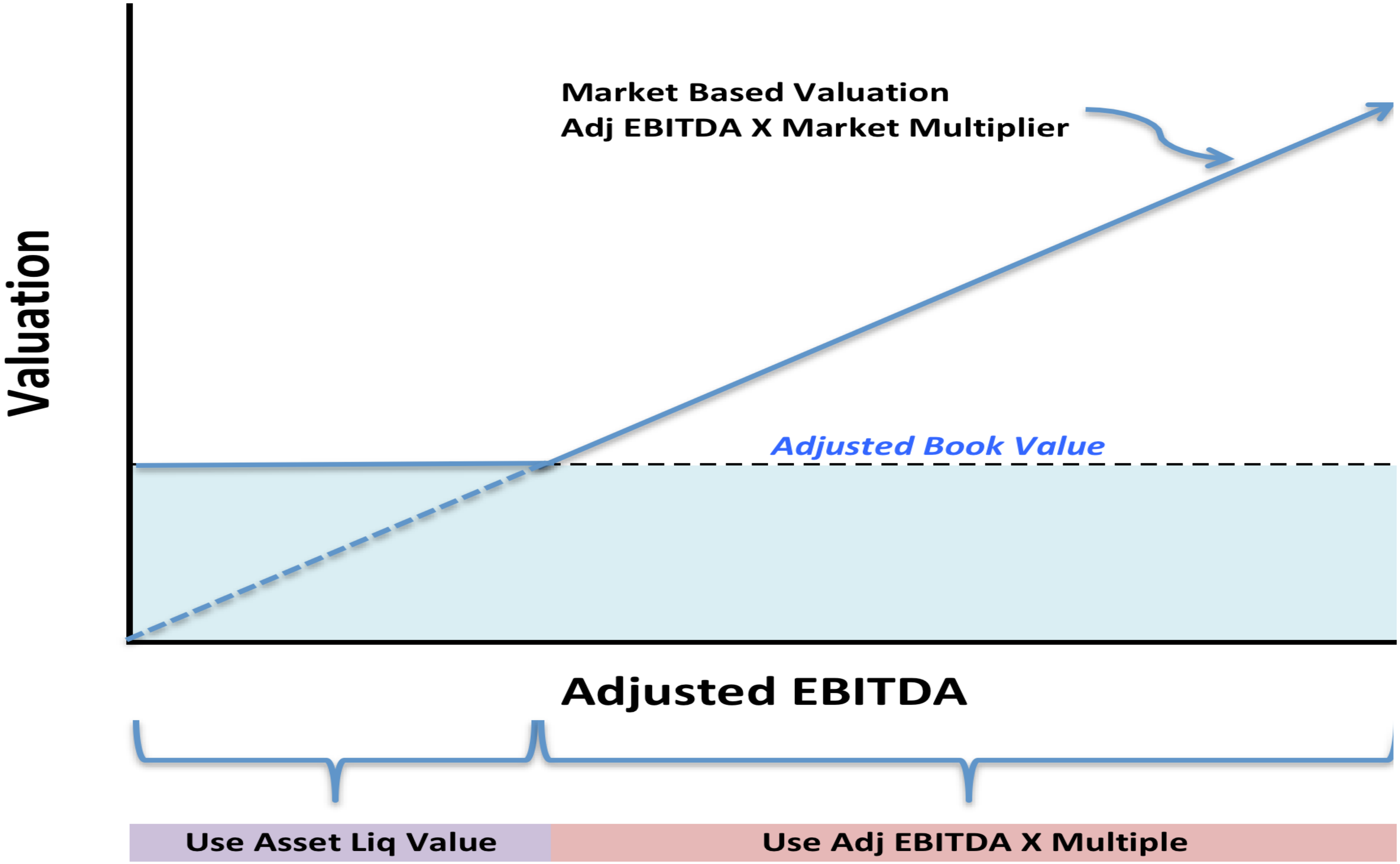
Internal Performance Metric | **External Market Factor**

- Every business is a black box that spits out cash as measured by Adjusted EBITDA.
- The value is purely economic & sterile, valued as a box that creates cash flow.
- The Market Multiple is based on comparable sales of the same size in the same industry segment.
- The Balance Sheet has no impact on value provided that this "going concern value" exceeds

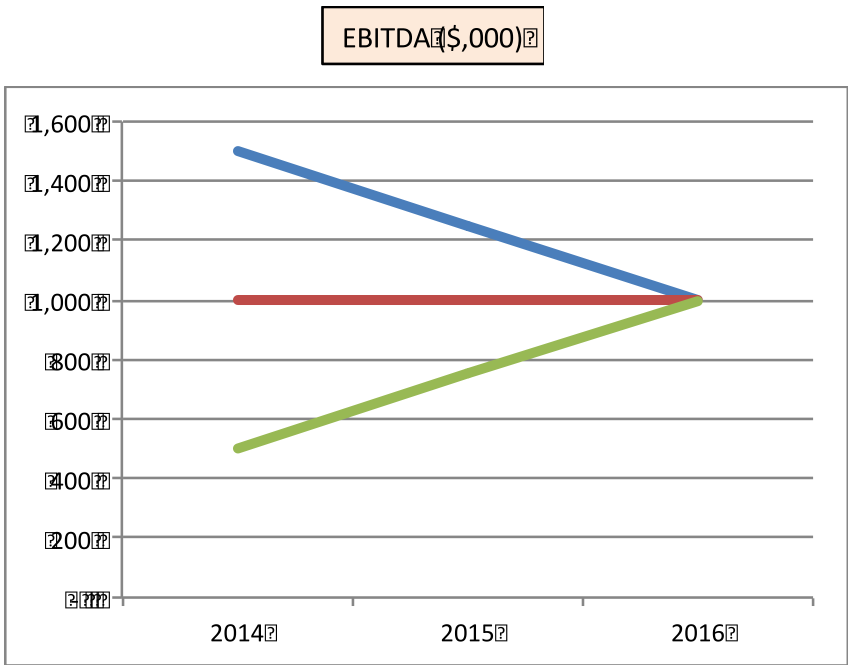
Conventional M&A Valuation – Key Terms

- The internal metric for valuation is **ADJUSTED EBITDA**. All other performance metrics are distilled into this one decisive metric of performance ==> the company's ability to generate cash flow.
  - Adjusted to normalize profit for owners compensation, expenses, etc.
- The **Market Multiple** is developed based on industry and market comps as well as adjustments for internal conditions compared to market norms.
- Different buyers will pay different multiples for the same business creating a range of exit valuations available in the market.

How Asset and Market Approaches are Used Together in M&A Transactions



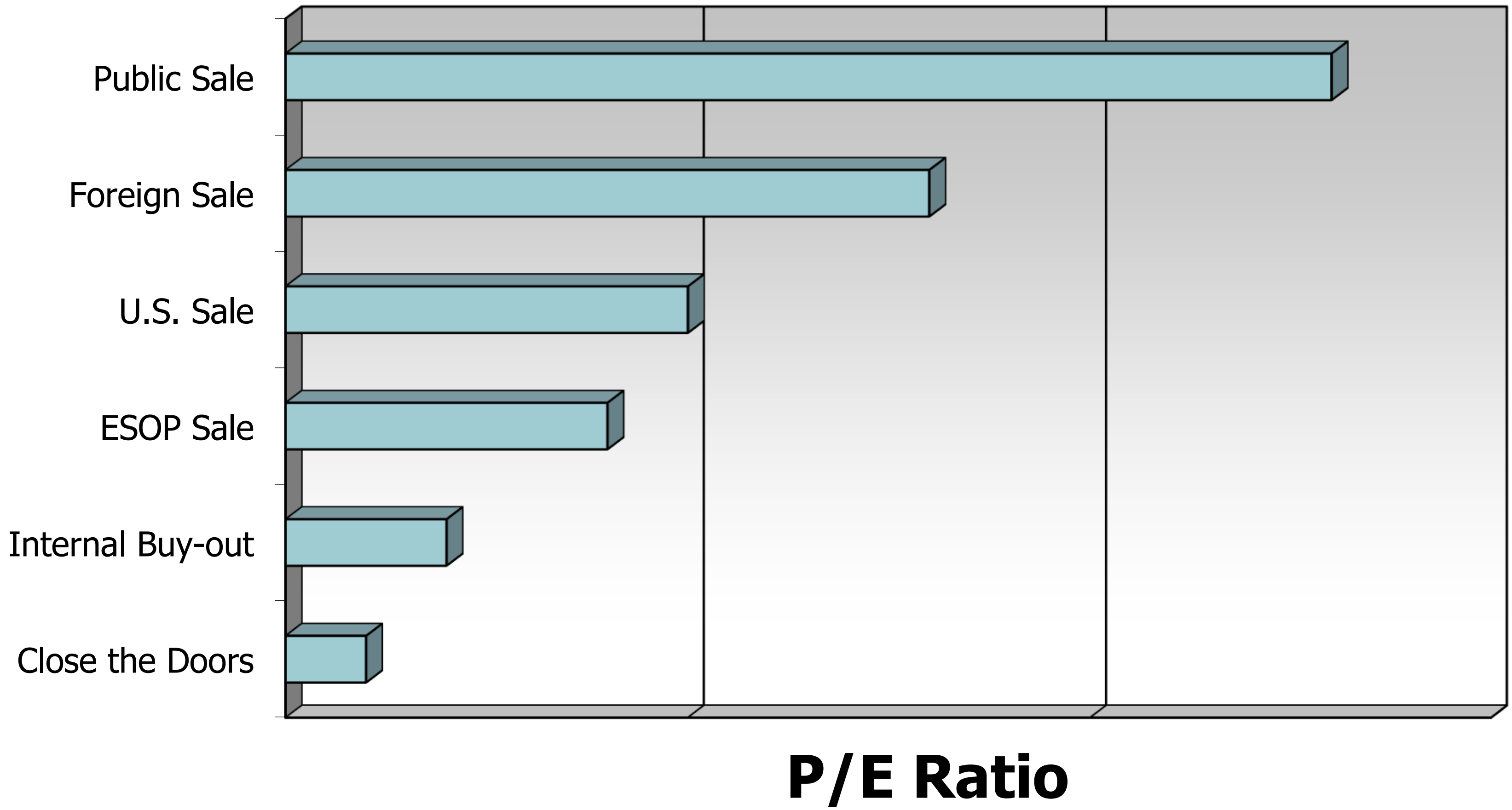
Basis for Valuation: Trailing 12 Months or Multiyear Average of Earnings?



Which company would you pay more for?

Valuation w 5X Multiple ($,000)			
	LTM	**3 Yr Avg**	**3 Yr Relative**
Blue	5,000	6,250	167%
Red	5,000	5,000	133%
Green	5,000	3,750	100%

Value Depends Greatly on the Buyer



Deal Structure - Stock or Asset Purchase?

BUYER:

- Usually wants to buy assets.
- Gets substantial tax benefits from an asset sale.
- Doesn't want to buy liabilities or past legal liabilities.
- Typical structure is all assets except cash and selected liabilities including AP and leases.
- Focused on total ROI.

SELLER:

- Usually wants to sell stock. Wants capital gains tax treatment either way.
- Wants to be relieved of liability.
- Focused on after-tax cash flow.
- Are contracts assignable?
- Valuation multiples based on asset sale, so stock sale requires price adjustment for shifted tax liabilities.

Deal Structure Practices

- Deal types – mix of three types:
  - Asset purchase
  - Stock purchase
  - Stock purchase with 338 (h) (10) election
- Terms:
  - Typically 50-70% cash at close with remainder in a seller note payable over 2-3 years.
- Earnouts:
  - Used often to close valuation gap. Structuring and measurement can be difficult if integration is the goal.

Perspectives for Sellers

- Think about the external sale process as a six-year process.
  - 3 years of performance pre-close will determine value and exit options.
  - 2-3 years post close involvement is customary.
- If internal sale is the goal, start the process early!
- Get calibrated on valuation metrics and expectations long before the sale event.

Sellers Dos & Don'ts

Dos

- Talk to your CPA to understand the tax consequences of the sale.
- Develop your management team.
  - Delegate, develop, involve in decision making and client relationships.
  - Business must be sustainable after your departure.
- Financials:
  - Use industry standard P&L format.
  - CPA reviewed financials with Adjusted EBITDA yearly.
  - Monthly budget and forecast for current year. 3 Year P&L forecast.
- Plan ahead anticipating a required stay period of 1-3 years post close.

Sellers Dos & Don'ts

<u>Don'ts</u>

- Expect the buyer to pay full price and pay your taxes.
- Compare your value to public companies.
- Be a control freak and "heroic leader". If you are too much of a key person, the value of the firm to external buyers is reduced.
- Grow key clients to the point where they pose a customer concentration risk.
- Allow an intermediary to put out sales collateral and financials that you don't agree with.
- Delegate the decision to advisors.

Internal Transition Option: Is it Feasible?

Leadership Transition

- Have we developed criteria for selecting the next generation leaders/owners?
- Will they be able to successfully run the firm?
- Can we convince them to invest some of their own cash to buy shares in our company?
- Are they willing to reinvest their equity bonuses to buy more shares?

Ownership Transition

- What is the value of the firm today?
- Can we increase it enough to meet our retirement needs?
- Can we generate enough profits and cash flow to allow the buyers to buy our shares?
- Do we have enough time to get the money into the buyers' hands so the sellers get fair value?

Overview of External Sale Process

1.) Develop sale process goals and objectives:

- Timing, price vs. legacy trade-offs, time commitment & role.

2.) Develop buyer target list based on goals and objectives.

3.) Solicitation using sanitized “teaser”.

4.) NDA and disclosure of seller to interested responders.

5.) Facilitate information sharing with Information Memorandum package.

6.) Site visits and negotiations with multiple candidates.

7.) Term sheet and LOI with exclusivity period granted to best buyer prospect.

8.) Due diligence and documentation preparing for closing.

9.) Closing and announcement.

Perspectives for Buyers

Utilizing M&A to Support Strategic Growth Objectives:

- Acquiring revenue is a faster path than growing revenue.
  - Geographic expansion vs. cold start of branch office.
  - Expand service offering.
  - Enter new market segments.
  - Gain access to key clients.
  - Acquire talent in a talent starved market.

- Synergy between existing operations and acquired company can elevate financial return on investment:

  Synergy

  Potential with Acquisitions ➔ 1 + 1 = 3

But!

- Acquisitions can be risky:
  - Financial return on investment.
  - Cultural fit and integration risks.
  - Assets (people) are fugitive and can leave if acquisition is not structured and communicated properly to motivate alignment.

How Does an Acquisition Speed Growth?

Expansion Strategies	Geographic Dimension	Practice Area Dimension	Client Type Dimension
1. Use an existing project to set up a permanent presence	✓		
2. Follow a client to new locations	✓		
3. Send one of your "young turks" to plant your flag in a new location	✓		
4. Sell new service to existing clients		✓	
5. Hang out where those clients go			✓
6. Learn the client's business			✓
7. Hire a “market leader” – Good Luck!!!	✓	✓	✓
8. Acquire firm with good reputation *(highest risk and reward)*	✓	✓	✓

Geographic Expansion- Acquisition vs. "Cold Start"

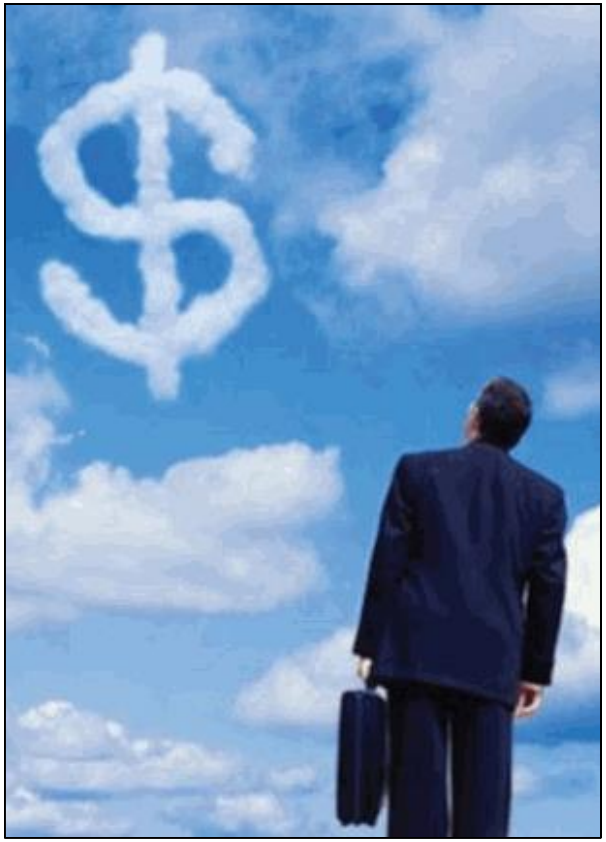
	Acquisition	Cold Start
Advantages	▪ Established client base ▪ Existing office space ▪ Equipment in place ▪ Knowledgeable support staff ▪ Shorter lead time to up-and- running ▪ Faster return on investment	▪ Your own culture in new location ▪ Hire only necessary staff ▪ Easier to "cut and run" ▪ Growth opportunity for existing staff
Disadvantages	▪ May have to send in manager ▪ Employees must shift loyalties ▪ Costs may be harder to recover ▪ Establishing new identity may be difficult ▪ Integration problems may occur	▪ High set-up costs ▪ Cost of "cold" marketing ▪ Have to train management ▪ Longer time to profitability

Common Reasons Why Acquisitions Fail

- Conflicting corporate cultures
- Poor strategic fit
- Conflicting expectations (between buyer/seller)
- Lack of key staff buy-in
- Loss of business momentum (post-merger)
- Unrealistic performance or synergy expectations
- Inadequate preparation (pre-merger)

Failure Often Caused by Cultural Mismatch

Business-Centered Buyer



Practice-Centered Seller

Three Types of M&A Synergy

1 + 1 = 3

Strategic Synergy:
Increasing net revenues by improving market position or reducing subcontracting.

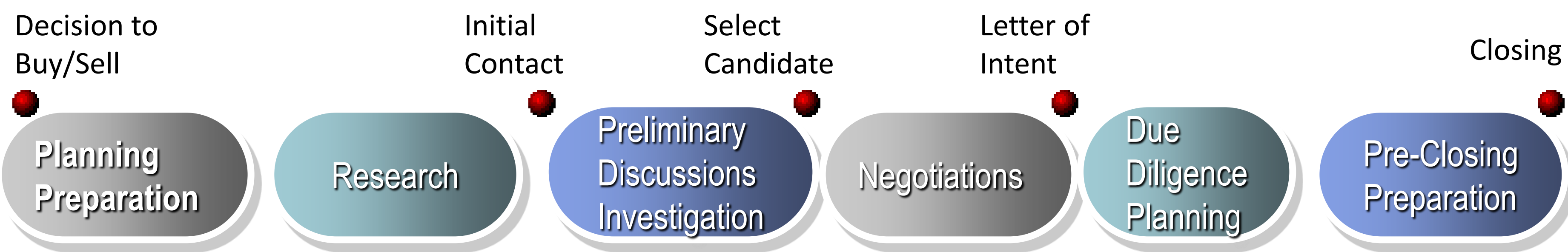
1 + 1 = 2.5

Efficiency Synergy:
Reducing overhead by consolidating office space, back-office functions, etc.

1 + 1 = 1.5

Negative Synergy:
Reducing overall profits because of integration difficulties.

Steps in the Acquisition Process



- Planning & Preparation (Including Retaining an M&A Consultant)
- Research/Identifying Candidates & Making Initial Contact
- Preliminary Discussions and Continued Investigation
- Negotiations & Reaching Agreement-in-Principle (LOI Point)
- Due Diligence Process & Post-Merger Planning
- Pre-Closing Preparation: Including Final Negotiations & Documentation
- Closing & Announcements

Buyer’s Acquisition Team

- First agree on a process & close on strategy.
- Clearly define team member roles.
- Team may include:
  - CEO or COO
  - CFO or finance manager/analyst
  - Functional manager
  - HR
  - “Deal Champion”
  - Advisors (Legal, CPA/tax, M&A)

Developing Search Criteria

- Profiling the ideal candidate:
  - Size: Annual Revenue / # of Employees
  - Geographical Location
  - Service Capabilities
  - Primary Markets / Client Targets
  - Project Types
  - Cultural Considerations

Objective: Look for the Intersection of Strategy and Opportunity

Implementing the Search

- "Ideal" Seller Profile – is it on target?
- Do you have a good target list?
- Making initial contact
- Use of an Intermediary
- The objective of initial contact

Typical Negotiation & Documentation Process

1.) Term sheet:

- Initial deal structure offer.
- Preliminary indications on price, deal structure, and key terms and conditions.
- Brief, non-binding, sets foundation for LOI and further disclosure.

2.) Letter of Intent:

- Prepared by a lawyer, defines all key terms and agreements of deal.
- Sets schedule and responsibilities of both parties to get to closing and definitive, binding transaction documents.
- Non-binding with binding provisions (Exclusivity period, confidentiality, non-disclosure, transaction costs).

3.) Closing Documents:

- Binding contracts that execute the transaction: Asset Purchase Agreement (or Stock), Employment Agreements, Non-Competes, Promissory Notes, Lease & Contract Assignments, Shareholder Agreements, Loan Agreements, etc.

Negotiation Strategy

- Flush out interest from the other party quickly and get alignment on deal structure, valuation, and critical non-financial matters EARLY in the process.
- Do not avoid or delay difficult topics.
- It is helpful to define price based on a metric such as an agreed multiple of Adj. EBITDA.
- Late stage deal failure is emotionally and financially painful. It can also damage reputation and client relationships.
- Due diligence between LOI and closing is not the time to be making go/no-go decisions.

Due Diligence or Indemnification?

Due Diligence

- Must quantify business risk
- Must identify transaction risk
- Must have good reasons for allocating both
- You are paying for past cash flow, but DD is required to insure sustainability of cash flow in the future

Indemnification

- You'll never find everything
- Some aspects of the deal are hard to define
- Must identify specific reasons for needing indemnification
- One of the reasons why seller financing is a good idea as it provides recourse

Correct Answer - Both

Project Due Diligence in the AE Industry

- Bad projects are a huge risk.

- First, spot check:
  - Earned value vs. expenditures for representative projects
  - Client relations
  - Potential for 3rd party lawsuits (e.g., condo projects)
  - Capabilities of the firm's project managers

- If the spot check turns up problems, start digging deeper.

Are the Cultures Compatible?

MOST ACQUIREES ← → MOST ACQUIRERS

Practice-centered Practice	*Business-centered Practice*
Practice-centered Business	*Business-centered Business*

Consider a Cultural Assessment Survey if you are concerned about cultural fit

Integration Planning

- Key to the success of an acquisition.
- Integrate or assimilate?
- There are many components:
  - Client: Deal PR/communication, relationship transfer.
  - Employees: Roles, reporting relationships, pay & benefits.
  - Infrastructure: Facilities, IT, support organizations.
- <u>The integration plan should be developed during the due diligence process.</u>
  - Involvement from target organization should begin prior to closing.

Post Acquisition Business Plan

- Should be developed during (and as part of) the due diligence process.
- Establish a common vision for the future.
- Communicate the vision to the combined troops.
- Get real commitment from key people.
- Avoid unhealthy conflicts among principals.
- Establish specific action items to realize your business objectives.
- Define (together) the earnout parameters.

Closing

- Legal driven documentation process.
- Formats vary. Live closings being replaced by virtual closings.
- Must be coordinated with communications and first actions from the integration plan, the Day-One Plan.
- Make sure the communication plan is coordinated between buyer and seller.

PSMJ - Mergers & Acquisitions, Ownership & Leadership Transition, & Valuation Services

- Conduct M&A and Ownership Transition roundtable education programs.
- M&A strategic advisory practice:
  - Utilizing M&A as part of a corporate growth strategy.
  - Should I sell my company internally or externally?
- Mergers & Acquisitions:
  - Growth by acquisition strategy development.
  - Buy-side acquisition search and process management advisory services.
  - Sell-side marketing and process management advisory services.
- Ownership and Leadership Transition:
  - Advisory services to help create and implement a plan to sell the firm to internally.
- Valuation:
  - Valuation reports for ESOP, internal stock transfer, OLT, M&A, and other uses.

Active PSMJ M&A Engagements:

- **For Sale:**
  - $6M Texas architectural design firm focused on medical facilities and the national retail sector.
  - $4M Nevada site civil/structural firm.
  - $3M Southern CA planning & landscape architecture firm.
  - $50M West Coast diversified AE firm.
  - $60M Western US construction testing & inspection firm.
  - $25M Australian architectural firm with work throughout SE Asia.

- **Buyer's Searching For:**
  - East Coast site civil/surveying firm of 5 – 50 employees.
  - Southern CA 10-30 person geo-tech firm. LA, Orange Counties or Inland Empire preferred.
  - 5-50 person North Central Plains MEP firm.
  - 5-50 person forensics/loss control consulting firm anywhere in the US.
  - SE US architectural design firm of 25 – 50 people. Military and facilities design experience a plus.
  - A national A/E firm is interested in a successful MEP firm in the Southeast with 10-30 employees. Experience in the healthcare and education markets is a plus.

Q&A

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