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Mergers & Acquisitions in the A/E/C Sector

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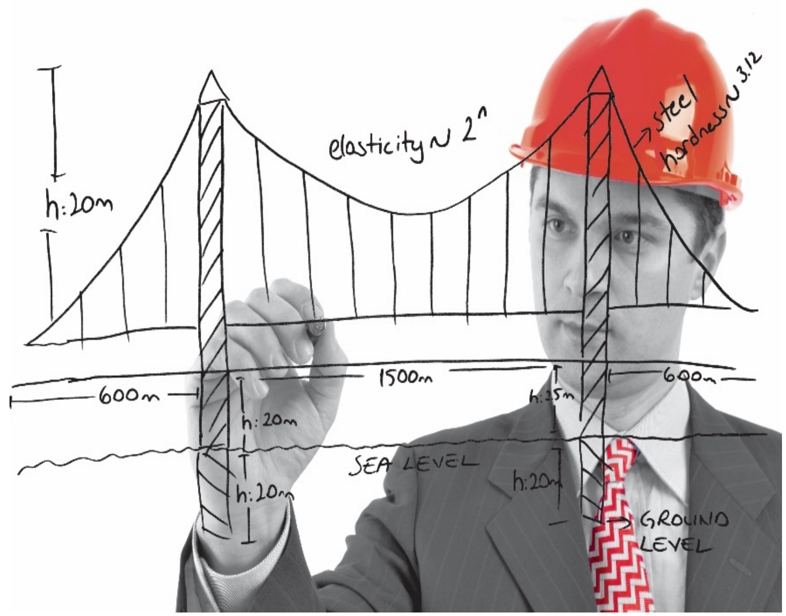


Review Topics

- Overview of the Current M&A Market in the A/E/C Industry
- Buyer & Seller Motives & Options
- M&A Process Overview
- Deal Structure
- Valuation
- Merger Option Review
- Private Equity Recapitalization Option Review

Karl Wohler - Bio

Education:

- BS Chemical Engineering, University of Massachusetts, Amherst
- MBA Finance, Babson College

Experience:

- Polaroid Corporation - Process engineering, R&D, manufacturing
- M&A investment banking advisory
  - Clients included DuPont, Chargeurs, Philips Electronics, Kodak, private equity firms
  - Lower middle market deal work in manufacturing, printing, consulting services
- VP of M&A for Bowne & Co. ($1B financial printing company)
- Owner/CEO of a $16M commercial printing company
- Joined PSMJ M&A advisory practice in early 2016

Overview of Current M&A Market

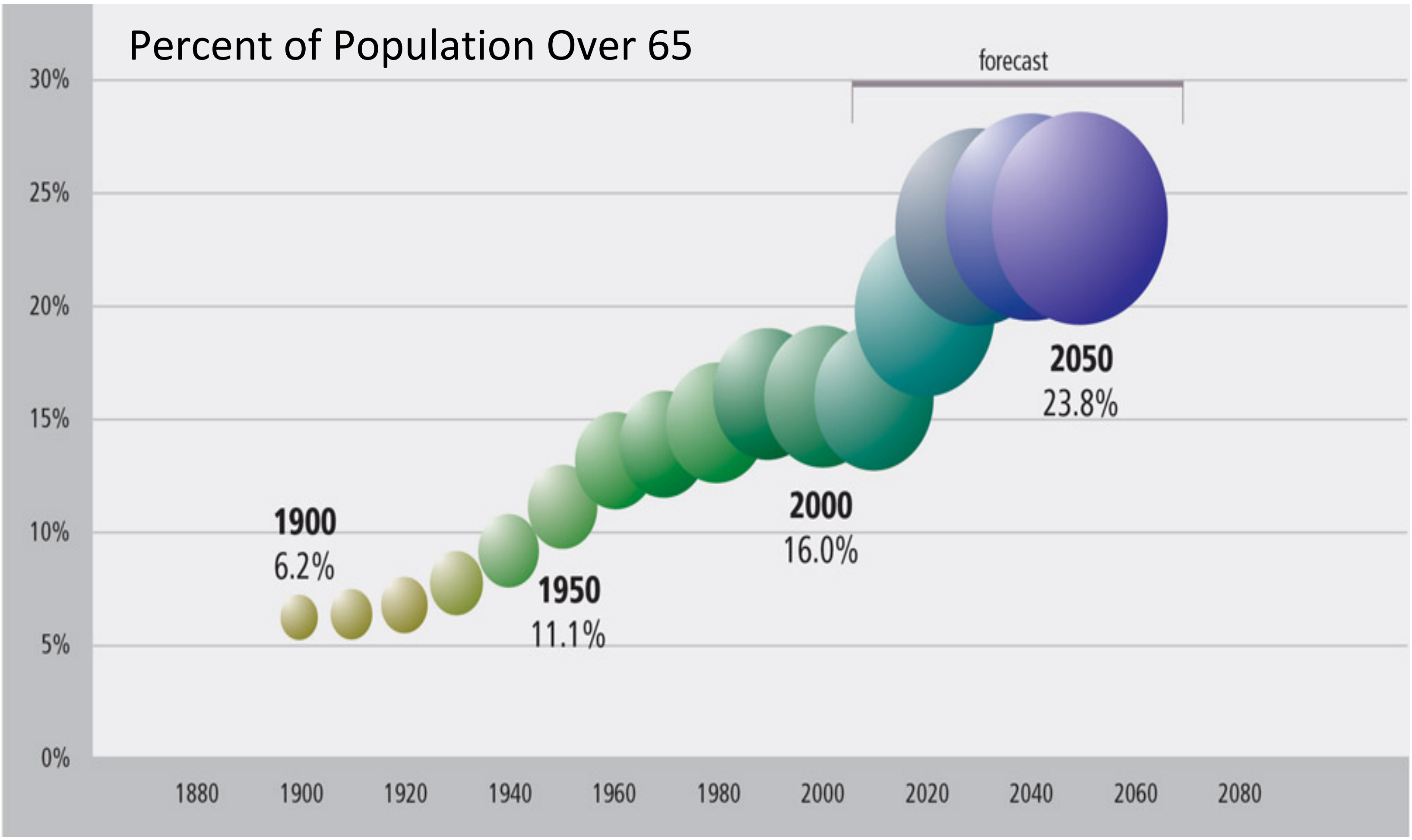
- Aging baby boomers driving retirement exit sales activity.
  - Success conundrum pushing some internal transitions to external sale.

- Desire for new locations, capabilities and talent driving buyer interest.

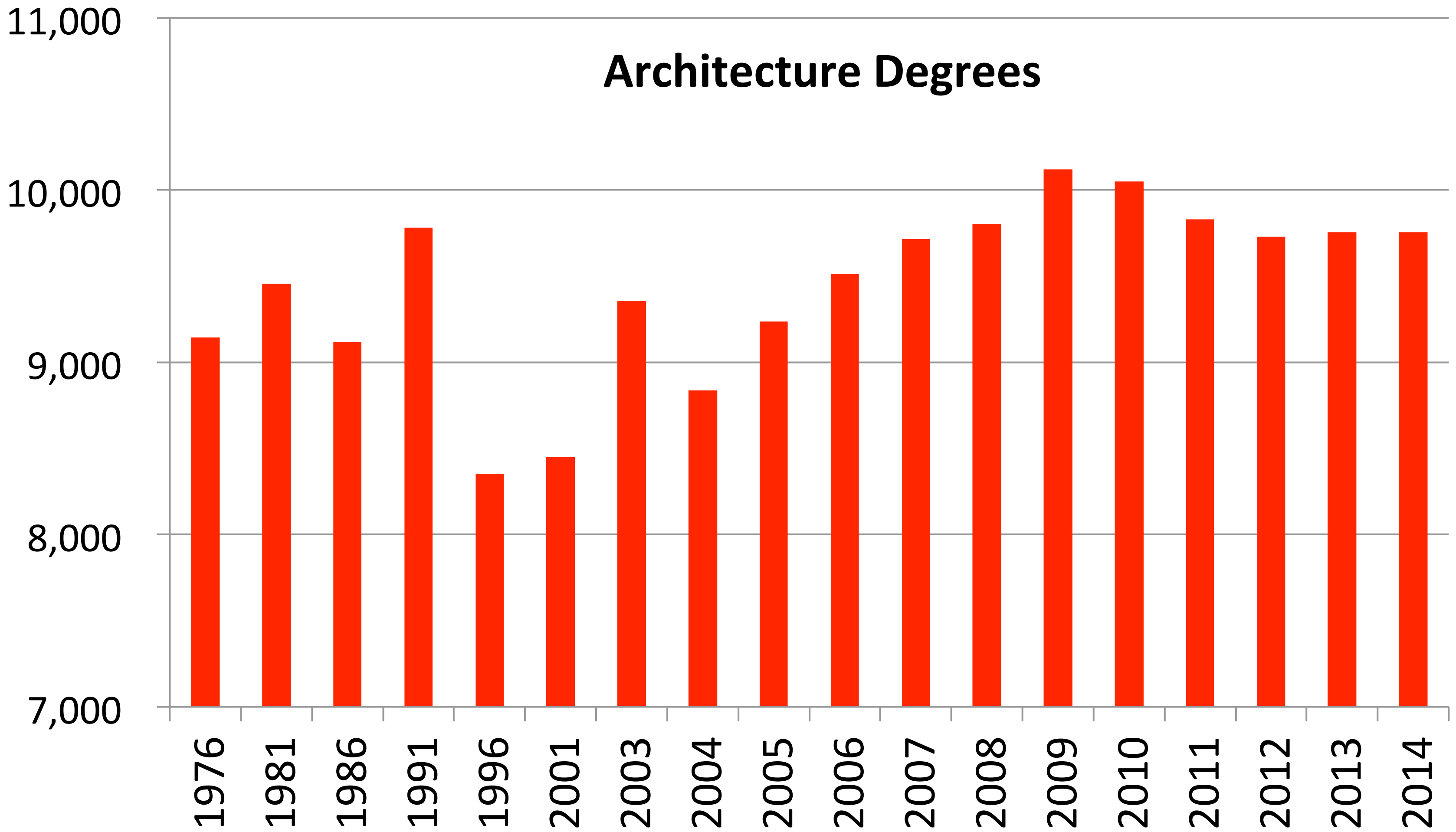
- Private equity interest increasing significantly although mostly in engineering & construction services.

- External sale M&A market robust, but variable:
  - Larger firms attract more interest and sell faster.
  - Engineering and construction services hot, but architecture soft & spotty.
  - Small architecture firms are a real challenge.
  - Hot M&A geographies follow US growth demographics (TX, CA, FL).
  - Infrastructure is hot.

The Retirement Wave is Coming



But, There is a Shortage of 40-somethings



The Net Effect

- Lots of retirement exit transitions overdue, in progress, or planned in the near future.
- Gap in talent for the baton pass to an experienced next level of command.
- Pushing some internal transfers to external sale or mergers and impacting transition timelines for external sales.

Seller Options & Buyer Motives

- Internal ownership transition market very active, but:
  - Some shift to external sale due to weak interest among next generation leaders.
  - Success conundrum creating other internal transfer challenges.
- Private equity showing increased interest in the professional services sector.
  - >$1 Trillion in dry powder and cheap debt driving diversification push leading to higher price multiples.
- Geographic and service area expansion are the leading drivers for add-on acquisitions.
- Shortage of talent is driving some M&A activity with M&A used as a talent acquisition tool.
  - Buy/sell engagements to solve stalled growth or succession planning issues.

Selling a Business is:

Just like selling a house:

- Want to get the highest price.
- Process will require lawyers and advisors can be helpful.
- Value will be based on the current market and what you have accomplished in improving the asset.
- Will have tax consequences.
- Buyers will want an asset purchase.

Not at all like selling a house:

- **Needs to be confidential!**
- **Valuation comparables are not available to the public.**
- **You will need to stay around for awhile.**
- There is much more buyer risk, so due diligence will be far more rigorous.
- A much more expensive and time consuming process.
- Sellers will likely prefer a stock sale.
- Partial sale, installment sale, and equity rollover options are available.

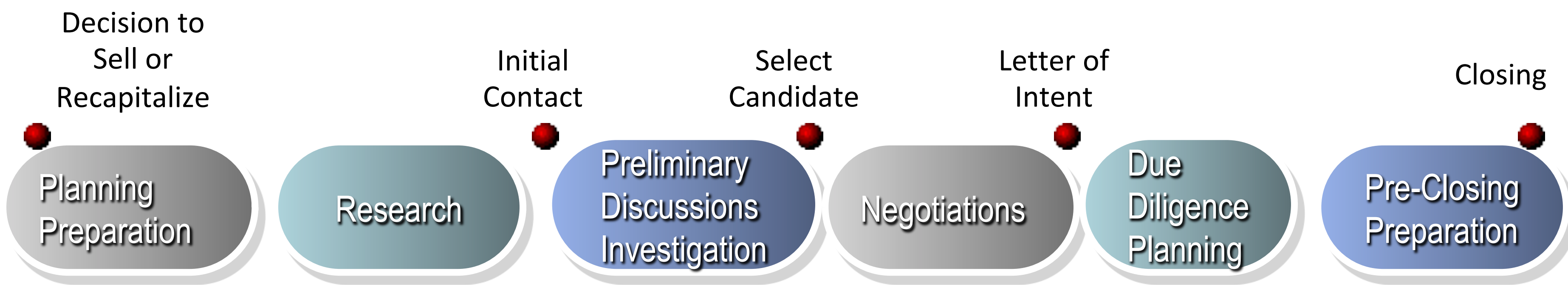
Key Differences vs. a Real Estate Sale

- Confidentiality a must!
  - Adverse consequences of early disclosure:
    - Employees and client will leave.
    - Competitors will poach employees and clients.
    - Difficulty in recruiting new employees and clients.
    - Major “water cooler” distraction and morale risk.
- No readily available valuation comparables.
  - Private transactions with price not disclosed to the public.
- Multi-year post closing transition is a must in most transactions.
- Selection of transaction type will greatly impact all employees and the legacy of the firm.

External Ownership Transition Options

- Outright sale:
  - Strategic buyer (AE firm) − Sell 100%
    - Current shareholders become employees. Some shareholders transition out over negotiated and agreed timetables.
    - Name likely to change over a period of time.
  - Strategic buyer with some equity rollover
    - Typically available with an AE firm with an in-place ownership transition program.
    - Typical structure is selling majority (controlling) interest and allowing other employees to join an ongoing stock ownership program.
- Recapitalization:
  - Financial buyer (private equity, family office, other investment group)
    - They are looking to back management and leave management in place.
    - Typically like to see 20-30% of equity rollover to have a management team with "skin in the game".
- In all cases expect to:
  - Sign an employment agreement and stay for a negotiated period.
  - Sign a non-compete for a period up to five years.
  - Receive payment in the form of cash at close, deferred cash in a note or earnout, and equity in the new entity in the cases involving equity rollover.

Steps in the Sale/Recapitalization Process



- Planning & Preparation – What are my goals in the transaction? Ideal buyer criteria development. Valuation estimate and expectations benchmarking.
- Process Marketing Package Collateral Development
- Research/Identify Candidates & Make 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

Utilizing M&A to Support Strategic Growth Objectives

- Merging or 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 merged company can elevate financial return on investment:

  Synergy Potential with Acquisitions ➔ 1 + 1 = 3

- But mergers and acquisitions can be risky:
  - Cultural fit and integration risks.
  - Assets are fugitive (people) and can leave if merger is not structured and communicated properly to motivate alignment.
  - Equity risk in new structure vs. status quo.

Developing Acquisition Search Criteria

- Search criteria needs to start with corporate strategy:
  - How do we use acquisitions to support our growth strategy?
    - Capital structure plan to fund acquisition?
    - Fit in the strategic plan?
    - Criteria for ideal candidate?
  - How does the acquisition impact internal owner transition?

- 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

External Sale – Deal Structure & Terms

- Deal types – mix of three types:
  - Asset purchase
  - Stock purchase
  - Stock purchase with 338 (h) (10) election (asset deal tax treatment)
  - The tax and legal consequences of the differing structures are significant.
- Terms:
  - Typically 50-70% cash at close with remainder in a seller note payable over 2-3 years.
- Earnouts:
  - Payments made after closing and contingent on future performance.
  - Used often to close valuation gap. Structuring and measurement can be difficult if integration is the goal.

Process – Typical Document Milestones

- Term Sheet
  - Bullet points of key business terms, brief, non-binding
  - Preliminary indications on price, deal structure, and key terms and conditions
  - Prepared by both firms and M&A advisor

- Letter of Intent
  - Detailed outline of the proposed deal, non-binding (subject to due diligence)
  - Prepared by legal counsel from both sides
  - All key terms and conditions should be resolved and documented
  - Process from LOI to Closing should be due diligence, integration planning and legal documents preparation

- Closing Documents
  - Purchase agreement ➔ binding contract
  - Shareholder agreement, employment contracts, lease agreements, etc.

M&A Valuation & Culture Alignment

- The #1 reason why deals don't close is a <u>valuation</u> gap between buyer & seller.
- The #1 reason why closed deals are deemed unsuccessful is a <u>culture and philosophy</u> mismatch between buyer & seller.
- The M&A process is time consuming & expensive, so:
  - Get culture, comfort level & price on the table early in the process to <u>avoid late stage deal failure.</u>
  - <u>Track your value on an ongoing basis to avoid a big disappointment at the time of sale.</u>
    - Know and understand the grading system!

M&A Confidentiality

- The seller must keep the process confidential until closing or as close to closing as possible.
- The buyer needs to respect and honor this requirement.
- Information disclosure is staged to protect "secret sauce" until late in the process.
  - Early: Financials & transition goals ➔ close on valuation and deal structure.
  - Late: Sensitive client, methods, and key employee info ➔after LOI when certainty of closing is high.

Valuation

Fair Market Value - IRS Definition:

Fair market value is the price at which the asset would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts.

Business Valuation Methods

<u>Asset Value:</u> Net market value of assets (liquidation value)

- Sets minimum/liquidation value of firm.

<u>Market/Cash Flow Value:</u> Value as a going concern based on recent profitability performance & market comparables.

- **<u>The most popular method for M&A transactions.</u>**

<u>Projected Income Value:</u> Value based on Net Present Value of projected future earnings.

- Not typically used in M&A (relies on subjective future projections).

The objective for buyers:

<u>Sustainability</u> and growth of profitability after the closing.

Business Valuation for M&A

- The three rules of real estate:
  - Location, Location, Location
- The three rules of business valuation for M&A:
  - EBITDA, EBITDA, EBITDA
- There are dozens and dozens of valuation methods, but <u>EBITDA is used in >90% of all M&A transactions</u>.

M&A Valuation Method & Formula

Blood
Sweat
Tears
$$$$

→ **Business** →

Free Cash Flow
as measured by
Adjusted EBITDA

$$\textbf{Value} = \underbrace{\textbf{Adjusted EBITDA}}_{\text{Internal Performance Metric}} \textbf{ X } \underbrace{\textbf{Market Multiple}}_{\text{External Market Factor}}$$

- 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 liquidation value.

Why Accrual Based EBITDA???

- Net Income is designed to show “all in” operating performance, not cash flow.
  - It includes debt financing costs, amortization of long term investments, non-recurring costs, and income taxes.
  - The goal is to lower Net Income to lower taxes.
  - Cash basis tax payers need to use <u>accrual financials</u> for valuation. Cash is best for taxes as you can defer taxes on your Accounts Receivable. But this deferral distorts performance in any given year.

- EBITDA: <u>E</u>arnings <u>B</u>efore <u>I</u>nterest, <u>T</u>axes, <u>D</u>epreciation & <u>A</u>mortization
  - Backs out financing, taxes and non-cash items (depreciation & amortization).
  - Accrual based EBITDA is a better measure of the Free Cash Flow of the business.

Why is EBITDA Recast or Adjusted?

- Closely held companies need to be adjusted for owner's discretionary items:
  - Adjust owners compensation including bonuses to market rate.
  - Adjust rent to related party to market rate.
  - Back out owners expenses.
- EBITDA is adjusted for non-recurring items:
  - Moving expenses, restructure costs, acquisition expenses, lease exit, etc.
  - Other non-recurring expenses/income.
- Bonuses require special attention. Non-shareholder bonuses included in operating expenses (above the line), shareholder bonuses are "normalized".
- Add EBITDA of acquired companies and deduct EBITDA of divested units.
- The goal is an accurate picture of the EBITDA run rate going forward after the transaction.
- When EBITDA is mentioned in M&A discussions, it is <u>Adjusted EBITDA</u>.

Adjusted EBITDA Worksheet

XYC Corp
P&L and Adjusted EBITDA Worksheet

		2015	2016	2017	2018 Fcst
Total Revenue					
Subs/Reimbursables					
Net Service Revenue		-	-	-	-
Direct Labor					
Gross Margin		-	-	-	-
Total Indirect Expenses					
Total Operating Expenses		-	-	-	-
Total Operating Profit/(Loss)		**-**	**-**	**-**	**-**
Add Back:					
Interest Expense					
Income Taxes					
Depreciation					
Amortizatipn					
EBITDA		**-**	**-**	**-**	**-**
Adjustments:					
Add:	Owners W2 Salaries				
Add:	Owners Bonuses				
Add:	Other Owner Benefits (Elim Post Close)				
Add:	Owners Personal Expenses				
Add:	Rent paid to related party				
Add:	Non-recurring Expenses				
Add:	Other Expense Unrelated to Business				
Add:	Other items?				
Add:	Other items?				
Subtract:	Owners Salaries - Market/Post Close				
Subtract:	Market Rent - Post Close				
Subtract:	Other Income Unrelated to Business				
Subtract:	Other items?				
Subtract:	Other items?				
Total Adjustments to EBITDA:		**-**	**-**	**-**	**-**
Adjusted EBITDA		**-**	**-**	**-**	**-**

- Add back Interest, taxes, depreciation & amortization to obtain EBITDA.
- Adjust to:
  - Normalize rent, owners comp & benefits.
  - Eliminate non-business related expenses.
  - Eliminate non-recurring expenses.

Other Valuation Analogs

Asset Description	What You Have	X	Market Value Factor *(Source)*	=	Market Value
Office Space For Sale Boston	100K Sq Ft Class A	X	\$500 - \$650/PSF *(Colliers Q2 2017 Market Report)*	=	\$50 - \$65M Sale Price
Office Space for Rent Boston	100K Sq Ft Class A	X	\$55 - \$65/PSF Gross *(Colliers Q2 2017 Market Report)*	=	~\$6M/Year Rent
Crude Oil	10 Million Barrels in Texas	X	\$42.52/BBL *(WTI Platts 9/2017)*	=	\$425M
100 Person A&E Firm in California	\$5M of Adjusted EBITDA	X	5.5 - 6.0 X *(PSMJ Proprietary Database)*	=	\$27.5 - \$30M

Comments:

Adjusted EBITDA is used as the unit of measure for business valuation as square feet is used in real estate and barrels is used in the crude oil market.

Unlike crude oil where every in spec barrel is the same, every company is different.

=> So there is a range of valuation multiples for different companies.

Price multiples for privately held companies vary by firm size, location, and type of buyer.

Market Comparables in M&A

- Most deal are private & confidential. This creates an information vacuum filled by good and bad information and methods.
- Price multiples are deal size dependent.
  - Large public (disclosed) deals only provide upper limit input, not value input.
  - This creates public metrics that distort expectations for small firm owners because public companies and larger deals trade at HIGHER multiples.
- Advisory firms keep closed deals statistics and can help with market multiples for targets of all sizes.
- Multiples can help facilitate efficient discussions about value to see if buyer and seller are on the same page regarding valuation.
- Sellers need to understand which performance characteristics affect exit price multiple.

Sample Large Deal Press Release (Abbreviated)

Intertek agrees to acquire PSI for $330 million

Strategic expansion in US growth markets (October 14, 2015)

Intertek Group plc ("Intertek" and the "Group"), a leading quality solutions provider to industries worldwide, announces that it has entered into an agreement to acquire Professional Service Industries, Inc. ("PSI"), for a cash consideration of US$330 million on a cash-free and debt-free basis, which is equivalent to a 7.6x multiple based on adjusted LTM EBITDA of US$43 million for the 12 months to 31 August 2015.

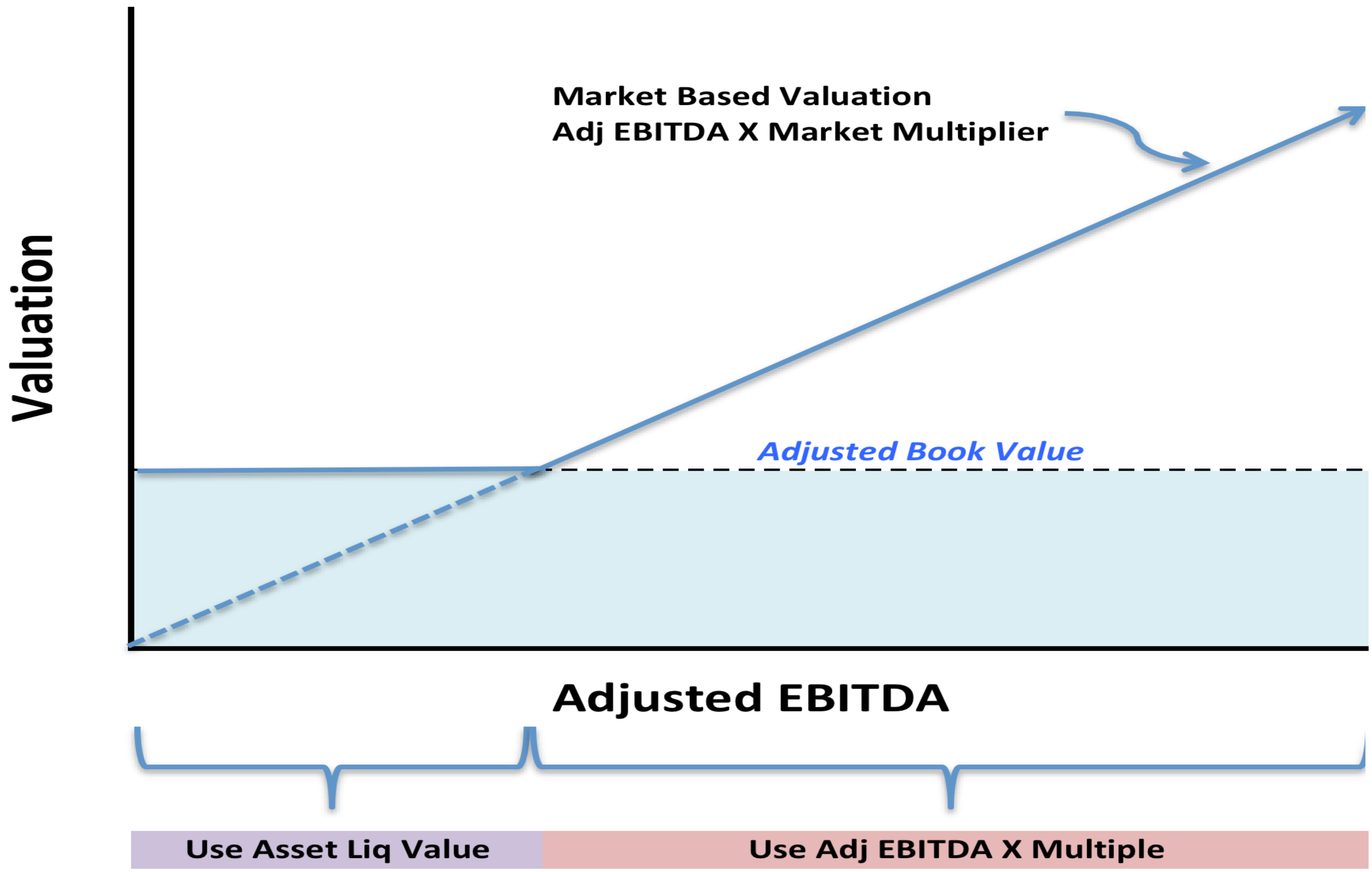
==

Strong financial rationale:

In its audited accounts for the year ended 31 December 2014, PSI reported revenue of US$254 million, adjusted EBITDA of US$40 million and adjusted operating profit of US$29 million.

For the full story, go to: http://www.intertek.com/news/2015/10-14-intertek-agrees-to-acquire-psi/

Using Asset & Market Valuations



Price Multiple vs. Deal Size

	Adjusted EBITDA				
	$500K	**$1M**	**$2M**	**$5M**	**$10M**
Price Multiple -Low	3.0	3.5	4.5	5.0	5.5
Price Multiple - Median	3.2	4.0	5.0	5.5	6.5
Price Multiple - High	3.5	4.5	5.5	6.0	7.5

Why do larger deals trade at higher multiples?

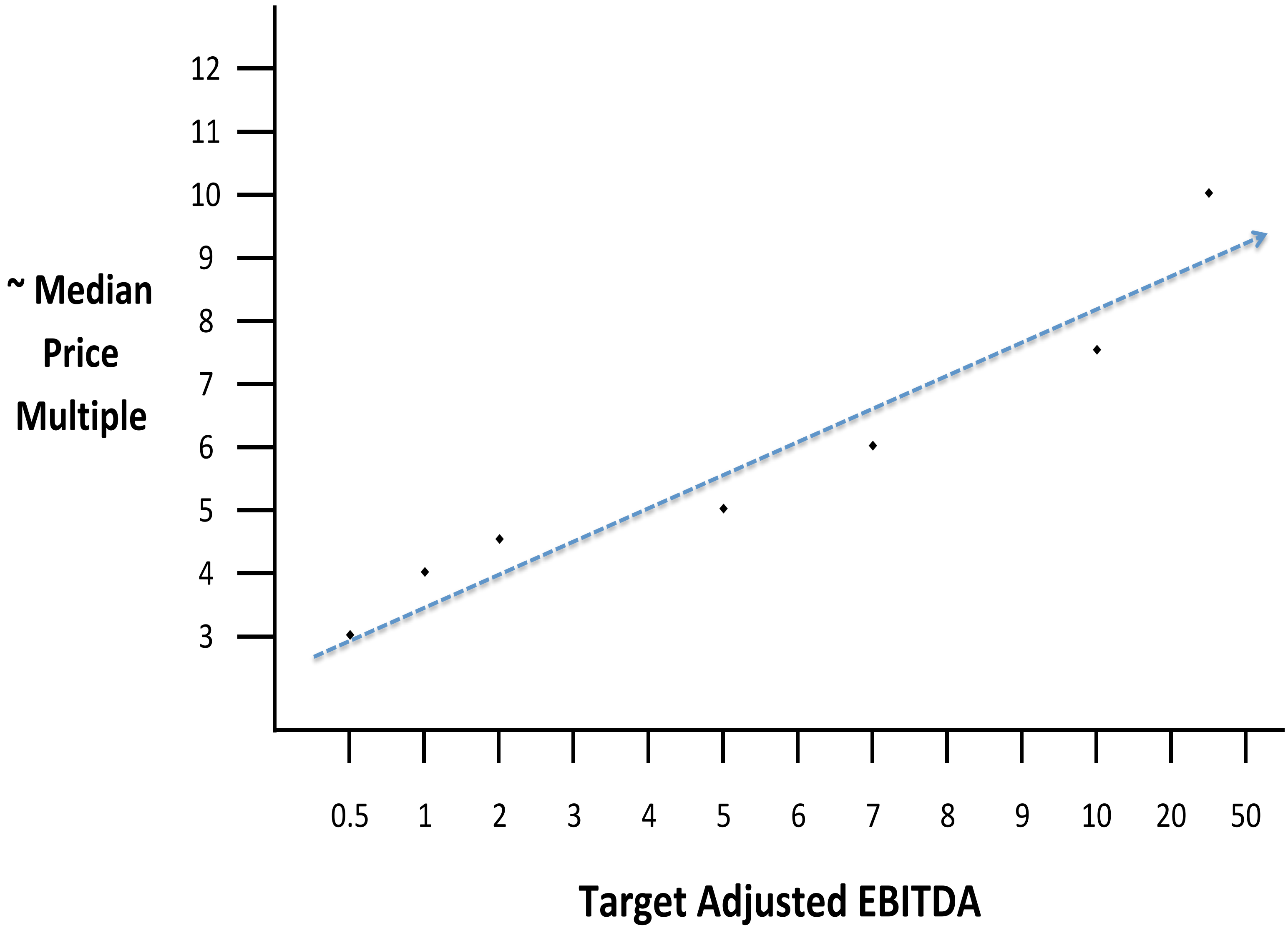
- Public companies trade at ~15X, so they can pay more, but they prefer bigger deals.
- Larger deals provide economy of scale with respect to transaction and financing costs.
- Larger deals are considered lower risk (more distributed revenue and leadership).

Why do deals trade over a range of multiples?

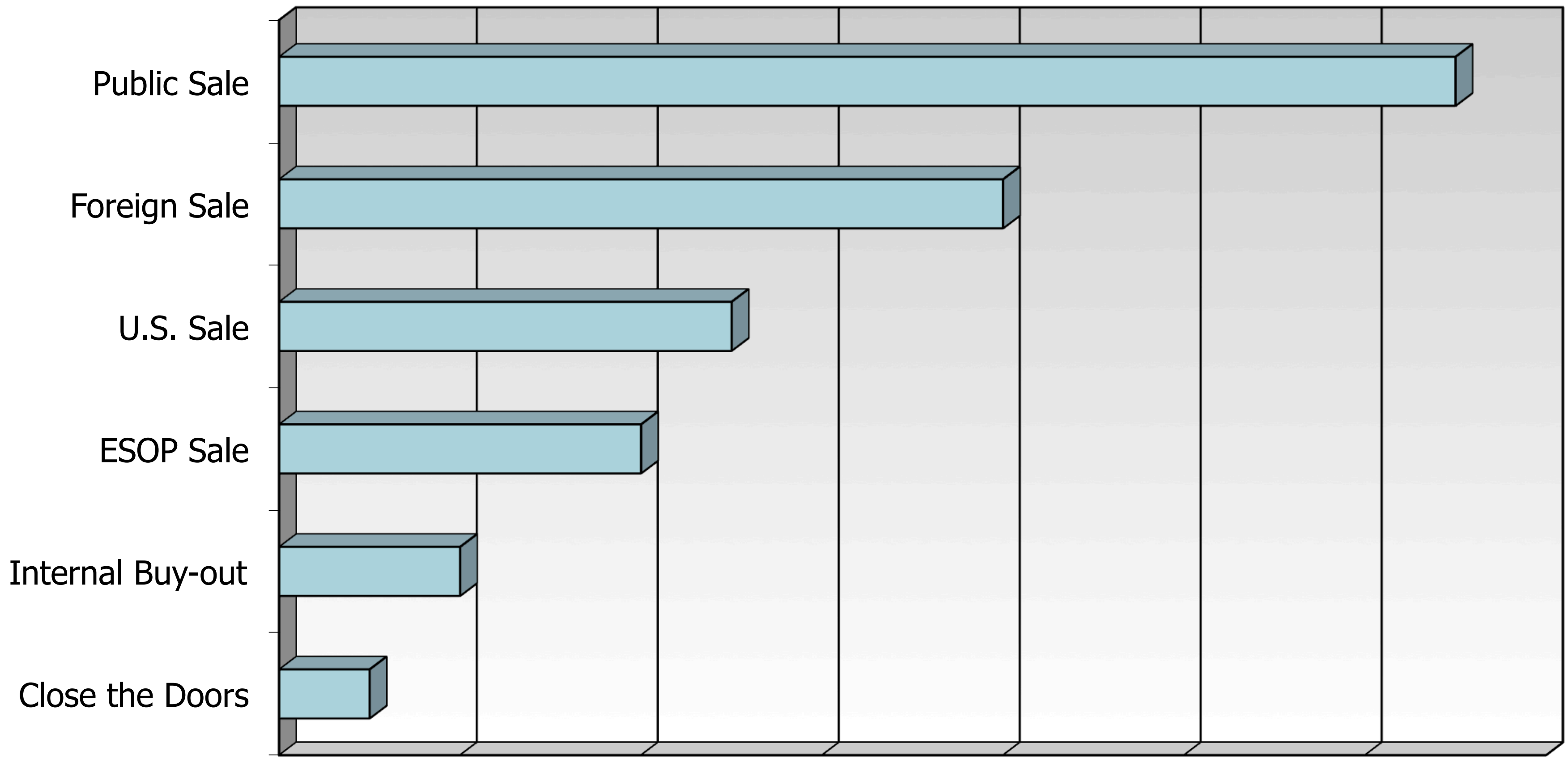
- Buyer type influences their willingness/ability to pay higher multiples.
- Firm attributes vs. industry averages impact multiple:

Factors That Increase Multiple	**Factors That Decrease Multiple**
Higher EBITDA Margin %	High customer concentration
Stable revenue and earnings growth	Clients relationship concentration
Fast growing location	Poor financial reporting/forecasting
Niche position in market	Cyclical earnings

Median Price Multiple vs. Deal Size



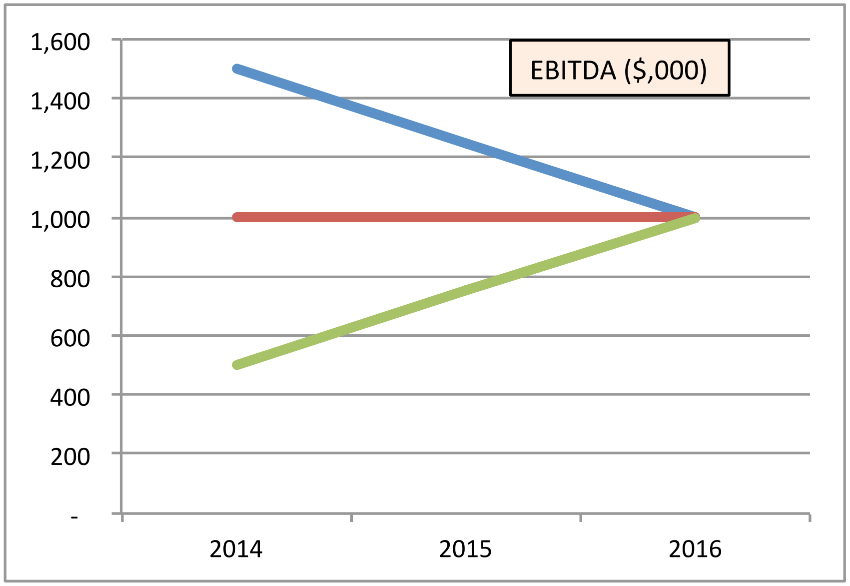
Value Depends Greatly on the Buyer



Relative Price/Earnings (EBITDA) Ratio

Earnings Basis:
Trailing 12 Months or Multiyear Average?

- Should you use trailing 12 months of EBITDA, or a three-year average?
- Averages are appropriate for cyclical businesses, but not for stable, growing businesses.
- Many buyers use three-year averages. So one early discussion point is what is your earnings basis for valuation?



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%

Valuation Key Takeaways

- Valuation is driven by sustainability and growth potential of profit (Adjusted EBITDA) post closing.

- Valuation is not driven by awards, revenue, headcount, fancy offices, backlog. It is all about Adjusted EBITDA!!!

- Valuation is different for different buyers.
  - Larger, public firms will typically pay higher multiples.
  - Some buyers are bargain hunters, so it is good to flush this out early.
  - So businesses will sell for a wider range of valuations than real estate or other assets.

- Cyclicality of earnings, key person reliance and customer concentration are the <u>three most significant valuation killers</u>.

What is a Merger?

- A formal and legal “marriage” of two firms to create one combined entity.
  - Branding/naming, publicity, integration and organization plans are business decisions with latitude on extent and timing.
- A Business Process:
  - What are the business objectives?
  - How do we manage the business decisions to achieve the business objectives?
  - How do we establish a fair structure?
- An Individual Process:
  - How do we manage the merger to make it a win for as many shareholders and employees as possible? Address to question: “What’s in it for me?”
- Legal process:
  - Managing and implementing the legal and tax mechanics.

Is a Merger Right for Us?

- The top priority is to answer the WHY?
  - Will we be better off in 2, 5 and 10 years with a merger?
  - What are the opportunities? What do we gain?
  - What are the risks? What do we lose?

- The second question is how to accomplish a fair merger?
  - Valuation/new shareholder plan and buy/sell agreement, transition plan.
  - Shareholder and employee impacts: financial, risk, career (role and mobility) , quality of work life.
  - An unfair structure can undermine a powerful why.

- Critical questions:
  - Will a merger be good for the firm?
  - Will a merger be good for me?

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.

Private Equity Recapitalization

- Private equity deals are referred to as recapitalizations as some equity is rolled over (retained) by the seller.
- This can be a compromise solution with some features more like internal transition than an outright sale.
- PE investors are typically interested in backing management, not replacing management.
- The name may stay the same or you may be co-branded with other A/E firms acquired by the PE firm to create a group of companies.
- PE recaps are becoming more common with new private equity firms entering the A/E/C market.
- PE firms have over $1 trillion of available investment cash driving their acquisition appetite and pushing valuations higher.

What is Private Equity?

- A firm that takes investor money into funds and invests and manages these funds on behalf of the investors. The goal is to provide a higher investment returns than other market options.

- Their focus is to acquire private, lower middle market firms from private sellers.

- Funds typically have a defined focus allowing passive investors to participate in private company (low middle market) with oversight by the private equity partners.

- Similar to how REIT's allows passive investors participate in the real estate market.

- Investors include endowment funds, insurance companies, high net worth individuals, pension plans, etc.

- Funds typically have a 5 − 7 year term, which can drive exit timing.

Comparing External Sale – PE Recap – Internal

	External Sale	PE Recapitalization	Internal Transition
Name	Likey to change to buyer name	Likely to remain unchanged or co-branded with platform	Unchanged
Leadership	Depends on buyer plans/negotiable 2 - 3 year required stay common	Typically look for continued leadership involvement for 3 - 5 years	Internal trasnsition to next generation of leadership
Valuation	Market Value	Market Value	20 - 70% below market value
Deal Structure	50 - 70% cash at close 30 - 50% seller note	10 - 40% owner equity rolled Remainder in buyer cash and bank debt	Multi-year payout to retiring members
Continuation of Employee Ownership	Eliminated in most sales. Can still be an option if buyer has an internal transition program	Yes through rolled equity Many PE firms also provide a 10% stock options pool for key employees	Yes as per buy/sell agreement and internal transition guidelines
Risk	Lowest	Moderate 60 - 90% of equity taken off table Rolled equty at risk	Highest Risk Payout dependent on firm performance

Pros & Cons of a Private Equity Recap

- Pros:
  - Legacy remains more intact with name and leadership retention.
  - Higher exit valuation and faster payout for retiring members.
  - More financial backing and management expertise brought to the table.
  - Continuation of ownership path for key employees.
- Cons:
  - Concern with short-term ownership horizon (<5 years).
  - Rolled equity at risk with loss of control.
  - Profit growth and add-on acquisition focus may not be consistent with culture.
  - Reduced ownership opportunity vs. internal transition.

In Closing – Key Takeaways

- Prepare for your exit transition throughout the life cycle of the firm.
- Determine and track Adjusted EBITDA every year so you can track valuation improvement over time.
- Understand the realities of valuation so the first offer doesn't become the messenger that gets shot.
- Understand the valuation killers (customer concentration, key person reliance, cyclical earnings) and work over the long run to minimize adverse impacts.
- Be aware of exit transition timeline so the process is not rushed or your departure delayed.
- Beware of culture issues and their impact on success.
- Never fall in love with a deal. Get the issues out early in the process and move on if the issues are significant.

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, the United Kingdom 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. We also conduct industry surveys and issue survey reports on topics ranging from compensation to financial performance.

- **Advisory Services:** PSMJ's sought-after expertise covers a range of critical business areas such as strategic planning, mergers & acquisitions, project management, valuation, and succession planning.

PSMJ M&A Advisory Services

- Conduct M&A and Ownership Transition roundtable education programs.
- M&A strategic advisory practice:
  - Should I sell my company internally or externally?
  - Utilizing M&A as part of a corporate growth strategy.
- Mergers & Acquisitions:
  - Growth by acquisition strategy development.
  - Buyer Representation: Buy-side acquisition search and process management advisory services.
  - Seller Representation: 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.

Thank You!

For more information, please contact:

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