CHAPTER ONE

The Current State of M&A for Architects and Engineers

The architecture and engineering industry has seen large swings in growth and decline, largely a reflection of macro-economic conditions beyond the control of the industry itself. At the time of this writing in 2018, we are enjoying an extended growth period following the Great Recession. However, there are significant economic factors that will affect the industry and M&A activity in the years to come. While these forces have already led many firms towards market consolidation, we want to evaluate how the future looks for continued M&A activity.

Three Industry Trends

For years, the A/E industry saw mostly steady growth, with the occasional short-duration slowdown, closely mirroring the health of the general economy. Similarly, the Great Recession impacted the A/E industry dramatically, leading to a net loss of 200,000 jobs from the peak of 1.45 million in 2008. Since the low-point in 2010, those numbers have been steadily climbing, and overall, the A/E industry is larger than it was before the pre-recession peak. Consequently, there are three trends we are observing in the current M&A environment.

To begin with, **large firms are actively looking at deals, with a distinct interest in larger acquisition candidates**—particularly if they have special expertise or markets, desirable (Read: growth potential) locations, and profitability. Structural growth with cultural compatibility is the main criteria. Thus, it is more important than ever to understand the strategies and cultures of these acquiring companies.

A second trend we are seeing is that **buyers of smaller companies, particularly architectural firms, are less abundant and less energized than they were a few years ago**. As a result, many companies are in "shopping" mode longer than expected. Two observations we should draw from this: 1) patience is important, and impatience can be costly; 2) it is

important to get and keep your financial numbers up. Sellers that are planning to exit in this period may need to adjust their expectations in terms of firm value and time it takes to close on a deal.

So, while companies with a desirable specialization, location etc. will still get the interest of the big buyers, it may be worthwhile for most sellers to consider broadening their view of ideal acquirers.

Finally, **earnouts are bridging the valuation gap**. No one is overly confident in an uncertain economic climate, and accordingly, earnouts are gaining popularity in bridging valuation gaps and making deals happen.

The Reasons Sellers Sell…and the Myth of the "Distressed Sale"

If buyers are more cautious *and* M&A is up, it stands to reason that there are a lot of healthy sellers out there. Not every seller has to sell; they *want* to sell.

Anecdotally, PSMJ observes three key reasons behind sales today:

1. **To facilitate ownership transition.** This is far and away the strongest drive. Many firm leaders realize they may not face the issue of underfunded stock redemption liabilities tomorrow, but that it could be lurking on the horizon over the next five to 10 years. As such, these firm leaders understand the importance of planning for transition now (before considerable value is eroded as retirement draws closer). This is an important point. All other things being equal, there is less risk for the buyer if the selling owner is 55 years old versus one who is 65 and ready to cash out. Put another way, there is a longer timeframe to transition/institutionalize key client relationships and knowledge.

2. **To get back to what they enjoy doing.** Running a company and working on projects require two completely different skillsets. This is especially true in sole-shareholder firms and firms of fewer than 20 employees. Many of these business owners are tired of pushing the stone up the hill, and want to unload some of the administrative burden of running the business (e.g., dealing with insurance renewals and HR issues), and return to the passion that got them in the business. Their goal is to team up with a firm and focus on flagship projects and business development.

3. **To gain the resources to accomplish more**. That's an effect of commoditization. Sellers have carved out a niche and see competition gaining ground, and they realize that if they can team up with a larger firm, they can scale up considerably into new geographies and markets.

Again, these aren't all distressed sales. However, they are driven by a goal-oriented objective, and they see that their current path will not meet that objective.

Acquisitions Speed Revenue Growth

For a firm seeking revenue growth of 20 percent or more per year, acquisitions are the fast track. It can be very difficult to achieve sustained growth at this level solely through organic means.

To be sure, organic growth can seem more "comfortable"—you foster in-house talent and capabilities and stretch your geographic boundaries. Your work is so exceptional that you have 95 percent repeat business, and all the new business you could hope for through referrals.

Organic growth works, particularly for firms under $25 million where it represents about 80 percent of revenue growth according to industry data. But it represented only a third of revenue growth for firms larger than $1 billion for the seven-year period of 2005 to 2011. These larger firms increasingly rely acquisitions to achieve growth objectives.

The following table outlines the various strategies that a firm may deploy to achieve growth objectives. It then charts these strategies against the specific growth objectives that they achieve. As an example, following a client to a new location is a very common strategy for geographic expansion. But, it does nothing for practice area or client type expansion.

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 a young emerging leader 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)	✓	✓	✓

Acquisitions (Strategy No. 8 in the table above) speed growth because they provide nearly immediate expansion across the three possible growth dimensions—geographic, practice area, and client type.

There is only one other way to grow across geography, practice area, and client type in one fell swoop. That is by hiring a true market leader (Strategy No. 7), permanently. On the surface, this person may seem impossible to find. That is because they generally are impossible to find. Not only are these the cream of the crop when it comes to recruiting, but they are usually principals and/or shareholders in their own firms and are restricted from leaving by non-compete agreements and/or financial penalties, and sheer loyalty.

The Situation:

A 300-person infrastructure engineering firm with five offices in the Midwest was looking to expand east, and make an acquisition in the Mid-Atlantic states. They were introduced to a 70-person civil/survey/ environmental firm headquartered in Virginia with small offices in West Virginia and South Carolina. The selling firm had been in existence for only seven years and was founded by three senior engineers who didn't like the fact that their previous employer had sold to an A/E mega-firm several years earlier. The buyer had never purchased a firm this large before and this was a purely opportunistic strategy by the sellers.

Seller Details:

- Average annual revenue - $10,500,000 (growing at 15 percent per year)
- Average annual profits - $1,500,000 (only over the last three years)
- Shareholder equity - $2,200,000
- Contract backlog - $17,500,000 (signed contracts – no speculation)
- Principals expect to stay for three to five years along with four other key associates.

Buyer's Offer:

$6,500,000 paid 50 percent in cash at closing, 40 percent in a three-year note, and 10 percent in buyer stock.

Justification:

The buyer was very attracted to the seller's business and especially to the youngest of the founders who they saw as CEO material. However, four times annual profits for a firm without much track record was seen by the buyer as aggressive and somewhat risky. The buyer had an independent BOD that applied a high degree of scrutiny on the deal. They referred to

"betting the farm" several times in meetings.

What Happened:

Due to the skyrocketing growth and strong backlog of the seller, the three founders' counter-offer was $10M cash paid in three equal annual installments. They presented a pro forma business plan that showed $12M in revenue and $3M in profits. The sellers were unwilling to negotiate from that position, and were very confident of their ability to keep growing independently. Through some very astute deal structuring and persuasion of the board, the buyer agreed to $10M over three years, but the final payment was subject to performance goals (earnout). The potential upside for the sellers was an additional $2M. The deal closed, and the first two years exceeded everyone's expectations. The key leader of the seller now runs the entire transportation operation for the 400-person firm and the final "bonus" payment for the third year looks to be almost a certainty.

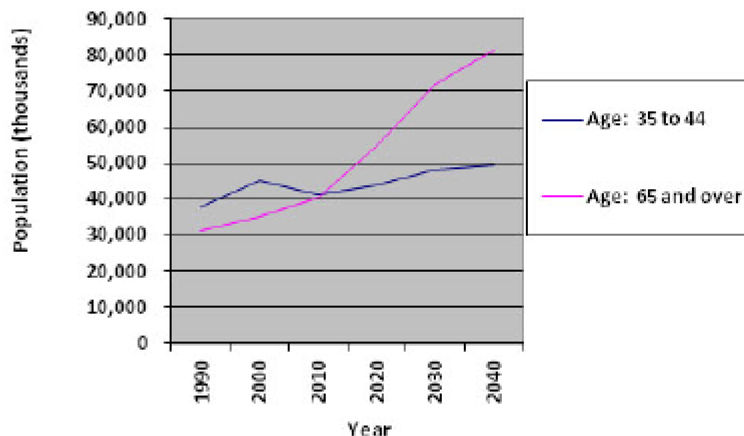
Five Long-Term Forces Driving M&A

Dozens of macroeconomic forces affect A/E firms, but the following five in particular are behind the growth in M&A activity.

1. The Capitalization Bubble Is Beginning to Burst

As the Baby Boomer generation has aged, an interesting economic phenomenon has occurred: The largest generational cohort has transitioned from "buyers" to "sellers" as their careers moved up from employee to manager to owner. The Baby Boom (1945-1964) was followed by the Baby Bust (1965-1984) with a significantly smaller cohort, who are just now in their 40's and 50's. The next large cohort, the Echo Boomers or Millennials are just hitting their 30's.

Simply put, we're facing an inverse ratio of buyers to seller, which enables buyers to be more selective. According to *US Census Bureau* data (see the chart below), Americans aged 65 and older (the typical sellers) overtook the number of Americans aged 35 to 44 (the typical buyers) in 2010, and the gap is widening rapidly.



On top of that, many senior firm leaders as part of their retirement plans want to create liquidity and monetize their equity holdings. This poses significant financial hurdles for even a healthy firm, and a lot of firms simply can't manage it; younger partners typically are not in a financial position to buy them out, so an external sale seems to be the only option.

But, most merger and transaction plans require that key leaders of the selling firm stick around for three to five years. The selling firm devalues itself considerably by waiting until the 11th hour—which unfortunately, most of them do. Leaders are busy with revenue-generating work. They know they should have a succession plan in place, but have kept it on the back burner.

In fact, PSMJ surveys reveal that while eight in 10 firms of over 500 employees have a plan, that number drops to four in 10 for firms of 351 to 500 employees; and just three in 10 for firms under 20 employees. However, almost nine in 10 mid-sized firms of 101 to 200 employees have a plan in place, with actions being taken. These are the active mid-tier acquirers and acquisition targets we spoke of before.

If your firm has no formal ownership and leadership succession plan, *you should begin planning now*, while you still have some runway ahead.

2. Bigger Is Better, Now More Than Ever

Just about every acquirer subscribes to the idea that bigger is better, and increasingly, so do clients.

Of course, there will always be a place for specialists and niche firms, with their deep expertise and client-centric nature. But the idea that an A/E firm creates value *through* growth is gaining ground. A large and sophisticated client likes the idea of more resources from a single firm, believing that ensures smoother, faster, more efficient delivery. Large firms too can attract top-notch projects and talent, and can capitalize on economies of scale and scope.

3. Everyone (and Everything) Is Global

For a good many A/E firms, international exposure helped them survive the Great Recession. Even small, niche design firms have established a respectable presence in emerging (or thriving) international markets.

Of course, that activity goes both ways, and non-U.S. firms recognize that the right acquisition is the quickest way to enter the U.S. market. An acquisition is the quickest way to enter *any* market, be it overseas or within the U.S. Despite the current pollical tensions, we anticipate that cross-border M&A activity will continue to gain ground in the coming years.

4. Private Equity Is Starting to Like What They See

The chilly relationship between A/E firms and investors is beginning to thaw. Traditionally, A/E leaders disliked the idea of answering to a board, and private equity investors were put off by the people-based, non-scalable nature of the A/E industry.

But A/E firms who find insufficient capital their biggest obstacle to growth are rethinking private equity investment. In turn, the investors are seeing diminishing returns from what were once hot markets, and they are seeing

strong demand in markets like energy, healthcare, and water/wastewater. Certainly, investment hasn't reached the level of activity you'd find in high-tech or manufacturing, but PSMJ is hearing from an increasing number of private equity firms interested in A/E opportunities.

The upshot: The financial buyer is becoming a formidable competitor to the strategic buyer.

5. Changing Definition of "Core" Business for A/E Firms

The A/E industry has long held the belief that a core competency—a strength that can't be easily replicated by competitors—translates into a deep project portfolio. Be the "go-to firm" for historic restoration, for example, and you'll never want for projects. That has been the conventional wisdom for many years.

Here are three reasons why that conventional "core" business strategy may be less true in today's volatile market:

- **Commoditization.** Whether or not the perception is fair, with dozens or hundreds of competitors claiming the same competence, clients may perceive all firms as equally good.

- **Diminished organic returns.** The fastest-growing firms achieve—organically—somewhere between 10 and 15 percent growth per year in most markets. The absolute fastest-growing firms might reach 20 percent, but that is hard to sustain for long.

- **Staff shortages.** Coming out of one of the greatest economic downturns in U.S. history (and one in which the A/E industry was particularly hard hit) where an unprecedented number of architects and engineers were looking for work, firms struggle to attract and retain quality talent.

Thus, a key strategy has become acquiring one's way into a stronger market position. Whether to consolidate market position or to expand beyond historic markets, M&A is an increasingly powerful tool in the A/E industry.

Sellers: Plan Now for Succession

Both the niche micro-shop and giants like HOK have their place. Sandwiched in between are the mid-sized firms contemplating whether to "eat or be eaten," through M&A. The time for action is now, with two specific actions:

1. **Develop a succession plan.** This plan will articulate the transition of ownership and leadership over a ten-year planning horizon.
2. **Develop a leadership development plan.** This will be a program that identifies and cultivates future leaders (and shareholders) in the organization.

If neither is feasible or practical, then:

3. **Develop an action plan for an external sale—now!** Buyers will be far more interested in your firm *if* they are assured that your leaders and rainmakers will stick around.

Simply put, buyers are disinterested in firms wherein leadership is at retirement age and looking to cash out.