But Who's Going to Buy ME Out?

Three Paths for A/E Owners

by Steve Gido

I recently met with the senior leadership team at an 85-person, multi-discipline engineering firm in the southeast - let's call them ACME Engineers. Despite the impact of Covid, ACME Engineers was coming off the best year in the company's history. The team felt proud of their financial success and client accomplishments given the environment, and with the possibility of a few big projects breaking their way felt 2021 would be even better. The nine owners present were between 45 and 65 years old and had a good sense of their collective mission, culture, and values. Unfortunately, not everyone at ACME was on the same page regarding which course to take with their ownership evolution, and together we discussed various strategic alternatives.

Underlying the ownership discussion was a feeling that while prospects for our industry and economy are still generally upbeat, there is recognition that the market may be at a mature/peak cycle stage. For some owners, particularly the older shareholders who've seen the ups and downs of industry waves play out over 40 years, the timing feels "right" to capture their value and implement a formal transaction. They also have a goal to bring a structure for long-term sustainability and survivability for the people at ACME and its clients. As with most A/E firms considering similar scenarios and challenges, there are three viable options to consider:

1. Traditional Internal Transition

Fortunately in this market, many A/E firms today are doing quite well – even growing. They are profitable organizations with little debt and strong cash flows which can serve as a great mechanism for internal transfer programs. In fact, there are many creative ways to implement these transactions from redeeming shares to direct buyouts and installment notes between individuals to hybrid deferred compensation models that could balance the needs of both buyers and sellers.

For the vast majority of A/E and environmental consulting firms, internal transition remains the most common form of ownership

ABOUT STEVE GIDO

Steve Gido specializes in corporate financial advisory services with a focus on exit strategies. Steve has assisted architecture, engineering, environmental consulting and construction firms of all sizes across North America achieve their growth or liquidity goals through successful internal transitions and mergers & acquisitions. You may reach Steve at sgido@rog-partners.com.

transfer. Similar to accounting and law firms, senior management cultivates the next generation of leaders and managers and subsequently sells them blocks of stock in a coordinated manner over many years. This concept struck a chord with several owners at ACME — particularly the younger leaders coming into their own who enjoy their independence and possess a desire to perpetuate the firm's legacy. Those owners anticipate minimal disruption to their clients and staff using this approach.

Other owners at the firm acknowledged the need for price affordability but believed the internal transition approach generates the lowest value to the senior shareholders (many of whom felt they were most responsible for the firm's recent success). In addition, while ACME is presently on solid footing, the prospect of assuming sizable shareholder redemption liabilities over a multi-year payout (seven years is typical) left some owners wary. There was a realization that ACME would have to serve as a financing conduit – either through raises, loans and/or bonuses – to the next generation, potentially leaving fewer funds available for other growth pursuits and incentives.

2. Employee Stock Ownership Plan (ESOP)

Hundreds of A/E and environmental consulting firms use ESOPs (a form of qualified retirement savings plan) as an ownership transition tool and employee benefit. ESOPs are often implemented to provide a market for the shares of senior owners who have sizable concentrations of shares, to incentivize and reward all employees (ESOPs are non-discriminatory plans), and to establish a trust to make tax-deductible cash contributions or borrow money at a lower, after-tax cost. Generally, companies with $10 million and above in revenue are the right size to pursue an ESOP and ACME meets that criteria and is a viable candidate for an ESOP— but there were concerns.

Some of the owners agreed with the powerful tax benefits and a likely higher valuation than the straight internal ownership approach with an ESOP; others noted the higher upfront costs to implement and a possible value dilution to the remaining shareholders. And, while having an ESOP doesn't mean other motivational arrangements (incentive compensation or stock appreciation rights) go away, some owners felt the ESOP would be overly complicated to administer and that "there's no going back" once ESOP is in place.

3. External Firm Sale

Finally, ACME Engineers discussed selling the company outright to a larger buyer. All firm owners saw the ramifications of a consolidating A/E industry with growth-oriented companies snapping up others and taking root in their region. For all ACME's success, the firm frequently felt squeezed between national behemoth and super-regional engineering firms with deeper marketing, recruiting, and financial resources and the small, local boutiques with lower fees and focused service or market niches.

ACME' younger owners seemed most resistant to selling but recognized it would most definitely yield the highest valuation and quickest liquidity for everyone. The entire group shared war stories of familiar firm sales that seemed to succeed and others that didn't. Professional services combinations can be fragile and integrating two disparate firms with different cultures, operations, processes, clients and egos, even with the best of intentions and expectations, are fraught with risk. With an external sale, some owners acknowledged the challenges transitioning from entrepreneur/owner to employee in a large firm where they'd likely be required to give up control and "have to work for someone else."

The Final Outcome

The consensus among ACME Engineer owners was that they might not have the number of interested and motivated next generation engineers and planners to make an internal transition work. While staff in their 20s and 30s were bright, capable, and eager there was a lingering worry (whether real or perceived) that the next generation didn't have an intense drive or aptitude to become owners. Despite the compelling argument that the rate of return (stock price appreciation plus annual dividends) has proven to be a strong investment for this team of senior owners, all saw a younger group as overburdened with college debt, a priority on "work-life balance", and were risk-averse to their career and ownership pursuits.

So, which path is best? Obviously, this is never an easy decision among a group of veteran practitioners with similar, but varied timing and personal goals. All three of these transition options must be carefully balanced with each owner's specific tax, wealth/estate, and professional goals or situation. Many A/E owners don't start a company with the endgame in mind, but better to be in control of your own firm's destiny than leave it up to chance. For ACME Engineers, implementing an ESOP was the right solution and they are in the process of creating that program.

For questions regarding successful internal transitions and M&A, please contact Steve Gido at sgido@rog-partners.com.