

## UPSWING IN M&A ACTIVITY FOR C&E FIRMS; MARGIN EROSION LESS THAN EXPECTED

**A**fter a decline in 2009, merger and acquisition (M&A) activity in the environmental and infrastructure consulting and engineering (C&E) industry is headed back towards the deal pace of the frothy 2007-2008 period. Buyers have lots of cash and are prepared to use it to get into “hot” markets through acquisition, while sellers have several motivations to undertake deals, including resolving ownership transition issues and making the transition while deal valuations remain at or near historic highs.

Another notable trend of 2010 is a relative lack of erosion in margins for C&E firms whose revenues are coming in lower than projected—“relative” in the sense that, while margins aren’t holding up for everybody, more firms than might be expected are maintaining margin projections in the neighborhood of 10% for the year despite lower revenue expectations. This phenomenon may reflect the elevated management savvy and financial prudence of environmental and infrastructure C&E firms, many of which took cost-cutting steps in anticipation of the revenue shortfalls.

While these two trends aren’t necessarily related—except in the sense that sustained margins have helped improve the flow of cash available for deals—they indicate that the industry has weathered the recession rather nicely. As in 2009, revenues may not be up this year, but confidence is returning. Firms are positioning themselves to be ready when the economy rebounds, or even to take advantage of markets that have remained stable or strong throughout the economic downturn.

That’s certainly reflected in the resurgent deal pace. “My feeling is that 2010 will undoubtedly be a year with more M&A transactions than 2009,” says Andrej Avelini, managing director at the **Environmental Financial Consulting Group’s** (EFCG; New York, NY). “Not that 2009 was bad,” he tells EBJ. “There was a dip. But I expect the pace to come back up towards the peak of 2007 and 2008.”

In EFCG’s “Overview Letter” for the C&E industry, issued in August 2010, Avelini outlined the key drivers for the elevated M&A activity. For one, constrained internal growth makes acquisition more attractive as an avenue for growth. Another big factor is the fact that C&E companies have lots of cash in hand. This strong cash flow is in part due, as noted, to strong margins, as well as to the fact that companies haven’t needed to invest in their working capital due to anemic internal growth. Many firms have also been “hoarding” cash and paying off debt, Avelini stated.

Companies are using this cash to enter or strengthen their presence in hot, or relatively hot, markets such as energy/power, water/wastewater, water resources, the federal sector, and high-end environmental niches such as natural resources and sustainability, Avelini noted. Acquisition is also a diversification tool, as firms seek to increase their service portfolio, geographical reach, or client base and reduce exposure to any one region, market, or client.

Additional drivers include an influx of foreign buyers, such as well-capitalized firms from Australia, Europe, and even India. Private equity interest also remains very high. While private equity’s expected returns have historically been higher than engineering firms could reasonably provide—in excess of 30%—today, “we see private equity available in the 15% expected return range, which is much more achievable by firms in our industry on a sustainable basis,” Avelini wrote.

Looking broadly at the architecture, engineering, planning (AEP) and environmental consulting sector, Steve Gido, partner and M&A specialist at **Rusk O’Brien Gido+Partners** (Boston, MA) is also seeing elevated M&A activity. “Through August of this year, industry M&A activity—including some design firms but a good fraction of it environmental—is up 20% over August of 2009.... “Last year was a bottoming out, a lot of retrenchment and looking at internal efficiencies,” he con-

tinues. Now, “buyers are looking to grow again, and it’s very hard to do that organically in this environment. They are playing offense again with manageable bets, looking at targets big and small. In 2008-09, buyers were on their heels, trying to make sense of the world. Now they are dusting off those strategic growth plans and getting the M&A plans up and running again.”

On their part, prospective sellers are seeing several drivers for transactions, according to Gido. “Certainly some of the leaders in this industry are getting older. Particularly over the last decade, as they were growing, a lot of them put off formal ownership transition programs. Now they are taking that on, looking at internal transitions but also considering external M&A activities.”

Gido’s partner Ian Rusk affirms that “there are a large number of firms with concentrations of ownership with people who are on the cusp of retirement. We’re seeing a spike in redemption liabilities in 2013 and 2014, when there is the most overlap of retiring owners seeking to sell their stock. At privately held companies, the redemption bubble can be a big hurdle to manage. That’s driving much of the M&A activity on the sellers’ side. Firms have looked at their stock redemption liability and decided that it’s too difficult to manage internally.”

### TAX DEADLINE A MOTIVATOR

M&A activity could also remain high for the rest of 2010 because of tax issues. Specifically, the capital gains tax rate is scheduled to increase from 15 to 20% for individuals, investors, and businesses in the 25, 28, and 31% tax brackets as of January 2011. “We may see a rush to the exits in 2010, with many more transactions getting finalized before December 31,” says Gido. “This is a consideration firms will be looking at. They won’t throw in the towel if they don’t get it done by then, but it is a contributing factor for some of the people we’re talking to.”

Gido is quick to point out that the prospective tax advantage isn’t, and shouldn’t be, a dominant motivator in getting a deal done. EFCG’s Avelini agrees. “It’s almost an excuse, and not really the driver,” he

tells EBJ. “It shouldn’t be. If you are going to sell the firm, you do that once in your lifetime and shouldn’t be driven by a little tax gain. The deal should be driven by strategic concerns.”

In terms of what markets buyers are looking for, “on the environmental side, anything to do with energy, whether it’s

building energy efficiency and modeling capabilities, or green building design, renovation, and retrofitting, is of interest,” says Gido. “Certainly, anything related to the water markets—water wastewater, stormwater/sewer, and natural/biological consulting and engineering—has also been of interest. And then alternative en-

ergy—nuclear, wind power, etc.—is of interest to buyers as well. I think for the larger, publicly traded firms or privately held firms, it’s much quicker to go out and buy these capabilities than start it from scratch. It’s hard to get 300 nuclear engineers at once.”

In summary, says Gido, “buyers are back on the prowl, and sellers are a little bit more motivated, given an uncertain environment, taxes, and an aging demographic. There are more Baby Boomers than Generation X and Y people out there.”

In such an environment, deal valuations are at or near historical highs—and analysts hasten to draw a distinction between deal-related valuations and absolute, or true, valuations in the current economy. Says Avelini, “if a firm’s earnings ‘power’ today is not as great as it was, that would affect absolute valuation. But we’re not seeing firms paying less per earnings dollar than before. In other words, I’m not seeing the major buyers pulling back on the multiple of earnings they are willing to pay for a significant firm that makes a strategic fit. There are exceptions to that of course.”

## CASH ON HAND

The availability of cash and the need to make the best possible use of it is one factor continuing to put upward pressure on valuations, Avelini explains. “If you are sitting on a pile of cash—and most players in this industry are—what do you get for that cash when it sits in the bank? Because interest rates are so low, that helps make valuations higher, because otherwise that extra cash is sitting on balance sheets and not creating appropriate risk-adjusted returns. And, from the seller’s perspective, having a lot of cash allows them to hold out for higher price, since the excess cash provides them plenty of capital to weather the storm and effect internal ownership transition.”

Some of the multiples paid for some of the big deals of the past year “tend to be in line with historical averages, at about five to seven times EBITDA,” says Steve Gido. Yet while there are factors keeping those valuations up, other factors are working to hold them there, in his view. “Companies are still exercising some financial disci-

## Big Deals of 2010

**Buyer:** AECOM Technology Corp.

**Seller:** Tishman Construction

**Buyer gains:** Added strength in construction management

**Seller gains:** Extended global reach

**What to look for:** How the engineering and construction business models work together. They haven’t always.

**Buyer:** URS Corp.

**Seller:** Scott Wilson (U.K.), \$340 million in revenue

**Buyer gains:** Expands presence in U.K. and other overseas locations

**Seller gains:** Likewise, expanded global presence, plus (for selling entities) a premium purchase price

**What to look for:** URS outbid CH2M HILL for Wilson. Public auction is unusual in the engineering/consulting industry. How will Wilson employees react?

**Buyer:** CDM

**Seller:** Wilbur Smith

**Buyer gains:** Platform for further acquisitions in transportation market, in U.S. and abroad

**Seller gains:** Diversification outside transportation, particularly into water

**What to look for:** Deal was in due diligence phase at press time. Two large employee-owned firms combining; will cultures mesh?

**Buyer:** WS Atkins

**Seller:** PBS&J

**Buyer gains:** Re-established significant presence in U.S., after selling Benham in 2003.

**Seller gains:** Greater access to capital, global scope, and solution to ownership transition issue that preserves management autonomy.

**What to look for:** Atkins to use PBS&J as a platform for further North American expansion.

**Buyer:** Cardno

**Sellers:** Environmental Resolutions, Entrix; \$140 million in combined revenues

**Buyer gains:** Australia-based Cardno significantly expands its presence in the U.S., which now constitutes its largest market.

**Sellers gain:** Expanded territory and service offering, with an owner that allows fairly independent operation.

**What to look for:** Possible rationalization of cost structures in the purchased businesses.

**Buyer:** S&ME

**Seller:** QORE

**Buyer gains:** A 250-person geotechnical firm that strengthens its leadership in the southeastern U.S. geo-environmental engineering market.

**Seller gains:** An exit from financial struggles with a buyer that presents a strong cultural and strategic fit

**What to look for:** S&ME’s familiarity with QORE’s leadership, markets, territory, and clientele may offset the risk of stepping into a financially challenging situation.

Sources: EBJ, EFCG

pline, and sellers are realizing they won't get a price like that through an internal transition.

"We've come through a period of frothy times, and then slow and uncertain times," he continues, "and sellers are expecting the valuations of a few years ago, while buyers want lower ones, so that's where some of these deals can break down. Buyers are maintaining a firm line on where they perceive valuations are going.

"I would say that the top two deal breakers are, first, price, in terms of sellers' expectations, and second, firm cultures. Buyers and sellers can have different methodologies and visions from each other, and trying to make sure that two disparate cultures can work in the same direction is easier said than done."

Apart from deal valuations, there are factors pressing down on absolute value. In the engineering and design industry, revenues are likely to be flat at best this year and profit margins are down from the historical 10 to 12% (of net revenue) range to a more modest 5 to 8% range in many smaller firms, Ian Rusk points out. "Generally speaking, this is what's driving the decline in firm values, rather than any fundamental change in industry valuation multiples," he says.

Another factor is the cloudy future of the economy—when will it bounce back? "Uncertainty makes it difficult to project future growth and earnings, and that has a downward pressure on valuations," Rusk notes, adding that "there are some contrasting forces. We're in one of the lowest interest rate environments than we've seen in a long, long time, and that reduces the cost of capital, so a number of factors are pushing and pulling in both directions. For the most part, the net effect has been a decline in valuations.. However, there are lots of exceptions to that, particularly in the environmental space, where many firms have ridden out of the recession very well with only modest declines in revenue and in some cases increases in profitability."

Data compiled by EFCG this summer supports this perception of exceptionalism in the C&E sector. In a "mini-survey" of 67 C&E firms, EFCG found a median

## AS AN ALTERNATIVE TO SELLING, "BOOMER" OWNERS LOOK TO ESOPs

The approaching retirement age of business owners from the Baby Boomer generation has prompted many firms in the design and engineering industry to consider a sale to an outside party as a solution to the ownership transition problem. As an alternative to selling, however, the adoption of an employee stock ownership plan (ESOP) model is also compelling under these circumstances, according to Ian Rusk, partner at **Rusk O'Brien Gido + Partners** (Boston, MA).

"The challenge of managing the buyback of retiring shareholders is driving more and more firms to seek an external sale or the adoption of an ESOP. An ESOP gives a firm an advantage in terms of an internal buyout scenario primarily for the tax benefits, by allowing them to use pre-tax dollars rather than post-tax dollars. That's huge. In a buyback, depending on the firm's size and the block of stock being transitioned, you could be saving six or seven figures."

Some form of employee ownership is typical today in the design and engineering sector, Rusk adds. Of the tens of thousands of firms in the sector, "the vast majority are privately held—that is employee-owned, not family owned. That's the norm by far. A concentration of that employee ownership is usually in the senior managers' hands. Typically, putting aside ESOPs, we see ratios of between 8 and 10 to 1, in terms of total staff to actual owners."

That ratio isn't necessarily a benchmark for optimal ownership structure, Rusk hastens to point out. "It just reflects the ratio of difference makers, principals, and leaders to the overall staff levels. That said, among larger firms with 100 to 1,000 people, we're seeing more and more of them adopt ESOPs as a supplement to their ownership structures. It's becoming increasingly popular. And we see it as a supplement, not a replacement, for senior management ownership.

Such companies sometimes designate a block of stock to be held by the ESOP for the benefit of all employees, and then a larger block to be held directly by the senior managers, "and that seems to be an effective model," says Rusk. "The reason for that is, you still have the ability to align leadership with ownership, getting different proportions of stock in difference-makers' hands. It's a balance of risk with rewards. You don't get that necessarily in a 100% ESOP firm, because you as a senior leader won't get many more shares than other employees of the company. A structure where a certain amount of stock is held outside of the ESOP and in senior managers' hands is often seen as optimal.

Such a structure also serves as a carrot to others who aspire to leadership, Rusk goes on to say. Linking individual performance to reward "is a key to creating organizational goodwill and value. Value to the organization is what senior people bring to the table in terms of managing clients and projects and bringing in new work. That has to be rewarded with significant ownership stake."

projection of 2.5% growth in revenue for 2010—down from the 4% projected by 100 firms represented at EFCG's CFO conference in April 2010, and certainly worse than initially projected 2010 budgets (although still better than the median 2% decline in revenue for calendar 2009).

Interestingly, respondents to EFCG's July 2010 mini-survey projected a median operating margin (EBIBT/net revenues) of

10.2%, somewhat less than the April CFO survey's 10.8% but certainly, and somewhat surprisingly, holding up very well. The question is, what explains this resilience in margins? The answer, in EFCG's view, is that the management at C&E firms, more savvy and experienced than in past recessions, took the necessary steps to prepare for the economic downturn this time around.

Although there has been room to cut overhead—office leasing rates are down, for example—for engineering firms, anticipating economic troubles means attending to staff—assessing the trade-off between the cost of being understaffed with the cost of being overstaffed, and “pre-cutting” if the opportunity presents itself. The proper advice may be, whenever management has the option of staffing a bit higher or a bit lower, choose lower.

“When you’re growing fast, obviously your biggest constraint is finding good people,” says Avelini. “When the growth goes away, and one of the priorities becomes protecting profitability in a severe economic downturn, suddenly having too many people becomes a problem. Obviously a big negative of ‘pre-cutting’ is you lose A-players who you need, and will cost you dearly to get back.”

There are other negatives associated with pre-cutting, besides the cost of turnover Avelini refers to. Employees can burn out through overwork, and if project delivery and quality deteriorate, client relations can sour, and a firm can lose business. On the positive side, obviously, is the higher profit that can come, along with the ability to be more selective in choosing projects, pricing those jobs more appropriately and favorably, and having more control over the risk you take on.

Ian Rusk sees opportunity in the anticipation of economic downturns. “Most firms find it difficult to maintain or increase margins while losing revenue. The tendency is to retain people, to resist the need to let people go and cut costs that way. The longer you do that, the more profit margins are impacted negatively.

“The firms that have sustained margins or improved them are the ones that have used the recession to purge poorly performing staff and make cuts in areas that they’ve been considering for some time, such as cutting non-performing offices. Thus the recession, perversely, has forced some firms to take decisive action. Firms that have used the recession as an opportunity to do that have been the ones that have fared the best.” ■

## FEDERAL MARKET REMAINS “HOT,” RELATIVELY SPEAKING; HOW LONG WILL IT LAST?

In EBJ’s latest Snapshot Survey, conducted in January and February 2010, respondents rated environmental contracting opportunities with the Department of Defense (DOD), the Environmental Protection Agency (EPA), and other federal agencies the top sources of sales growth in 2009. With little fanfare, the federal government market had surpassed pre-recession favorites such as the energy sector, the water industry, and mining and metals.

More recent confirmation of the elevated popularity in the federal sector came in August from *Engineering News-Record* (ENR). ENR’s latest list of the Top 200 Environmental Firms, ranked according to 2009 revenue levels, exhibited a sizable shift in the relative mix of commercial, federal, and state and local clients. Specifically, the commercial-revived revenue of the 200 firms on the list decreased from 43% of the total in 2008 to 37% in 2009. By comparison, the federal share increased from 25 to 29% over the same period.

So, a hot market? Perhaps it’s all relative. “Maybe it’s considered hot because it hasn’t declined,” says J.T. Grumski, senior vice president and business unit general manager at **Science Applications International Corp.** (SAIC; McLean, VA). The federal environmental market, in his view, certainly isn’t as strong as the energy markets were prior to the recession. “It’s been steady, compared with the commercial sector, where we’ve seen a pretty big contraction in spending.”

Indeed, a bit of concern about the stamina of the federal markets is reflected in the 2010 Snapshot Survey. Asked to project the best source of opportunity and sales growth over the next two to three years, respondents placed the electric utility sector back on top, followed by DOD, water utilities, petroleum extraction and refining, mining, and solid waste. Opportunities with EPA, the Department of Energy (DOE), and other federal agencies didn’t fare badly on the list—compared, say, with

commercial and residential property development—but the private-sector is widely seen as coming back, and the federal sector starting to drop in comparison.

In the meantime, however, environmental consulting and engineering (C&E) firms active in the federal market report that they are enjoying a wide variety of opportunities in several different niches. What’s more, there has finally been some impact from the American Recovery and Reinvestment Act of 2009 (ARRA)—the economic stimulus package—but it has been uneven across programs.

As popular as the federal environmental market appears to be, some players report that they aren’t seeing lots of new faces in their particular niches. There are more bidders for work, but by and large, the environmental field has higher barriers to entry than, say, military construction (MILCON). The principal challenges come from the contracting offices themselves, in the form of more stringent contracting terms and oversight.

Grumski says SAIC has seen a shift in its client mix towards federal business, which in 2009 accounted for 81% of revenue compared with 69% in 2008. “In 2010, we may see a further uptick,” he observes. The volume of commercial work hasn’t changed much, whereas SAIC has been able to take market share in the federal sector, he adds. Acquisitions of the **Benham Companies** and **R. W. Beck** enhanced the increase in federal market share.

A provider of what Grumski calls “total life cycle” services in the remediation field—among other environmental service categories—SAIC has recently won a \$15 million indefinite-delivery/indefinite-quantity (ID/IQ) job from the Army Corps of Engineers and a \$9 million clean-up project, also from the Corps. The firm has also seen increased opportunities in the areas of planning and natural resource modeling, especially for the Army Corps and the Navy.