Environmental Business Journal

2020 M&A Edition

Please see below for EFCG Managing Partner Jessica Barclay's interview responses to EBJ's 2020 M&A questions.

Question #1

Include a brief description of your organization to serve as an introduction. Please provide approximate size of business (revenues and/or employees), recent growth or M&A, regional footprint, services offered, basic customer mix, etc. and the title, and short bio of respondent/s.

The Environmental Financial Consulting Group ("EFCG") is solely focused on advising the Architecture, Engineering, and Construction (A/E/C) industry. We leverage our 30 years of proprietary industry research and data to provide differentiated M&A advisory expertise, financial and strategy consulting, and executive conferences.

EFCG hosts five annual industry executive conferences. Using our exclusive database of financial data from more than 300 private and public firms, we provide our attendees with key insights on industry trends and transformative performance metrics.

We have advised on over 160 completed M&A transactions in the industry and our services include advisory on potential acquisitions, mergers or capital raises, acquisition searches, market creation for a merger or sale of a company, post-merger integration, and more.

Our Advisory group is known for its valuation and peer benchmarking work. We have also significantly increased our capabilities to include post-merger integration, recession-planning, risk management strategy, and technology strategy.

Question #2

Can you provide an overview of the state of the A/E/C Industry? Please provide detailed information for 2019 and what are you expecting for 2020 & 2021 and why.

In 2019, the A/E/C industry was doing extremely well. Median profitability had doubled over the past 25 years, and growth was trending up. M&A multiples, which had plateaued at 2015 highs for several years, rose again in 2019 to create new all-time highs. 2020 was looking to bring another year of record profitability, growth, and M&A multiples to our industry. Sellers were in high demand given robust acquisition plans from both industry strategics and financial sponsors, including many firms seeking to invest in the A/E/C industry for the first time.

The market has materially changed, though, since early March, 2020 with the US spread of the novel coronavirus. Many buyers are pausing talks with targets they were underwriting, and many sellers are on hold, waiting to see what the multiple impact will be due to COVID-19.

There will most likely be companies that need to raise cash and that means potentially divesting a business segment. Willing/ready buyers with cash will likely be able to acquire assets that wouldn't have previously been available. We are currently working to analyze the multiple impact of the Great Recession ('08-'09) on our industry and project the likely multiple impact from this global pandemic.

We believe the M&A market will strongly rebound once the threat is largely cleared, because projects, while delayed, still need to be completed. We also continue to receive strong interest from financial sponsors who have capital to deploy and are interested in investing in our industry now.

Question #3

What's been the flow of new companies coming to you to seek valuations? What type of companies have been looking for your expertise? Are they new growing firms, are they looking for ownership transitions, what are they looking for and what type of assistance do they need?

Succession planning is necessary for many firms, especially those with executives looking to retire. With rising valuations, it becomes more challenging to buy out large shareholders as the cash required to do so is material. The new companies reaching out to us include those looking to transition their business to a new owner, those who are in growth mode and want to understand where they stand today, and those seeking capital now to meet cash flow needs and seize growth opportunities.

Question #4

Can you provide examples of the most successful transactions in which you believe that the acquiring company was able to generate their expected value or ROI? (please provide some reasoning behind it and explain what contributed to the success of the transaction)

There are many examples of this, but we are not able to share names or specific examples here due to client confidentiality.

Question #5

Could you provide some comments on trends involving the following type of deals? Please describe in detail how they've been over the past couple of years and how do you expect them to be in the near future.

- **Divestitures/spinoffs**
- **Equity funded transactions**
- **PE-to-PE transactions**
- **Public-to-private transactions**
- **Private equity exits**
- **Roll-up strategies**
- **Domestic vs International**

Fun question. Let's touch on this at a high level. For the serial acquirer, some deals work better than others so there will be a need to spin-off assets that no longer fit the core capabilities of a company. Since M&A is widely accepted in A/E/C, these opportunities will continue. If you are an investor who covets an asset in this space but have lost multiple times at the bidding table, now may be the time to bid and gain that asset.

We don't see a trend in public-to-private transaction if valuations remain as high as they have. (Note: clearly this is rapidly evolving.) At EFCG, we create a global report quarterly on over 20 publicly traded A/E/C companies that we track. Analyzing the results as of 12/31/2019, 10 of these firms were hovering at a 2-year high, making valuations pricey.

Private equity will exit when they are ready and that could be driven by holding period, cash-on-cash return or IRR. We will see whether COVID slows down that exit process. In a healthy deal environment, PE-to-PE transactions seem inevitable with valuations increasing, and in a healthy market, PE firms running an auction process should bump up bids.

Roll-up strategies are a great way to create a platform investment, if acquiring one company doesn't fit the required size for a PE firm to transact. Outside of A/E/C examples, Insurance Services, another professional services industry, presents a good example of what the execution of this strategy could look like.

Lastly, we continue to see strong interest from well-capitalized, highly successful international firms looking to break into the US market. If they are willing to pay the required premium, they will be able to enter the market successfully.

Question #6

With more private equity interest and transactions, have you noticed a measurable uptick in valuations?

We certainly see interest in the A/E/C industry from private capital and it is safe to say this has increased industry multiples. During our conversations with private equity investors, we ask why they are interested in our space, and three common reasons come up:

1) Low CapEx spend: A/E/C firms require low capital expenditure to support their businesses compared to other industries, which means more free cash flow.

2) Fragmented Industry: Not only are there opportunities to grow inorganically, but firms in this industry are also comfortable with growth by acquisition, facilitating PE firms' strategy of growing through targeted M&A.

3) Recession resilient firms: A/E/C firms have long-term contracts and projects that need to be completed eventually, even if they're put on pause. Exposure to public sector work and non-discretionary projects also help to buoy revenue during a downturn.

Question #7

Digital transformation is a hot topic within the A/E/C industry. Can you comment on the rate of adoption of new technologies? How does it compare to other industries?

This is a topic that EFCG has been closely analyzing and luckily there is plenty of historical data on which we are able to rely. The digital transformation of the A/E/C industry has been an ongoing process for more than 40 years now. The earliest major digital transformation outside of academic circles arrived with the advent of personal computing coupled with computer aided design tools and GIS starting in the early 1980s. We saw those shifts take 15 years to move from early adoption to standard practice.

We see similar uptake curves taking shape for technologies like BIM, remote sensing, ground based LIDAR, dynamic document delivery, and IoT among many others. Interestingly, although we often hear that civil engineering is slow to adopt new technologies, when you look at other non-consumer industries you see similar behavior and similar uptake periods.

One overlooked aspect of technology adoption in civil engineering is the long tail of change. Once the industry does shift to a new standard of practice or in a new direction in earnest, further change away from these new approaches and tools takes considerable time. This "stickiness" can be an asset where significant capital or training is required as the return on well targeted investments pay dividends over long periods.

Question #8

How are technologies/digital strategies impacting M&A activity in our industry?

Technology firms are valued at multiples of revenue, even if they have very low, or even negative EBITDA. As A/E/C firms begin/continue to build and buy technology strategies, this will begin to drive M&A multiples higher. Our industry is still grappling with how to value technology firms, and we are seeing firms execute a number of different strategies when it comes to technology practices: some firms are divesting their technology businesses because they are so different from their core capabilities, while other firms are creating tech firms within their business, or buying tech firms to complement their business. Technology will be a large driver of M&A over the next decade.

Question #9

How can companies find alternative sources of capital for new technologies?

We have some very effective strategies for how firms can source capital for new technologies. We are working with our clients to implement these strategies. We will share more once this deal activity is completed!

Question #10

Is cybersecurity and related regulations impacting the deal activity?

A/E/C firms are certainly investing more in cybersecurity now vs. five years ago, but this is not really impacting deal activity.

Question #11

What growth, financial and strategic challenges are companies struggling with most and how do you suggest they approach them?

Cash flow is one of the biggest issues that many A/E/C firms are facing right now. We have developed a financial model and framework for firms to easily identify and adjust short-term levers to manage cash flow.

Question #12

Are A/E/C companies starting to prepare for the next recession? How are they preparing? What impacts in the industry should we expect from a possible recession?

Due to the massive impact of the Coronavirus outbreak, the economy is already in a recessionary period. We've seen projects facing delays, postponements and cancellations due to late shipments of components and other containment measures. As such, A/E/C firms are focusing on reinforcing their cash flows, cutting costs without hampering productivity, and avoiding accumulating debt and massive layoffs in an increasingly uncertain economic environment. Notably, the nature of the crisis hinders many options to mitigate impacts such as diversification across other locations or sectors, which makes things more difficult.

Yet, some firms were already better prepared to address such crises when the Coronavirus outbreak escalated. Well-managed firms that are more efficient and productive, and take more calculated risks have a wider set of tools available to mitigate the impact of the outbreak and other crises. On the other hand, the less efficient firms with struggling financials and poor cash flows must implement more aggressive cost cuts and are more likely to be hardest hit and experience severe impacts.

The extent of the impact on the A/E/C industry depends on how long the outbreak lasts, but will be massive, nonetheless. Overall, most sectors will be hit hard for the remainder of 2020 and firms are likely to experience significant revenue and profit shortfalls. Some sectors, such as transportation and general buildings, are already disproportionately affected. The scale of the impact also depends on the initiatives the federal government implements over the next weeks to assist the economy. For instance, a new infrastructure bill covering new public works programs would help the A/E/C industry get back on track more quickly.

Question #13

How is a possible downturn impacting M&A activity?

This would depend on whether there is a business-cycle downturn (typical recession) or one that would be financially driven (such as "The Great Recession" in 2008). What we are seeing with COVID-19 is much more than a downturn and we feel is several big challenges in one crisis. It will certainly greatly slow down M&A with so much uncertainty in the marketplace. Well-capitalized strategic firms and financial sponsors are still acquiring and investing in firms, and we're still closing and progressing deals despite the uncertainty, so we do not expect M&A to come to a complete standstill during this time.