

ENGINEERING ROUNDTABLE

MERGERS & ACQUISITIONS

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Agenda

2

- Current M&A Trends Within the Industry
- How to Determine Value in an M&A Deal
- The Top 5 Deal Issues to Consider
- What to Look for During the Due Diligence Process
- Deal Structures - Advantages & Disadvantages
- Tools that Will Help you Succeed



Current M&A Trends Within the Industry

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Current Trends

4

- Deal activity has returned to pre-recession levels
- Transaction values have increased
- The debt market continues to improve

Current Trends

5

- Transaction activity (through September) has increased 37% from same period in 2009

- Trend is:
 - 3.5-5 times EBITDA for firms < \$15 million in revenues
 - 4.5-6.5 times EBITDA for firms > \$15 million in revenues
 - 45-80% of net revenue; 1.5-4 times book value

- Debt to EBITDA ratios have rebounded to the 2003 to 2005 timeframe.

Current Trends

6

- Approximately 18% of 2010 transactions involved foreign acquirers

- Value is impacted by the size of the company

- Larger companies command higher multipliers for several reasons
 1. More in demand and competition drives up price
 2. Buyers will pay a premium for industry leaders
 3. Lenders are often willing to provide more debt for larger deals

Current Trends

7

- Organic growth is expected to be slow so M&A may be an option to speed growth
- Many companies have built large cash reserves that can be used to fund acquisitions
- Many sellers are motivated by expectations of rising tax-rates
- Many sellers are more willing to accept “earn-out” provisions or “self-finance” to bridge valuation gaps

Current Trends

8

- A/E/C Industry Study :
 - 30% of companies eventually will liquidate
 - 60% sell/transfer to family or employees
 - 10% sell to a third party



How to Determine Value in an M&A Deal

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Determining Value

10

- Most A/E firms are valued based on:
 1. Earnings Approach: Usually an analysis of current and/or expected cash flows
 2. Market Approach: Applying market data against the firm's own data
 3. Book Value: What is leftover after subtracting all of the liabilities from the assets on the firm's balance sheet

Determining Value

11

- Earnings Approach - DCF
 - All future cash flows are estimated and discounted to the net present value to determine the value of the cash flows
 - The expected cash flows are discounted using an appropriate discount rate
 - The rate is the return an investor expects given market conditions and level of risk

Determining Value

12

- Earnings Approach – Multiple Based
 - Value based on a multiple of EBITDA (earnings before interest, taxes, depreciation and amortization). This assumes a debt free purchase.
 - Current, historical or projected EBITDA is often used for this technique.

Determining Value

13

- Earnings Approach – Multiple Based - continued
 - The multiple is the number of times EBITDA that the buyer is willing to pay.
 - The buyer may be willing to pay a higher multiple depending on intangible factors of the business known as “goodwill”.

Determining Value

14

- What is goodwill?
 - Definition – an intangible asset valued according to the advantage or reputation a business has acquired (over and above its tangible assets)

Determining Value

15

- What are the drivers that can create goodwill?
 1. Reputation
 2. Leadership/People
 3. Attractive or unique opportunities – niche markets, specialty services, key contracts, etc.

Determining Value

16

- Market Approach -
 - Often known as the publicly traded guideline method
 - Attempts to use the market data of similar companies, however, the difficulty is obtaining this data for privately held businesses.

Determining Value

17

- Market Approach - continued
 - Market data is applied to the subject firm to determine value:
 - Backlog
 - Net Service Revenues
 - Book Value
 - # of Employees
 - In some cases, a firm will use industry financial surveys to obtain the market data

Determining Value

18

- Book Value Approach
 - Normally, business owners make a living and can take out profits, but haven't really built much more
 - Business does not have value separate from the asset and liabilities it accumulates
 - Usually the simplest way of determining value. Many companies use NBV (or a multiple of) for buy/sell purposes.
 - Keep in mind that the method used for internal purposes than for an M&A deal.

Determining Value

19

- Caution: Valuation is an art not a science...
 - Emotions can get in the way
 - Be prepared for differences in the seller's expectation of value
 - This is common when dealing with smaller firms (< \$ 5million in revenues)

Determining Value

20

- Tips for driving up value:
 - ▣ Operate profitably – best of class metrics
 - ▣ Develop systems – HR, budgeting, financial, PM, etc.
 - ▣ Have tight project controls and reporting
 - ▣ Keep policies current – OT, timesheets, vacation, etc.
 - ▣ Deal w/unproductive principals – eliminate the “deadwood”
 - ▣ Resolve any legal issues/lawsuits, etc.
 - ▣ Build a team that is committed to the organization (provide potential ownership)



The top 5 Deal Issues to Consider

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Top 5 Deal Issues to Consider

22

1. Reasons for the merger/acquisition
2. Understand the Target
3. Integration
4. Legal Issues
5. Communication

Top 5 Deal Issues to Consider

23

- Reasons for the merger/acquisition
 - What is the goal of making and acquisition?
 - Attract new customers/services?
 - Cost reduction?
 - New talent?
 - Eliminate competition?
 - Never bet the company on an acquisition
 - Only buy good companies (especially in distressed situations and you do not have experience with turnaround)
 - Treat the acquisition process as an important operating strategy
 - Select the right team, establish budget, etc

Top 5 Deal Issues to Consider

24

- Understand the Target
 - Financial – Help to establish purchase price
 - Analyze trends in the financial statements
 - Have they had audit/review done by CPA?
 - Are there “recast” adjustments that need to be made?
 - What are the Liabilities and commitments?
 - Customers/Markets
 - Understand the market/industries/practice groups
 - Especially out-of-state transactions
 - Major clients
 - Backlog
 - Repeat business

Top 5 Deal Issues to Consider

25

□ Understand the Target

■ People / Culture

- Management structured after acquisition
- Benefits
- Hours / flexibility
- Agreements – written or unwritten
- Meet key people and sell the Buyer
- Logistical hurdles

Top 5 Deal Issues to Consider

26

- Integration Strategy
 - ▣ Identify the key cultural differences
 - ▣ Consider leadership selection
 - ▣ Identify the synergies – both the revenue/cost
 - ▣ Put together an “integration” team

Top 5 Deal Issues to Consider

27

- Legal Issues
 - Use advisers for help!!!
 - Confidentially/Non-Disclosure Agreement
 - Adequate reps/warranties
 - Indemnity / Escrow
 - Consider “tail” insurance
 - “Iron clad” Purchase and sale agreement
 - Particularly when an earn out is involved

Top 5 Deal Issues to Consider

28

□ Communication

- Don't fall in love
- Address difficult issues proactively
- Share culture, vision and strategy
- Talk with key staff members
 - Change is scary



What to Look for During the Due Diligence Process

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What to Look for During the Due Diligence Process

30

- Are there compatible financial metrics and symmetry
 - Do they perform within acceptable parameters?
 - Set minimum standards before you get into the game
 - The M&A process takes a significant amount of time and energy
 - Understand how they recognize revenue and value WIP
 - Interview CFO and key PM's
 - Obtain 5 years of history and data

What to Look for During the Due Diligence Process

31

- Understand their business and clients
 - ▣ Do they have repeat business?
 - ▣ Are they obtaining and keeping new customers?
 - ▣ Are there consistent profits from their best customers?
 - ▣ What markets are they in, who runs the market sector and how profitable is each sector?

What to Look for During the Due Diligence Process

32

- People, People, People
 - Have they developed and retained staff across industry sectors
 - Look at staff by market sector and define key people
 - Determine if the staff talents are deep or if one person drives the business
 - Look at profitability by Project Manager
 - Determine how they market each segment of their business

What to Look for During the Due Diligence Process

33

- People, People, People.... again
 - Look at the current leadership and how the firm is structured
 - Look at roles and determine who will help you move forward
 - Look at the “next” generation of targeted leaders and associates and see if they understand the business
 - Identify key non chargeable employees in HR, IT, Marketing and Finance

What to Look for During the Due Diligence Process

34

- Backlog
 - Backlog is a big component of what you are buying.
 - Don't just look at the “numbers”
 - Understand what's in it! Is it “on-call” work, funded projects or indefinite quantities/task order based. Know the backlog by market sector. Recast a proforma based on the backlog.
 - Take off, and rebudget the major contracts in WIP and in the backlog to determine if multiples are realistic
 - Compare the projected profitability vs. historical results

What to Look for During the Due Diligence Process

35

- Understand the company's systems
 - Look at the Company's key systems
 - What do they use to manage their business?
 - Are they intergraded?
 - How is their infrastructure?
 - Have they kept up with technology?



Deal Structures – Advantages and Disadvantages

Deal Structures - Advantages & Disadvantages

37

- Most deals are “asset” purchases vs. stock deals
- More and more deals have a mix of cash, stock, debt and “future” performance factors (i.e., earn-outs) to meet seller and buyer expectations

Deal Structures - Advantages & Disadvantages

38

- Asset Deals:
 - Usually benefits the buyer
 - Purchasing identified and KNOWN assets and KNOWN liabilities
 - The buyer can revalue the assets when recording them on their books
 - Amortization of Goodwill is allowed for tax purposes (15 years)
 - May avoid minority interest problems if some don't want to sell

Deal Structures - Advantages & Disadvantages

39

- Disadvantages of an Asset Sale
 - Contracts and assets may be to be changed/re-titled.
 - Consent may be need to transfer leases, licenses and other assets you are purchasing
 - Usually more costly to get done

Deal Structures - Advantages & Disadvantages

40

- Stock Sales:
 - Usually benefit the seller
 - C Corporations will have one level of tax vs. two levels
 - Easier transfer of assets
 - No wind down of a shell company when the stock is sold
 - Take attributes/(i.e. NOL's)flow to the buyer but may be limited
 - Buyer does not receive step up in bases – unless a 338 election is made and pay related income tax

Deal Structures - Advantages & Disadvantages

41

- The deal structure is key however it should not be a deal breaker.
 - ▣ Understanding the corporate structure can facilitate a deal
 - ▣ It is critical to understand the entity structure that is buying or selling

- There are ways to protect yourself in stock deals (insurance, contingencies, etc.)

- The deal structure may effect the final price paid – It should be Win-Win for all, especially since you will most likely be working together!



Tools that Will Help you Succeed

- ❑ Define your target criteria- what are you looking for and how much will you pay?
- ❑ Define minimum financial criteria to establish a purchase price
- ❑ Obtain necessary NDA agreements
- ❑ Formulate a checklist of information you'd like to receive
- ❑ Establish a time line

ANY QUESTIONS?



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