Critical Factors in Valuing and Selling an Architectural Firm

Presented by:
Darrell V. Arne
CPA, ASA, CBI
Arne & Co.

© Copyright 2007 Darrell V. Arne
All Rights Reserved
Table of Contents

I. Critical Factors When *Valuing* an Architectural Firm

II. Critical Factors When *Selling* an Architectural Firm

III. Concluding Remarks

Appendixes:

- Article: “Five Steps: The Selling Price of your Business Can Go from Traumatic to Dramatic”
- Twelve Commandments for Business Owners
- Background of Darrell V. Arne
I. Critical Factors When Valuing an Architectural Firm
Two Critical Factors When Valuing an Architectural Firm

#1. The value of an Architectural Firm lies in its **FUTURE** operating cash flows. Historical operating cash flows are only relevant if they are indicative of what future operating cash flows might be.

#2. Arriving at a value for an Architectural Firm requires assessing the business **RISKS** associated with an Architectural Firm achieving future operating cash flows.
Operating Cash Flows

Sales
- Operating Expenses
= Operating Cash Flows (EBITDA)
- Depreciation/Amortization
= Earnings Before Interest & Taxes

Current Year End Operating Cash Flows: $ _____________ (E)

The level of certainty (risk) of achieving future cash flows will determine how much a buyer will pay, in the form of a market multiple.
Business Growth Stages

- **Entrepreneurial Stage**
  - Personal Relationships - Customers, Suppliers, Employees, Landlords
  - Reliance on Referral Sources for Business
  - Personal Know How - Operations, Marketing & Administration

- **Managerial Stage**
  - Contractual Relationships - Customers, Suppliers, Employees, Landlords
  - Formalized Organizational Structure and Management Information System
  - Trained Work Force and Defined Work Procedures

- **Professional Stage**
  - Market Entry Barriers – Patents, Copyrights, Trade-marks, Trade Secrets, Non Compete Agreements
  - Internal Controls, Third-party Board Members
  - Key Management Incentive Compensation Plans

**Keys to Growth**
1. Market/Customer (a problem is solved or a need satisfied)
2. Management (motivated talent)
3. Time
4. Capital (money)

- **Entrepreneurial Stage**
- **Managerial Stage**
- **Professional Stage**

- **Risk / Value Index**
- **Business Risks**
- **Valuation**

Business Stage
Your Architectural Firm - Risk Profile (M)
(SWOT Analysis)

<table>
<thead>
<tr>
<th>Internal</th>
<th>External</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Strengths</strong> (risks down)</td>
<td><strong>Weaknesses</strong> (risks up)</td>
</tr>
<tr>
<td>.</td>
<td>.</td>
</tr>
<tr>
<td>.</td>
<td>.</td>
</tr>
<tr>
<td>.</td>
<td>.</td>
</tr>
<tr>
<td>.</td>
<td>.</td>
</tr>
<tr>
<td>[Six M’s: Men (people), Money, Machines, Methods, Materials, Markets]</td>
<td></td>
</tr>
</tbody>
</table>
Architectural Services Statistics

• Percentage of Firms – By Number of Employees
  (82% if New Mexico’s 412 Firms: 1-4 Employees)
• Percentage of Firms – Location of Client Base
  (51% of Clients: Metro area/Single State)
• Net Billings Per Employee – By Size of Firm
• NM Dept. of Labor – Architect Salaries
  (New Mexico Mean Salary: $62,200)
• Percentage of Firm Billings – By Construction Sector

Sources: 2006 AIA Firm Survey, New Mexico Dept. of Labor, & Reference USA
Business Valuation Process

Valuation
Conclusion

Valuation Approaches
and Methods

Normalize *Historical Financial Statements*
and/or Rely Upon

*Projected Financial Statements*

Internal Analysis &
Risk Assessment

External Analysis &
Risk Assessment

Business Risks (M)

Operating Cash Flows (E)
Basic Valuation Formula

Value = Earnings X Multiple

Lower Multiple:
• Higher Business Risks
• Lower Growth Potential
• Debt Capital is Not Readily Available

Higher Multiple:
• Lower Business Risks
• Higher Growth Potential
• Debt Capital is Readily Available

Earnings (E) can be defined in several different ways.
Middle Market Company Life Cycle

Characteristics
- Business to Business
- Sometimes a Large Capital Investment
- Niche Market Creates Barrier to Entry
- Some Competitors
- Managerial Managed at Maturity

Sources of Capital
- Personal Svgs
- FF&F
- RE
- Institutional Debt
- PEGs (recapitalize)
Example: Valuing the Larger Architectural Firm

Example: “Current Year” Income Statement

Gross Sales $ 5,000,000

Operating Expenses (Including All Necessary Management Salaries) - 3,800,000

Earnings Before Interest, Taxes, Depreciation & Amortization (EBITDA) 1,200,000

- Depreciation & Amortization - 200,000

Earnings Before Interest & Taxes (EBIT) 1,000,000

- Interest Expense - 100,000

Earnings Before Taxes $ 900,000

Value = Earnings X Multiple

Earnings = $1,200,000

Market Multiple Range:
Three (3) to Five (5)

Assets Purchased
- Working Capital
- Fixed Assets
- Going Concern Value & Goodwill

Merger and Acquisition Valuation Method
Small Company Life Cycle

Operating Cash Flows (EBITDA)

- Family Transfer
- Sale to 3rd Party Owner/Operator

Characteristics
- Commodity Product or Service
- Low Capital Investment
- Few Barriers to Entry
- Lots of Competition
- Entrepreneurial Managed at Maturity

Time

Sources of Capital
- Personal Svgs
- FF&F
- RE
- Institutional Debt (e.g. SBA Guaranteed)

Startup Costs

(+)

(-)
# Example: Valuing the Smaller Architectural Firm

**Example: “Current Year” Income Statement**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross Sales</td>
<td>$300,000</td>
</tr>
<tr>
<td>- Operating Expenses (Excluding Owner/Manager Salary)</td>
<td>$200,000</td>
</tr>
<tr>
<td><strong>Seller’s Discretionary Earnings (SDE)</strong></td>
<td>$100,000</td>
</tr>
<tr>
<td>- Owner/Manager Salary</td>
<td>$60,000</td>
</tr>
<tr>
<td>Earnings Before Interest, Taxes, Depreciation &amp; Amortization (EBITDA)</td>
<td>$40,000</td>
</tr>
<tr>
<td>- Depreciation &amp; Amortization</td>
<td>$10,000</td>
</tr>
<tr>
<td>Earnings Before Interest &amp; Taxes (EBIT)</td>
<td>$30,000</td>
</tr>
<tr>
<td>- Interest Expense</td>
<td>None</td>
</tr>
<tr>
<td>Earnings Before Taxes</td>
<td>$30,000</td>
</tr>
</tbody>
</table>

**Value = Earnings X Multiple**

Earnings = $100,000

Market Multiple Range:

One (1) to Three (3)

**Assets Purchased**

- Fixed Assets
- Going Concern Value & Goodwill

---

*Merger and Acquisition Valuation Method*
Small Business Valuation Formula

SIC 8712: Architectural Services

Multiple of Seller’s Discretionary Earnings (SDE)

- Low – 1.41
- High – 1.84
Universe of Business Buyers (and/or Transferees)

- Strategic Buyers
  - Strategic PEGs
- Suppliers
- Customers
- ESOP
- Key Management
- Outside Owners
- Outside Investor(s)
- Non-strategic PEGs
- Family
- Outside Owner/Operator
- PEG – Private Equity Group

Strategic Buyers (Add On)
Financial Buyers (Stand Alone)
Consolidators
Competitors
Levels of Value – Depends Upon the Buyer (Purpose)

Levels of Value

Strategic Buyers
- Strategic Value
  - Synergistic and/or Emotional Premium

Financial Buyers
- Minority Interest Value
  - Lack of Going Concern Discount

Buyer (Purpose)

- Outside Sale or Merger to a Third Party (Add On)
- Outside Sale or Merger to a Third Party (Stand Alone)
- Inside Sale to Family, Other Owners, Key Employees, ESOP
- Transfers to Family or Others by Gift (lifetime) or Bequest (at death)
- Outside or Inside Sale
Business Transaction Deal Structuring

**Qualitative Factors**
- Perceptions of Risk and Growth
- Motivations
- Negotiating Strength

**Quantitative Factors**
- "Cash is King"

**Valuation**
- Tax Structure
- Financing Structure

**Qualitative Factors**
- Perceptions of Risk and Growth
- Motivations
- Negotiating Strength

Buyer

Seller
Value vs. Price

**Seller Factors**
- Negotiating Strength Favors Seller (e.g. Better Knowledge, Skill and Quality of Counsel)
- Seller Perception of Business Risks are Low / Growth is High

**Buyer Factors**
- Highly Motivated Buyer (e.g. Strategic Buyer Seeking Synergies)
- Tax Structure Favors Buyer (e.g. an Asset Sale of a C Corp)
- Deal Structure Favors Buyer (e.g. Small Cash Down, Seller Financing Terms Favor Buyer)

**Fair Market Value**

**Price Increase**
- Seller Factors
  - Highly Motivated Seller (e.g. a Distressed Personal Situation)
  - Tax Structure Favors Seller (e.g. a Stock Sale of a C Corp)
  - Deal Structure Favors Seller (e.g. Large Cash Down, Seller Financing Terms Favor Seller)

**Price Decrease**
- Buyer Factors
  - Negotiating Strength Favors Buyer (e.g. Better Knowledge, Skill and Quality of Counsel)
  - Buyer Perception of Business Risks are High / Growth is Low

“You determine value, and negotiate price”
II. Critical Factors When Selling an Architectural Firm
The Process of Exiting an Architectural Firm

Step #1 - Goals & Objectives
When & Why Do I Want to Sell or Transfer My Architectural Firm?

Step #2 - Valuation
What's My Architectural Firm Worth? What are My Options?

Step #3 - Design
Who Should I Sell or Transfer the Firm To?

Step #4 - Implementation
How Should I Do It?

... the rest of my life.
Sale or Transfer Options

1. Third Party Buyer
2. Management
3. Other Owners
4. Family
5. ESOP
6. Voluntary Liquidation
Desired Transfers vs. Actual Transfers

<table>
<thead>
<tr>
<th>Insiders:</th>
<th>Desired</th>
<th>Actual</th>
</tr>
</thead>
<tbody>
<tr>
<td>Family Member(s)</td>
<td>50 %</td>
<td></td>
</tr>
<tr>
<td>Employees</td>
<td>30 %</td>
<td>30 %</td>
</tr>
<tr>
<td>Co-Owners</td>
<td>15 %</td>
<td></td>
</tr>
<tr>
<td>Outside Third Party</td>
<td>5 %</td>
<td>70 %</td>
</tr>
</tbody>
</table>

Source: The Exit Planner, November 2001
1. Third Party Buyer

Advantages

• Greatest chance to receive the highest price and best terms

• Removes owner’s investment and financial risks

• Based upon size and quality of the buyer, most probable chance of post transaction growth for the company

• Allows owner to control date of departure
1. Third Party Buyer

Disadvantages

• Is often inconsistent with original exit goals

• M&A process normally takes from 6 to 12 months to complete which increases the chance for confidentiality leaks

• Loss of owner identity, and loss of the company’s mission and culture

• Potentially detrimental to employees, customers and suppliers
1. Third Party – Exit Strategies

Controlled Auction – based upon the nature of the business (size and value drivers), selling the business to competing strategic buyers will likely result in the highest price and best terms.

Re-capitalization – selling a controlling interest (51% - 75%) to a financial buyer (e.g. private equity group), will allow the owner to realize some liquidity, then grow the company with a financial partner for “another bite at the apple”

Tax Minimization – selling stock, allocation of purchase price, installment sales, mergers, etc.
Positioning Strategies Prior to Sale

- Have 3-5 years CPA Prepared Financial Statements
- “Recast” Historical Financial Statements
- Have a Well Trained Work Force
- Clean up the Balance Sheet
- Eliminate Contingencies
- Document “Intangible Assets”
- Make sure “Rights” are Transferable
- Get Equipment Fixed and Systems Fixed

See Appendix
Article - “Five Steps: The Selling Price of Your Business Can Go From Traumatic to Dramatic”
### Process of Selling a Business to a Third Party

**Phase I: Planning**

- **Planning Phase I**
  - Identify Owner’s Initial Objectives
  - Determine Range of Most Probable Selling Price
  - Consider Options of Exiting the Business
  - A “Hold & Grow or Sell & Go” Decision
Growing a Business: The “Six M” Reality Check
# Process of Selling a Business to a Third Party

## Decision to Market the Business to Third Party Buyers

<table>
<thead>
<tr>
<th>Phase I</th>
<th>Phase II</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Planning</strong></td>
<td><strong>Integration</strong></td>
</tr>
<tr>
<td>• Identify Owner’s Initial Objectives</td>
<td>• Train New Owner</td>
</tr>
<tr>
<td>• Determine Range of <em>Most Probable Selling Price</em></td>
<td>• Sign an Employment or Consulting Agmt.</td>
</tr>
<tr>
<td>• Consider Options of Exiting the Business</td>
<td>• Collect on Seller Financing</td>
</tr>
<tr>
<td>• A “Hold &amp; Grow or Sell &amp; Go” Decision</td>
<td>• Potential Post Transaction Price Adjustments – Up or Down</td>
</tr>
<tr>
<td><strong>Research</strong></td>
<td></td>
</tr>
<tr>
<td>• Position for Sale</td>
<td></td>
</tr>
<tr>
<td>• Set Scope for Buyer Search</td>
<td></td>
</tr>
<tr>
<td>• Prepare Teaser and CBR</td>
<td></td>
</tr>
<tr>
<td>• Prospect for Buyers Along with a Teaser</td>
<td></td>
</tr>
<tr>
<td>• Screen Buyers</td>
<td></td>
</tr>
<tr>
<td>• Buyers Signs NDA and Given the CBR</td>
<td></td>
</tr>
<tr>
<td><strong>Negotiation</strong></td>
<td></td>
</tr>
<tr>
<td>• Negotiate Price &amp; Terms</td>
<td></td>
</tr>
<tr>
<td>• Negotiate Tax and Financing Structure</td>
<td></td>
</tr>
<tr>
<td>• Sign LOI or Term Sheet</td>
<td></td>
</tr>
<tr>
<td>• Respond and Satisfy Buyer’s Due Diligence Requests</td>
<td></td>
</tr>
<tr>
<td>• Sign Definitive Purchase Agmt.</td>
<td></td>
</tr>
<tr>
<td><strong>Closing</strong></td>
<td></td>
</tr>
<tr>
<td>• Collect on Seller Financing</td>
<td></td>
</tr>
<tr>
<td>• Sign Definitive Purchase Agmt.</td>
<td></td>
</tr>
<tr>
<td>• Potential Post Transaction Price Adjustments – Up or Down</td>
<td></td>
</tr>
</tbody>
</table>
2. Management

Advantages

• The skills and knowledge of key management are known quantities, and becomes a way to reward the owner’s protégé

• Perpetuates company’s mission and culture

• A quick sale because of minimum buyer due diligence, with limited breach of confidentiality

• Owner can still remain involved in the business
2. Management

Disadvantages

• Most completed without a competing bid, and therefore unlikely owner will receive a top price

• Management has strong negotiating advantage by threatening to leave if owner does not sell to them

• Required owner involvement after transfer, to include increased (or continued) financial risk

• Management’s inability or unwillingness to assume an ownership role
2. Management – Exit Strategies

**Boot Strap Acquisition** – sell minority interest “outside” the company; company redeems the remaining interest under an installment note

**Staged Buy In:**
- Sell minority interest (at an affordable price)
- Seller paid deferred compensation over time
- Remaining interest sold, under an installment note, or paid in full with bank financing

**Cash Out Entirely** – MBO financed with bank debt, along with PEG or mezzanine financing
3. Other Owner(s)

Advantages

• The skills and knowledge of other owners are known quantities

• Perpetuates company’s mission and culture

• A quick sale because of minimum buyer due diligence and limited breach of confidentiality

• Owner can still remain involved in the business
3. Other Owner(s)

Disadvantages

• Price may be below fair market value

• Need to take back an installment note for a substantial part of the purchase price

• Required owner involvement after the transfer, to include increased (or continued) financial risk

• Other owners may lack necessary qualifications to own and manage all facets of the business
3. Other Owners – Exit Strategies

**Buy/Sell Agreement Sale** – at death, funded with life insurance; other than death, payable under an installment note; price at predetermined formula or appraisal

**Negotiated Sale** - includes various forms of payment to the seller:

- Purchase of the ownership interest
- Deferred compensation
- Life and/or disability insurance benefits
- Other employee benefits
4. Family

Advantages

• Transfer is to a known entity – one’s flesh and blood

• Family business legacy continues, along with the company’s mission and culture

• Provide family members’ financial security with employment and retirement opportunities

• Owner can still remain involved in the business
4. Family

Disadvantages

• Transfers by gift or bequest provide no liquidity to the owner or his/her estate

• May require owner’s involvement after transfer, to include increased (or continued) financial risk

• Family successor’s inability or unwillingness to assume an ownership role

• Treating other family members fairly, to include perceived nepotism by non-family employees
4. Family – Exit Strategies

**Lifetime Gift** – minority interests at a discount

**Installment Sale** - must be at FMV to avoid gift tax; borrowing against the obligation will trigger the gain

**Private Annuity** – taxability based upon mortality tables; payments cease upon death of transferor (i.e. no estate tax consequence)

**Self Canceling Installment Note (SCIN)** – attributes of installment sale and private annuity; purchaser never pays more than a certain amount, and may pay less (seller dies prematurely); a SCIN is not included in seller’s estate (i.e. no estate tax consequences)
5. ESOP

Advantages

- A ready market for business owner at fair market value
- Tax free rollover for the owner in a C Corp
- Ability to service ESOP debt with pretax dollars, along with conversion to an S Corp
- A method to retain valuable employees, and a motivator to increase performance and productivity
5. ESOP

Disadvantages

• A leveraged ESOP adds financial risk to the Company, and often requires the owner to pledge qualified replacement securities

• Price to a strategic buyer is likely to be higher than fair market value

• Keeping middle management motivated, and gaining acceptance of an “open book” culture

• Administrative costs and complexities
5. **ESOP – Exit Strategies**

**Pre-funded ESOP** – company makes ESOP contributions over 2-5 years; then ESOP purchases at least 30% of owner’s C Corp stock; seller obtains Sec. 1042 rollover tax benefit

**Staged Purchase** – by written agreement, ESOP purchases a controlling interests over time, allowing C Corp owner to receive a control premium and Sec. 1042 rollover

**100% ESOP Purchase** – ESOP purchases all of C Corps stock (seller gets Sec. 1042 rollover), and converts to a S Corp (becomes a tax-exempt entity) which assists in servicing the ESOP loan
“ESOP Feasibility Checklist”
6. Voluntary Liquidation

Advantages

• Speed

• Cash

• For a declining business, it could be the best option to maximize the net proceeds from the sale of:

  ➢ *Tangible Assets* (e.g. real estate, equipment, vehicles)

  ➢ *Intangible Assets* - that can be separated from the business (e.g. customer lists, intellectual property)
6. Voluntary Liquidation

Disadvantages

• Minimal net proceeds - loss of any possible proceeds from going concern value, along with costs to liquidate

• Immediate tax consequences

• Loss of employment – family and others

• Negative impact on customers and other stakeholders (e.g. community at large)
6. Liquidation – Exit Strategies

Hidden Intangible Value – seek out potential purchasers (particularly competitors) interested in purchasing customer lists and other intangibles

Orderly Liquidation – hire a professional auction company to liquidate inventory and equipment

Employee Outplacement – have in place a referral agency that can assist former employees with employment search
III. Concluding Remarks
Business Ownership Life Cycle

Phase → Start Up → Expansion → Instability → Exit

Business and Financial Risk

Manager

Owner

Time Line

“Dual Roles”

Less Motivated To Exit

More Motivated To Exit

Remove Risks to Satisfy Liquidity Objectives

Need for:
- Capital
- Talent

Change in:
- Business
- Personal

• Capital
• Talent

Need for:
• Capital
• Talent
Timing is Everything!
Timing is Right!

The Owners (positive motivations)

The Business (increasing cash flows)

The Market Place (up business cycle)

The lesson is: “Be Prepared”

Motto of the Boy Scouts of America

1. **The Owners** are motivated but not compelled to sell
2. **The Business** is maximizing its operating cash flows with its current management talent and capital
3. **The Market Place:**
   - More growth expected in the market place
   - Buyers are motivated and competing to buy
   - Finance sources are willing to fund acquisitions
Timing is Wrong!

The “Dismal D’s”

The Owners (death, disability, divorce)

The Business (declining cash flows)

The Market Place (down business cycle)

“Business owners seldom sell too soon but often wait too long.

By failing to make the decision to sell when the timing is right, the business owner allows it to be made for him or her – often when the timing is wrong”

- BUSINESS TRANSACTION MAXIM

Again, the lesson is:

“Be Prepared”
Personal options decrease over time

Business options decrease over time

Timing is Everything!
Exit Planning Obstacle

“Change”

It’s a business owner’s worst enemy!

The best insurance policy in dealing with change is to meet it head on in a proactive way by developing, implementing and monitoring an “exit plan.”
“When selling your business, it’s what you keep that counts”
The Top 10 “Keepers”

1. **Keep** the business until it’s properly positioned for sale

2. **Keep** the management focused on running the business during the selling process

3. **Keep** the selling process structured and confidential

4. **Keep** the time to sell the business to a minimum

5. **Keep** the qualified buyers motivated and competing
The Top 10 “Keepers” - cont

6. **Keep** the deal momentum going and emotions in check

7. **Keep** the employees you care about with the business

8. **Keep** the highest price and best terms for the business

9. **Keep** the tax liabilities to a minimum

10. **Keep** the post-transaction risks to a minimum
Summary

• The decision to sell or transfer your business is largely an emotional one.

• Communication is essential since every stakeholder’s emotional and financial needs will differ.

• Patience. Transferring business ownership is a time consuming process occurring before, during, and after the sale or transfer.

• Seek out qualified advisors who have particular expertise to assist you throughout the process.
See Appendix

“Selling or Transferring Business Ownership: Twelve Commandments for the Business Owner”
Free Stuff on Arne & Co. Website

• Business Transaction Marketplace (sample Registration page)
• Planning Tab:
  - Comprehensive Planning for Business Owners
  - Business, Exit and Estate Planning Processes
  - Exit Plan Self Assessment (checklist)
• Resources Tab
  - Articles and Newsletters
  - Tax Matters
  - Glossary of Terms
Thanks for your participation today!

Please Complete the Workshop Evaluation Form