



zweig group

# Owning and Operating an Architecture Firm

**WILL SWEARINGEN • JULY 2020**

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# The Complexity of Owning and Operating an Architecture Firm



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- 06 ● **Ownership Transition**
- 07 ● **Planning for Tomorrow, Today**



PURPOSE

WE EXIST  
— to —  
**elevate**  

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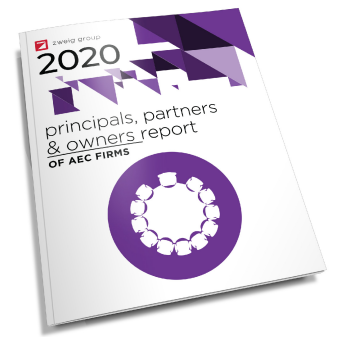
THE INDUSTRY.



# Industry data



## Zweig Group data sources



What do you wish you knew more about,  
prior to becoming a principal?



01

**BUSINESS EDUCATION AND EXPERIENCE  
WITH FINANCE / ACCOUNTING**

02

**THE AMOUNT OF STRESS AND  
TIME IT TAKES**

03

**EMOTIONAL INTELLIGENCE, CONFLICT  
RESOLUTION AND COMMUNICATION**

04

**HOW TO PREPARE FOR OWNERSHIP  
TRANSITION**

# 2018 AIA Report



NUMBER OF EMPLOYEES	PERCENT OF FIRMS
1	26%
2-4	24%
5-9	22%
10-19	14%
20-49	10%
50-99	3%
100-+	1%

*Note: data from the 2018 AIA Annual Report*



# Strategic and business planning





## Tiers of management



## Why have a plan?



- **Builds a common sense of direction** aligning your entire team with your firm's vision, mission, values, goals, and culture.
- **Guides your future** helping make the firm more sustainable, able to withstand market fluctuations and other “threats.”
- **Reduces the stress of owning and operating a business** enabling the firm to maximize resources and avoid wasting time, effort, and money on activities that are not profitable, or are holding the firm back.
  - Builds confidence with lenders, creditors, investors and employees.
  - Trains employees in how your business operates and makes money.

## Strategic plan components



- **Vision** – Why do we exist?
- **Mission** – Our core purpose. What are we doing to achieve our vision?
- **Values** - How do we do things? Unwavering principals that through action define our culture.
- **Strategies** – What are the basic philosophies that guide us in critical business areas?
- **Goals** – What are we going to do?
- **Actions** – Who, when, and how?

## Business plan components



- Definition of markets being pursued.
- Client research.
- Competitive research.
- Employee research.
- Strengths, Weaknesses, Opportunities, and Threats (SWOT) Analysis.
- Financial modeling (pro formas, balance sheets, cash flow, stock value).
- Org charts.
- Realistic budgets for everything from recruiting to training.
- Other back up materials and exhibits.

## Executing your business plan effectively



- Be open to change – Unless firm leaders are sufficiently open and willing to consider all options, nothing will get done.
- Think and act holistically – Always have the big picture in sharp focus and have it lead your daily actions.
- Be nimble – Be willing to adjust along the way when new market conditions or data suggest to do so.
- Use the plan often – Everyone needs to know it, understand it.



# Financial overview

## Financial statement overview

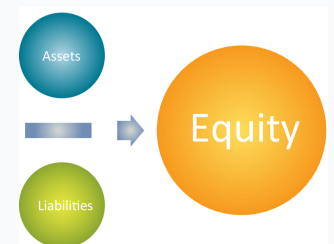


- Income statement - shows firm financial performance *over a period of time*. Details income and expenses and ends with profit or loss.
- Most firms focus on net service revenue (NSR), not gross revenue. NSR is gross revenue less pass-throughs including subconsultants and reimbursable expenses.
- Revenue - expenses = profit (loss).
- Expenses are ordered from most to least “direct”.
- Isolate discretionary expenses (such as bonuses) if possible.
- Profit doesn’t equal cash!

## Financial statement overview



- Balance sheet - shows a “snapshot” view of financial condition at a point in time.
- “What you own vs. what you owe.”
- $\text{Assets} - \text{liabilities} = \text{owners' equity}$  (also referred to as “book value”).
- Assets and liabilities are ordered by liquidity





## Financial management vs. accounting



- **Strategic financial management** is the link between daily activity and overall firm direction.
- **Accounting** focuses on historic review. Financial management is forward-looking.
- **Financial management** focuses on predictive measures and goals.

## Financial performance metrics

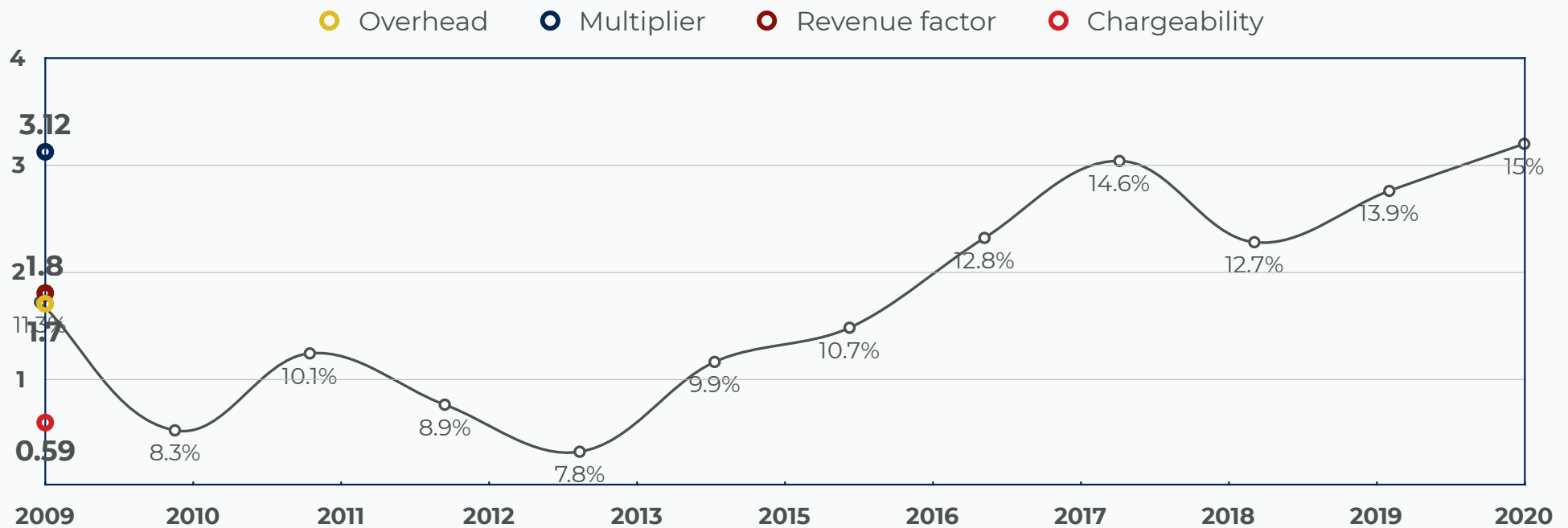


	OVERALL MEDIAN	HIGH PROFIT	ARCHITECTURE
Net Service Revenue/FTE	\$150,157	\$166,648	\$165,389
Net Multiplier	3.09	3.2	3.35
Revenue Factor	1.9	2.04	2.12
Utilization	62%	63%	63%
Overhead	1.59	1.49	1.68
Pre-tax, Pre-bonus Profit/NSR	15%	19.5%	25.7%
Average collection period	70 days	73 days	90 days
Return on Equity	54%	78%	92%

**Note:** Simplified median data from the Zweig Group 2020 Financial Performance Survey of AEC Firms

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## Metrics over time



## Predictive metrics



- Pipeline
- Backlog
- Revenue forecasting
- CRM database entries
- Web hits
- Inquiries
- Project opportunities
- Proposals
- Sales



# Cash flow management

## Managing cash flow



- Working capital is a metric that represents operating liquidity. It includes current assets such as cash, AR, WIP, minus other current liabilities.
- Getting billings out the door faster and collection of accounts receivable are the most important elements of managing cash flow for the typical firm.
- Reducing your firm's average collection period begins at home (meaning stuff you can control!), including managing scope, time sheets, bringing more NSR in house vs subbing it out, and improving WIP.

## Work in process (WIP)



- Total value of work performed that has not yet been billed to clients. Usually expressed in days of unbilled revenue.
  - 2020 Median: 15 days

$$\text{WIP} = \frac{\text{Unbilled Revenue (wip)}}{\text{Annual Gross Revenue}} \times 365 \quad (\text{expressed in days})$$

## Average collection period (ACP)



- Measures how quickly revenue turns into cash.
  - 2020 Median: 70 days

$$\text{ACP} = \frac{\text{Accounts Receivable}}{\text{Annual Gross Revenue}} \times 365 \quad (\text{expressed in days})$$





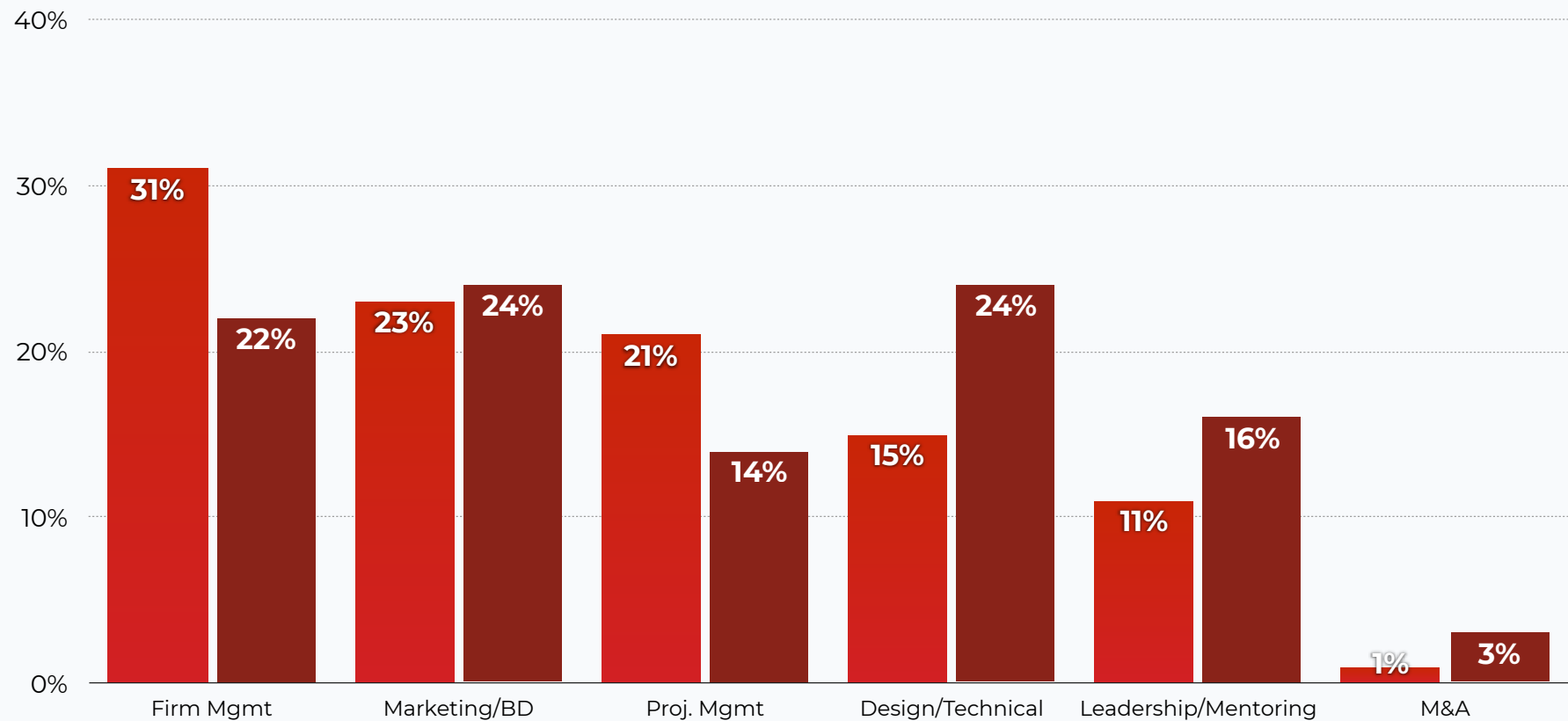
# Industry data on owners

## Top challenges as an owner

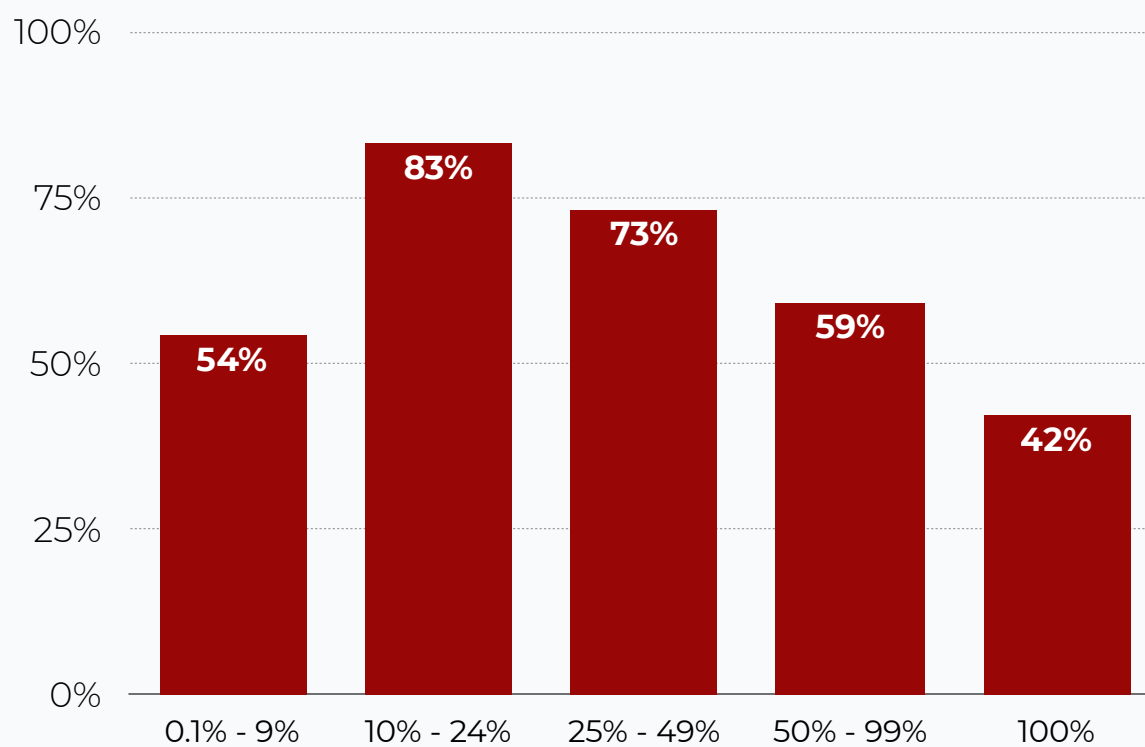


		ARCHITECTS	ENGINEERS
Recruitment/Retention		3.5	4
Business Planning	→	3.7	3.1
Owner Transition	→	3.6	2.9
Time Management	→	3.5	2.8
Growth/Profits		3.3	3.4
Financial Issues		3.2	3.2
Communication		2.9	2.9

## Real vs. **ideal** time management for architects (owners)



## Does your firm carry a life insurance policy for you?

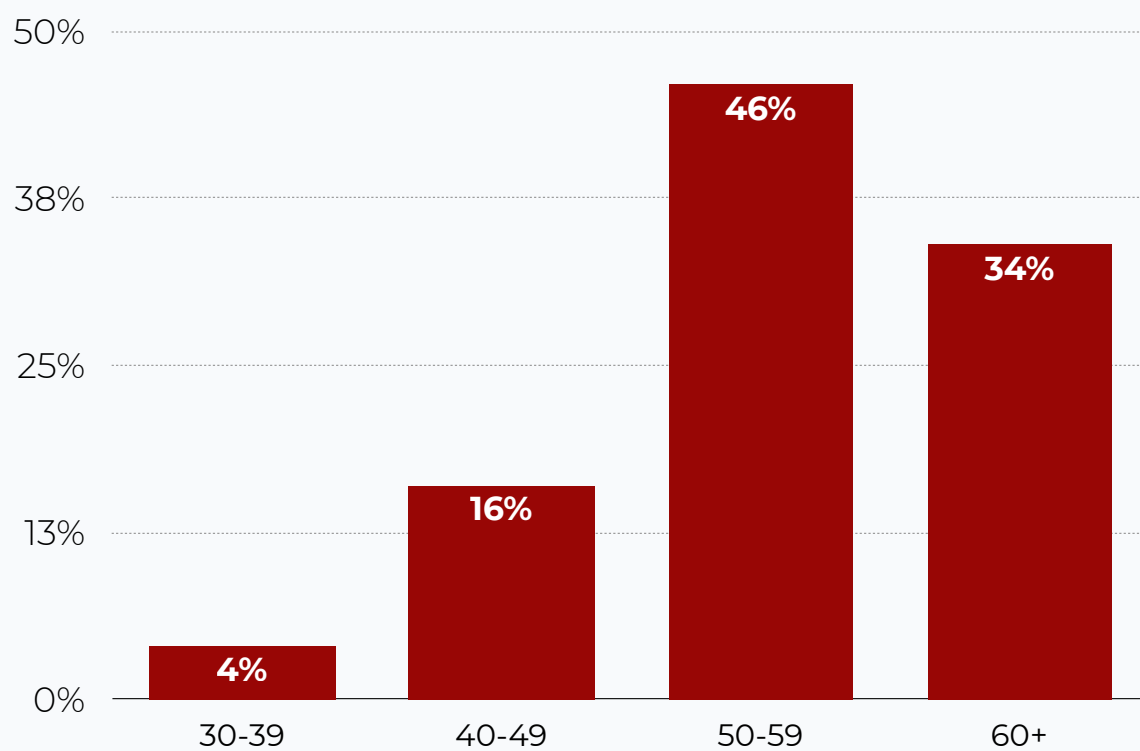


## Owners in AEC firms without life insurance policy securing equity value

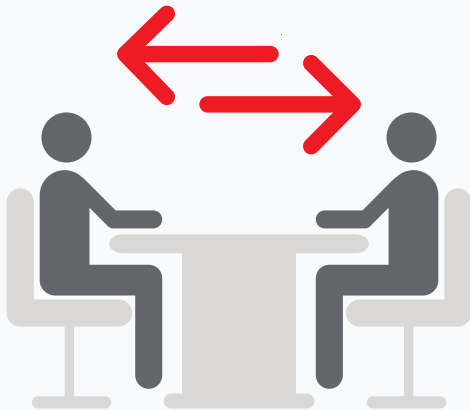


OWNERSHIP PERCENTAGE	NET SERVICE REVENUE	EQUITY VALUE @ 50% NSR	UNINSURED VALUE
0.1% - 9.9%	\$122,332,272	\$61,166,136	\$3,058,307
10.0% - 24.9%	\$42,613,000	\$21,306,500	\$3,195,975
25.0% - 49.9%	\$2,790,788	\$1,395,394	\$488,388
50.0% - 99.9%	\$14,427,190	\$7,213,595	\$5,410,196
100%	\$2,603,844	\$1,301,922	\$1,301,922

## Aging ownership population



# Why should I care about ownership transition planning?



01

**IT'S THE ONLY WAY TO KEEP AN ARCHITECTURE FIRM AS A GOING CONCERN, OPTIONS ARE TRANSITION OR SHUT DOWN.**

02

**IMPACTS EVERY ASPECT OF AN AEC FIRM.**

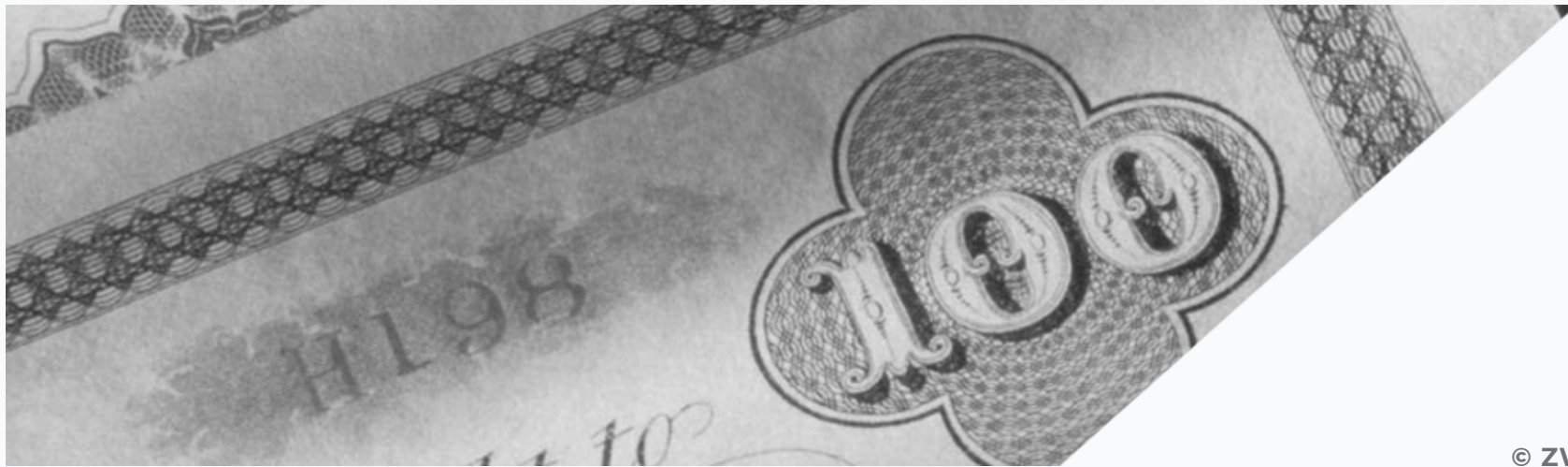
03

**THE VEHICLE TO HARVEST VALUE.**

04

**IT TAKES TIME!**

# Transition options





## Understanding the basic options



- Selling ownership interest internally.
- Selling the ownership interest or some portion of it to an Employee Stock Ownership Plan (ESOP).
- Selling the firm externally.
- Using debt to retire equity shareholders.
- Using a deferred compensation strategy.
- Merging the firm with another firm and then pursuing one of the above.
- Going public (available to very few).

## Key elements of internal transition



**FINANCIAL  
ARRANGEMENTS**



**MANAGEMENT  
SUCCESSION**

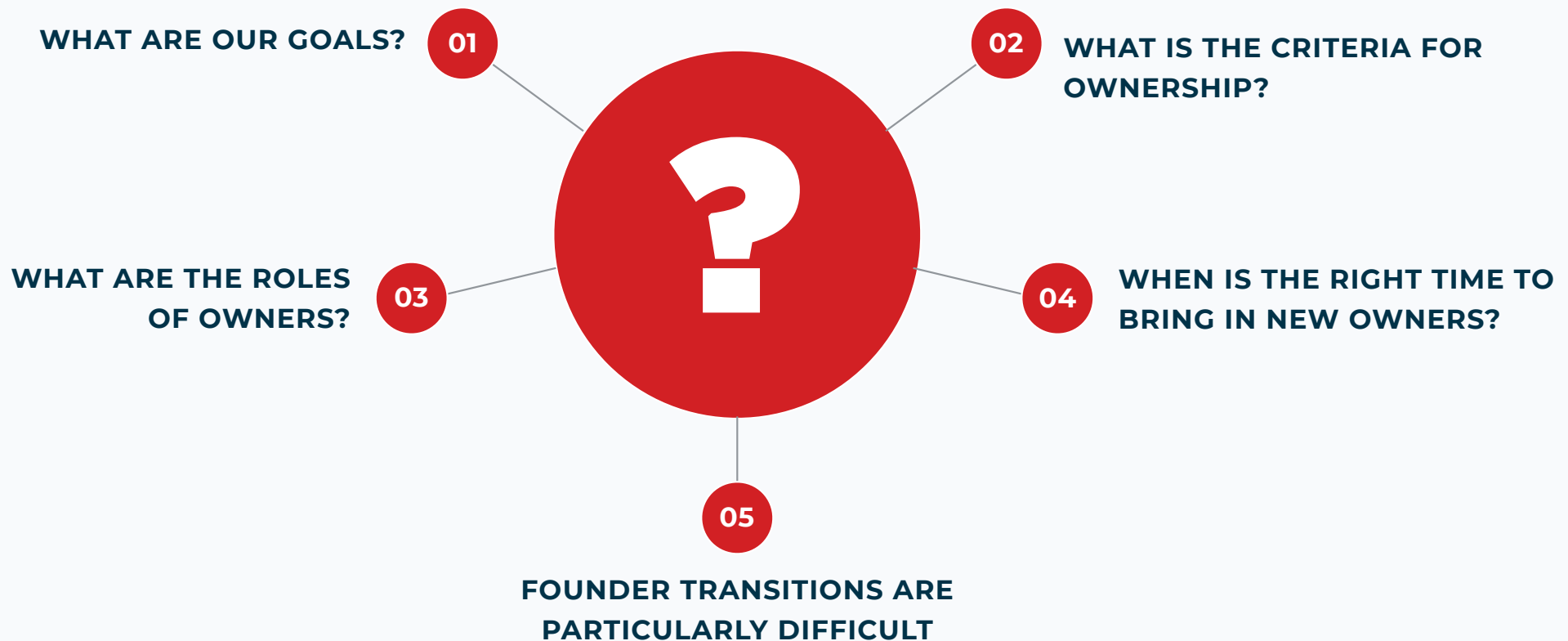


**CORPORATE GOVERNANCE /  
LEADERSHIP ROLES**



**CULTURAL  
CONTINUITY**

## Growing a business is different from exiting a business



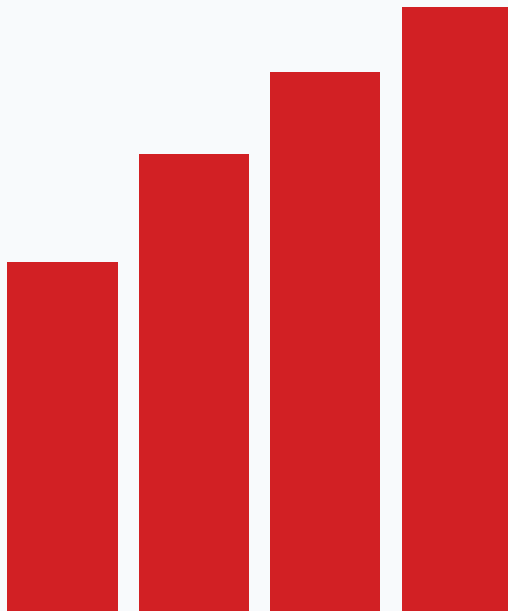
## Leadership vs. ownership



In a mature firm, leadership and ownership may not be the same

In a young firm, leadership and ownership may be synonymous

## Drivers of value



- 01 GROWTH RATE
- 02 PROFITABILITY
- 03 CONSISTENCY OF PERFORMANCE
- 04 QUALITY OF FINANCIALS
- 05 BRAND NAME
- 06 SPECIALIZATION
- 07 CEO SUCCESSOR/SECOND TIER MANAGEMENT
- 08 STAFF QUALITY
- 09 CLIENT/POTENTIAL CLIENT DATABASE
- 10 CLIENT CONCENTRATION
- 11 BENCH DEPTH OF KEY SELLERS



### **MARKET APPROACH**

Z-Values, industry comparable's, etc.

### **INCOME APPROACH**

Capitalization of earnings or discounted cash flow analysis.

### **ASSET APPROACH**

Book value, AE industry is not an asset heavy class, so not used very often.

## Valuation ratios: z-formulas



**\$75,747**

**VALUE PER  
EMPLOYEE**

**0.54**

**VALUE TO NET  
SERVICE  
REVENUE**

**0.63**

**VALUE TO  
BACKLOG**

**3.87**

**VALUE TO  
EBITDA**

**3.55**

**EQUITY VALUE  
TO PROFIT**

**1.95**

**EQUITY VALUE  
TO BOOK  
VALUE**

*Note: Simplified median data from the Zweig Group 2020 Valuation Survey of AEC Firms*

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## Percentage ownership



### **CONTROLLING INTEREST**

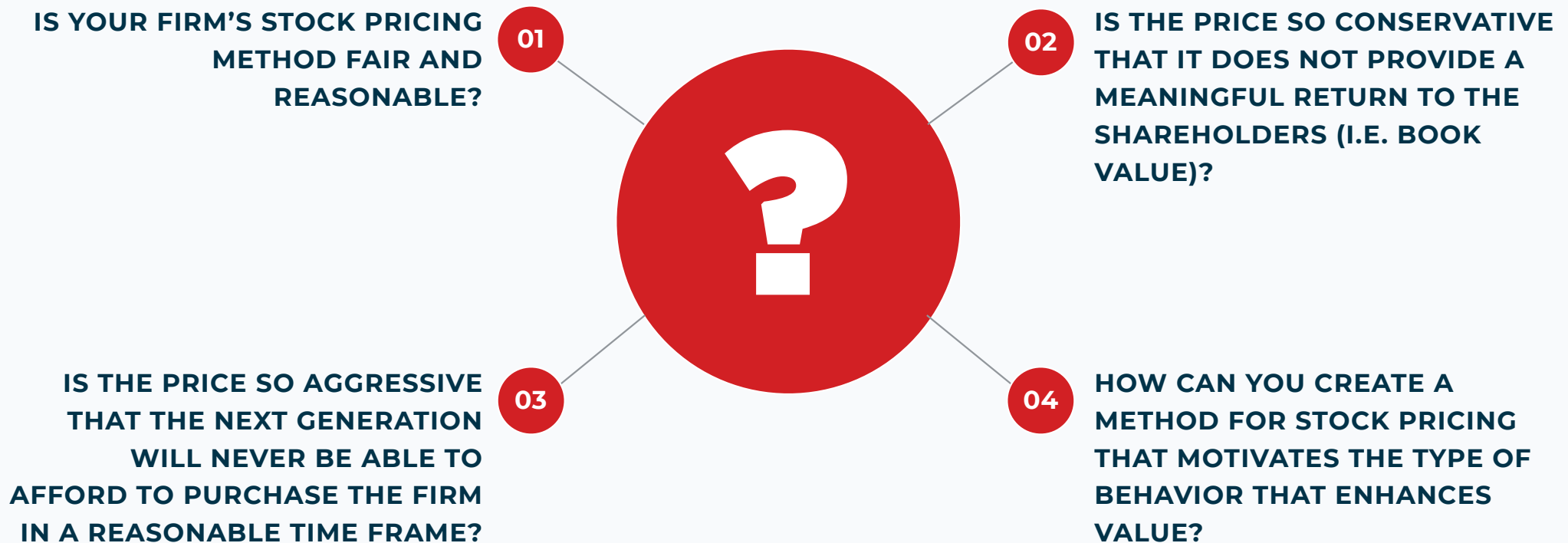
- Represents 50.1% of ownership
- Market value or premium over internal value

### **MINORITY INTEREST**

- Typically has discount applied to market value
- Discount for lack of marketability
- Discount for lack of control



## Valuation considerations: internal ownership transitions



**Start planning now**



## Preparation



- Develop an internal stock market
  - Share financial information and state of the company regularly.
  - Invest in leadership training
- What should a prospective owner know?
  - Income statement
  - Balance sheet
  - Cash flows
  - Return on equity (*assumptions*)
- Get your team organized
  - Legal council, CPA, tax planning professional, business advisor, etc.



Developing a strategic plan – and sharing it widely – creates focus and direction, helping staff work towards common goals.

01

**WHERE DOES YOUR FIRM WANT TO BE IN FIVE YEARS? MISSION & VISION.**

02

**WHAT MARKETS, SERVICES, DISCIPLINES? DO WE WANT TO GROW?**

03

**WHAT TYPES OF CLIENTS?**

04

**WHO ARE THE NEXT LEADERS? WHAT ARE OUR CORE VALUES?**

## What you should do today



- 01 **BALANCE NEAR LONG TERM PLANNING WITH LONG TERM PLANNING**
- 02 **UPDATE YOUR STRATEGIC PLAN ANNUALLY**
- 03 **HAVE AN OWNERSHIP TRANSITION PLAN AND FINANCIAL MODEL. TEST SCENARIOS**
- 04 **CHOOSE YOUR TEAM CAREFULLY**
- 05 **MONITOR FINANCIAL PERFORMANCE**
- 06 **KEEP ASSUMPTIONS AND EXPECTATIONS FOR VALUE AND TIME LINES REASONABLE**

Thank you!!

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