Making Ownership Affordable and Attractive

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Many design professional firms are actively considering expanding their ownership teams and/or transitioning ownership to a new generation of leaders. They know that offering ownership is essential to ensuring the ongoing prosperity of their firms, to attracting and retaining highly qualified and ambitious staff, and to enabling current owners to benefit from the value they created through long years of hard work.

However, challenges abound. An unprecedented percentage of owners of architecture, landscape architecture, engineering and specialty design firms are approaching retirement. Professionals with more than 10 years of experience are actively being solicited by recruiters and competitors. And prospective owners in their thirties and forties tend to be more focused on living a balanced life—of which work is but one element—and have limited financial resources to invest in purchasing equity in a firm. Hence many firms face a growing challenge: How do we make ownership attractive and affordable?

Consider incorporating these strategies into your ownership transition and expansion framework:

- **Start with a Realistic Valuation**. Fair market value, generally defined as the price at which ownership would change hands between a willing buyer(s) and a willing seller(s), with all parties having reasonable knowledge of relevant facts, sounds simple enough. But sellers often place an inflated value on their firms. As they built a strong network of clients and created impressive portfolios, they incurred risks, invested in staff and expended tremendous effort navigating through challenging economic cycles. In their minds, they should be rewarded and future owners should be willing to make similar investments. To a prospective owner, however, the calculation is different. Are the risks of ownership and the expectations of long hours and greater responsibility worth the cost and, if so, what kind of payback can be expected?

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  Valuations must find the right balance and reflect 1) a firm's net worth, and 2) its ability to generate future profits. Firms with substantial assets, relatively few liabilities, significant backlogs and a strong history of profitability should generate a premium value. Similarly, firms with few assets, a shrinking backlog, large liabilities and/or a sporadic history of earnings should yield a much lower value.

  When valuing your firm, stay away from simple rules-of-thumb such a multiple of book value. Make sure the valuation accounts for 1) items that may have been mistakenly omitted from the balance sheet (such as work-in-process, pre-paid expenses, depreciation, allowances for bad debt, and accrued expenses), 2) projections for future earnings based on a three- to five-year outlook, 3) intellectual capital that differentiates your firm, and 4) discounts for various risk factors.

- **Include Appropriate Discounts**. Most privately held design firms differ from publicly held firms in terms of governance, liquidity, restrictions on ownership, reliance on key personnel, and degrees of diversification. Valuations and share prices should reflect the following discounts:

  – Minority Discount. As most new owners will own a small percentage of a firm's outstanding shares, they will have limited governance and decision-making control of the firm. Unless a firm's bylaws and corporate governance agreements provide minority owners with substantial decision-making powers, it is not unusual to incorporate a 10 – 20% minority discount. Similarly, if a controlling interest is being sold that entitles a new owner to certain rights, which is seldom the case in an internal transition, then a premium might be added.

  – Reliance on Key Persons(s) Discount. When a business is highly reliant on one or a few key people, particularly in the sales and marketing areas, a valuation discount may be appropriate to account for the risk of reduced future earnings should the firm not obtain the same volume of new business without this person(s).

  – Key Client Discount. When a business is highly reliant on relatively few clients, a valuation discount may also be appropriate to account for the risk of reduced future earnings should the firm not retain these clients and/or the pipeline of business from some or all of these key clients substantially decreases.

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- Lack of Marketability Discount. Marketability (or liquidity) refers to the ability of an owner(s) to convert their ownership interest in a security to cash. Unlike unrestricted minority interests in publicly traded stocks, minority interests in privately held companies are generally considered to be "non-marketable" due to the absence of an active exchange on which they can be traded.

- **Distribute a Portion of the Firm's Net Worth**. Because a firm's value includes its net worth (assets minus liabilities), the outlay required by incoming owners can be reduced by distributing or allocating a portion of the firm's cash, accounts receivable and work-in-process to its current owners. This strategy reduces the buy-in price for incoming owners while distributing a portion of the firm's value to current owners.

- **Develop a Deferred Compensation Plan**. Similar to distributing a portion of a firm's net worth to new owners, a firm can allocate future compensation or profits to one or more of its current owners. A Non-Qualified Deferred Compensation plan (NQDQ) is a fairly common and relatively easy plan to implement. In addition to lowering a firm's net worth by creating a future liability, a NQDC can provides substantial tax benefits to both a firm and to recipients of the deferred compensation.

- **Offer Initial Shares at a Lesser Price**. To help jumpstart an ownership buy-in program, firms can offer the initial tranche of shares at a lesser amount. For example, in exchange for the intellectual capital and skills that a person is expected to contribute to the company as an owner, a firm might offer that person a set number of shares at 50% or 75% of the share value. (This is often accompanied by a vesting schedule.) Be careful though that these are not construed as discounts that might trigger taxes to the offeree or obligate the firm to pay taxes on behalf of the offeree.

- **Consider One-Time Salary Increases or Bonuses**. Providing an incoming owner with a one-time salary increase or bonus, again in recognition of his/her contributions to the firm and the additional responsibilities anticipated as an owner, can help offset buy-in requirements. Some firms that provide such a bonus also "gross up" up the bonus to cover the recipient's additional income taxes.

- **Provide Additional Incentive Bonuses**. Instead of one-time bonuses, consider implementing a program that rewards incoming and/or new owners with additional bonuses aligned with the firm's culture, marketing and other performance targets, and long-term goals. Then distribute these bonuses either as cash (so that recipients can use the after-tax proceeds to purchase additional shares) or directly as shares (in which case consider bonusing additional cash to cover the recipient's tax obligations).

- **Modify the Firm's Bonus and Distribution Framework**. By changing the relative amounts of a firm's pre-bonus profits allocated to owners, to key persons and to other staff, a firm can allocate a portion of its bonuses and/or distributions to help people fund future buy-ins.

  If doing so with distributions, make sure that the corporate and tax status allow distributions not aligned with actual ownership percentages. When doing so either through bonuses or distributions, make sure that other owners understand how such changes might affect their total compensation packages.

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- **Provide Financing Options**. Although a down payment is recommended so that each owner has some skin in the game, providing a financing option allows initial purchases to be paid partially in cash and partially through a promissory note held by the firm. While the terms of the note can be negotiated (such as duration, minimum payments, collateral and offsets through future distributions and bonuses), make sure that such financing meets IRS regulations for an arm's-length transaction so that unforeseen taxes are not triggered.

- **Offer Ownership in Phases**. Offer ownership in smaller tranches over five to seven years. This makes each purchase more affordable and provides time between major purchases for new owners to receive profit distributions and to pay down loans.

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- **Plan a Business Plan to Increase Future Profits**. Remember, almost all ownership purchases depend on future profits to make the transaction worthwhile. And with new owners and an expanded ownership team, a firm should be positioned to increase future profits, making an ownership investment all the more worthwhile.

There are numerous intangible values of ownership: greater opportunity to shape a firm's future; a more effective platform from which to market and guide clients; more involvement in firmwide governance and decision making; and expanded opportunities for professional growth and recognition. Yet unless there is a strong financial incentive, many qualified offerees will continue the recent trend of declining offers to purchase equity or, worse, seek a better offer elsewhere.

Please share your thoughts on making ownership more attractive and affordable by emailing Michael@StrogoffConsulting.com or calling us at 415.383.7011.

About the Author:

Michael Strogoff, FAIA, has advised many of the nation's most successful architecture, landscape architecture, design, engineering and construction firms; managed large and complex projects over a 30-year career; and guided firms nationwide in the ownership transition process. As a former managing principal of an architecture firm, a frequent speaker and author on mergers and acquisitions and ownership transitions, a five-year Advisory Group member to AIA's Practice Management Knowledge Community, and an advisor to design professionals nationwide, Michael Strogoff brings an in-depth understanding of the architecture, landscape architecture, engineering and related design industries and of the ownership transition and mergers/acquisition process.

Michael recently authored the chapter on Ownership Transitions for the 15th edition of AIA's The Architect's Handbook of Professional Practice. He has been awarded Presidential Citations and Commendations from the AIA California Council and AIA San Francisco for his contributions to the design professions and, in 2009, was elevated to the American Institute of Architects' College of Fellows for his contributions to the practice of architecture. Michael has also served as a mediator and as an expert witness pertaining to valuations of closely held design firms.

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