Consolidation Nation

Industry Consolidation Is Part Of The "New Normal" For MEP Firms.

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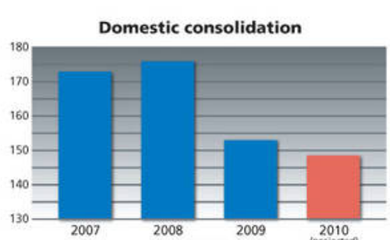
More than a quarter of the *Consulting-Specifying Engineer* 2010 MEP Giants merged with, sold to, or acquired another architecture, engineering, and construction (AEC) firm—and in some cases non-AEC firms—over the past year. This is up from one in five of the giants who participated in mergers and acquisitions the prior year.

Does this increase indicate a trend? Does it mean that all *Consulting-Specifying Engineer* readers will soon work for one of a handful of industry giants, as the big firms get bigger and small firms get swallowed up by their larger competitors? Is the industry going the way of every other mature industry where there are a handful of global players who can compete for the biggest, most complex, and most profitable projects anywhere while the rest of the market fights over the commodity scraps left?

The answer to all three of these questions is a resounding … maybe. But one thing is for certain: as mechanical, electrical, and plumbing (MEP) firms emerge from the carnage of this recession, mergers and acquisitions will be more commonplace over the next three years and will continue to shape and impact individual firm strategies and tactics (e.g., How does a 50-person MEP firm compete against a 50,000-person firm?). Let's look at how mergers and acquisitions impacted the industry—and the competitive landscape—over the past year.

Bottoming out

While the *Consulting-Specifying Engineer* Giants saw an increase in the level of mergers and acquisitions activity within their ranks, overall industry consolidation actually declined globally and nationally (see Figures 1 and 2) in 2009 from its peak levels in 2008. This occurred as a result of larger, stronger firms putting the breaks on their acquisition initiatives due to market uncertainty; smaller firms choosing not to sell because their financial condition became so precarious that they couldn't secure an attractive (or any) valuation; and many small firms that were hoping to sell simply failing or going out of business. Mergers and acquisitions tends to follow the economic cycle, with more activity during boom times and less during recessions. So during the fourth quarter of 2008 and for most of 2009, the bottom fell out of the AEC mergers and acquisitions market. Globally activity declined some 23%, while domestically it fell by 13%.



However, as the economy begins to slowly recover, mergers and acquisitions activity this year has stabilized at 2009 levels and is beginning to pick up pace as the third quarter of 2010 wraps up. In fact, it is anticipated that consolidation—among this year's *Consulting-Specifying Engineer* Giants and in the industry overall—will hit a frenetic pace in the fourth quarter of 2010 fueled by a combination of cash-rich publicly traded AEC firms looking to acquire, and highly motivated sellers who are unable to generate the capital required to

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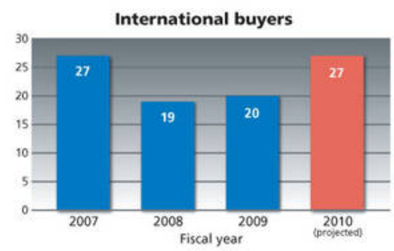
continue independently and want to take advantage of the lower tax environment before capital gains and personal tax rates increase at the end of this year.

Defensive deals in vogue

Last year saw the continuation of a very interesting trend in the consolidation of the design industry. The percentage of domestic deals that occurred across state lines fell to an all time low of 50% (see Figure 3). Prior to 2007, generally two-thirds to three-quarters of domestic deals involved one firm buying another in a different state. This phenomenon represented the fact that mergers and acquisitions typically was driven by a firm's desire to grow across state lines to diversify earnings and revenues and capture new opportunities. However, since 2007, this percentage has been declining to its low point this year, where only half of all deals represented geographic growth. The other half represented intrastate deals.



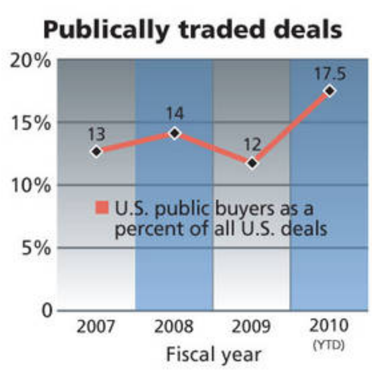
This decline is representative of the fact that during this recession, mergers and acquisitions has been significantly influenced by firms in financial distress that are in the same states or cities. They wind up merging with each other because either one of the firms would go out of business if they didn't, or would have to consolidate their operations. And while there are no accurate statistics on bankruptcies in this industry, anecdotally it's clear that as an industry we have seen more of them this year than ever before. We anticipate that the low levels of inter-state mergers and acquisitions activity will continue through the first half of 2010, but then start to rise in 2011 as consolidation takes off due to pent-up buyer and seller demand.

The British are coming!

Another consolidation trend that continued to shake up our industry last year involved the acquisitions of U.S. firms by overseas organizations (Figure 3). Among the *Consulting-Specifying Engineer* Giants this is best exemplified by the acquisition of Parsons Brinckerhoff by Balfour Beatty. Last year, 13% of sales of domestic firms involved an overseas buyer, up from 10% the prior year. Based on this year's mergers and acquisitions activity, it's anticipated that close to 18% of all U.S. firm sales in 2010 will be to a foreign buyer—representing a significant inflow of foreign capital into the domestic industry. This trend is in large part driven by the size and relative attractiveness of the U.S. AEC market compared to individual international markets and the desire of overseas buyers to position themselves in the United States when valuations are low compared to where they were in 2007 and 2008.

How Wall Street is shaping the industry

Possibly the most intriguing aspect of industry consolidation has been the role of publicly traded firms. Public firms such as AECOM, Stantec, URS, and Balfour Beatty all contributed to consolidation of the *Consulting-Specifying Engineer* Giants over the past year. For the most part, these publicly traded industry giants are buyers, not sellers, in the consolidation equation.



Publicly traded buyers put a hold on mergers and acquisitions activity in the fourth quarter of 2008 when the financial crisis was at its worst, and they did not begin to return to the market until the third and fourth quarters of 2009. U.S. publicly traded firms made fewer acquisitions in 2009 than in either of the prior two years. However, through the first seven months of 2010, deals involving publicly traded firms number the same for the entire prior year. This is representative of the fact that most of the publicly traded firms have a lot of cash on their balance sheets (as do most of the *Fortune 500* and *Russell 2000* publicly traded firms). They have identified "bargain" buying opportunities of firms that have a good brand name and great talent, but that have been significantly damaged by the recession. They are deploying their cash (which is earning them minimal returns) and investing it in strategic and opportunistic acquisitions that they believe will provide them a greater return on their capital in the future.

Conclusion

As we move into the final quarter of 2010, we can expect to see further consolidation of the *Consulting-Specifying Engineer* Giants. Based on the trends that we are tracking and the conversations between buyers and sellers, it won't be surprising to see more Korean, Canadian, British, and Australian owners of *Consulting-Specifying Engineer* Giants in next year's rankings. It would also be a good bet to assume that many of these international buyers will be publicly traded and will join more U.S. publicly traded firms among the leaders in the MEP industry space.

If all this makes your head spin, don't worry. But do try to get used to it, because it will become the new normal for you and your team. Your challenge is to determine how these changes can create opportunities for your firm.

Editor's note: Birdsall, Syska & Hennessey, and EMC Engineers took part in mergers and *acquisitions over the past year, but erroneously did not report that in their MEP Giants questionnaires.*

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