

2008 OPENS WITH EYES ON POTENTIAL IMPACTS OF CREDIT CRUNCH ON DEAL FLOW, VALUATIONS

As 2007 rolled into 2008, the faltering state of the U.S. economy was making its way to the front pages of the nation's newspapers and highlighting the coverage of the major TV news networks, shoving aside the war in Iraq and jockeying with the presidential campaign. The subprime mortgage lending crisis and associated credit crunch that emerged during the summer of 2007 continued to reverberate through the U.S. economy and beyond, and the ultimate impact remained anybody's guess late in the first quarter of 2008.

Few economists, government officials, and pundits would dare say that the economy has entered into a recession, but none could avoid frequent and anxious discussions revolving around the "R" word. Meanwhile, housing prices continued to plunge, foreclosures mounted, residential construction cratered, consumer spending slowed, and the economy lost 17,000 jobs in January—the first employment decline since 2003, according to *The Economist* (Feb. 9, 2008). Not all states suffered, but the specter of a potentially severe economic downturn was sufficient to move Congress to act in (relatively) rapid fashion and pass an economic stimulus package in February—albeit, one focused on rebates for individual taxpayers rather than new infrastructure programs, as many of the nation's governors would like.

Like everyone else, executives at environmental and infrastructure consulting and engineering (C&E) companies are casting a nervous eye into 2008, coming off a pair of years that had been the best the sector had seen in some time. Looking back on 2006, executives of 194 C&E firms responding to the 2007 CEO survey conducted by the Environmental Financial Consulting Group, Inc. (EFCG) (New York, NY) (www.efcg.com) indicated that internal growth averaged an impressive 12.9% for 2006. They had predicted their customary 10%, and these projections had historically been higher than the actual figures. The financial performance for 2007 was looking like it would fall just a bit compared with 2006, but not by much.

In a mini-survey of its 15 largest engineering and construction (E/C) clients conducted in January, EFCG discerned an undercurrent of optimism for 2008 mixed with a significant dose of concern about the economy. Five firms experienced better financial performance for the fourth quarter of 2007 than they had projected in October, while nine firms were essentially on target with their October predictions and one firm fared worse than projected. In their outlook for 2008, four firms said that they would perform even better than they did in 2007, three predicted that performance would be about the same, three said that their performance would be worse, and five said that the outlook is "not clear."

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According to ZweigWhite's 2008 AEC Industry Outlook, respondents to its latest annual Business Trends Survey identified the performance of the U.S. economy as the second most important challenge facing A/E/P and environmental consulting firms in 2008, behind the inability to find qualified staff and ahead of staff training, health insurance costs, and increasing competition. Seven percent of the respondents said that economic conditions in late 2007 were "much better" than one year earlier, 23% said "somewhat better," 27% said "the same," 41% said "somewhat worse," and 2% said "much worse."

Looking forward into 2008, many questions are on the minds of architectural, engineering, planning (A/E/P), and

environmental consulting executives. What market segments would be affected, and how badly? Would the recent, sector-wide double-digit growth fall back to single-digit levels? What would happen to merger and acquisition activity, which in 2007 reached a dizzying pace? Would company valuations, which also had attained historic highs, come back to earth, or worse?

As for affected market segments, companies having any business tied to land development, and in particular residential land development, were starting to take hits in the last quarter of 2007 (see the article by EDR's Dianne Crocker on page 6 of this issue). Companies doing capital project work for municipalities were hanging their hopes on the fact that many of these types of projects, with their long timelines, were already in the pipeline, and that any slowdown would be at least several months away. They have reasons for concern, however.

"The biggest risk right now, while the credit market is tightening, is how does that affect the tax base in the U.S.," said Michael O'Brien, a principal in ZweigWhite's Washington, D.C. office and head of the firm's valuation and ownership transition consulting practice. "You are starting to see the tax base shrink for municipalities. Whether they are relying on property, income, or sales taxes, some firms are concerned about the long-term prospects for funding specific projects. We have not seen any funding cut yet," O'Brien told *EBJ* in late January, "but companies are mindful that there could be an issue 12 to 24 months out. If the credit market loosens, that could help."

In fact, one trend that O'Brien has observed, especially among those firms that were overexposed in land development, is "a push into municipal business. These companies are saying, yes, the margins are lower, but we appreciate the lower volatility." He added that companies "have done some staff trimming, but they are taking a hard look at staff capacity, and they are culling the bottom rather than making arbitrary cuts. They see the need for their services as coming back, and it's hard to lose people in these industry sectors, which are so hard-pressed to find and retain talent."

Firms serving the private sector remain cautiously upbeat, especially those serving clients with operations outside the United States, or with exports gaining a push from

the weak U.S. dollar. Most confident are those environmental consulting and engineering firms serving the robust energy sector. U.S. generation and transmission capacity was severely pinched in the earlier part of the decade, and energy demand is exploding in the United States and abroad (consider the 10% economic growth in India and China). Oil prices are high and thus prompting capital expenditures to meet this demand and close the capacity gap in the conventional energy market, while climate change concerns and the prospect of future carbon regulation have stimulated investment in alternative energy development, such as biofuels production and wind and solar power generation. "We don't see our market as recession-exposed," noted Emily Grothe, CEO of **Natural Resource Group LLC** (Minneapolis, MN) (www.nrginc.com), a provider of environmental services exclusively to the energy industry. "We see it as recession-proof."

VALUATIONS DOWN SLIGHTLY

What impact has the credit crunch had on valuations and M&A deal flow through the first three months of 2008? "Not much" and "none at all" appear to be the respective answers. Valuations and stock prices have fallen somewhat from their mid-2007 highs, but not anywhere near enough yet to deter the drive to acquire.

That drive has the pedal to the floor, continuing the 2007 trend. Again, according to EFCG's 2007 CEO survey, 40% of the 194 respondents indicated that they planned to complete 148 transactions in 2007—the most active M&A market that EFCG has seen in 20 years and twice the number of deals completed in 2000, the previous high point. The survey respondents said that they expect to undertake 150 transactions in 2008, and financial advisors to the A/E/P and environmental consulting industries report no erosion of deal backlog. Several factors conspire to ensure that this elevated pace of M&A activity should continue—not the least of these the weak dollar, which is fueling an already intense interest on the part of non-U.S. firms in gaining a toehold in the U.S. engineering market through acquisition.

In a white paper released in early January 2008, the investment banking firm **FOCUS LLC** (New York, NY) (www.focusbankers.com) cited the weak U.S. dollar as helping to stabilize the U.S.

economy by "encouraging overseas investments, and thus helping offset the looming predictions of a 2008 recession." The white paper, titled *The 2008 Middle Market M&A Forecast*, cited a study by the Economist Intelligence Unit and CIT Group, Inc., which concluded that, despite the predictions of a recession, 64% of U.S. middle-market companies with revenues between \$25 million and \$1 billion are expected to grow in the next 12 months. According to FOCUS, foreign acquisitions are driving this growth: "The weak U.S. dollar compared to foreign currencies has created compelling investment opportunities for overseas buyers, particularly Middle Eastern, European, and Indian investors."

Asked in late January whether any developments following the release of the white paper prompted his firm to reconsider its upbeat scenario, FOCUS CEO Doug Rogers acknowledged that uncertainty persists. Generally, in these kinds of economic slumps, "banks try to overstate write-offs in the initial announcement, to give them extra maneuvering room," he told *EBJ*. "When they have to restate the write-offs and make them larger, and do this multiple times, that gives me concern." With this in mind, it was obvious as of late January that "the worst was not over," he said. The Federal Reserve Bank cut the federal funds interest rate by an "unprecedented" three-fourths of a percent on January 22, he pointed out, and *The Wall Street Journal* had just reported that banks had written off \$100 billion in losses. "Have we finally at least properly sized the losses?" he asked, with more than a hint of skepticism. "Hopefully, they oversized them. Or is there another shoe to fall? That's the biggest question. I don't think anybody knows."

Still, all signs appear to indicate an ongoing high level of deal flow. As of February, both ZweigWhite and EFCG were reporting full backlogs of transactions in which they were serving as advisors to at least one of the parties. "I'm not sure I have even seen one iota of an impact of (the credit crunch) on my business," observed Steve Gido, a ZweigWhite principal in its Washington, D.C. office who heads the firm's mergers and acquisitions consulting group.

In a February 2008 *Overview Letter for the Engineering and Consulting Industry*, EFCG did note that it is seeing

private-equity firms that "rely heavily on financial leverage (i.e. debt) to finance their transactions becoming unable to be as aggressive as they were six months ago." Nevertheless, EFCG said, those private-equity firms whose primary strategy is to rely on growth rather than financial leverage to achieve their return objectives remain "very interested in making investments."

One of the key factors sustaining the high level of M&A activity is what EFCG Principal and Vice President Andrej Avelini characterizes as a "phenomenal run" of growth in the stock prices of publicly traded E/C firms. Stock prices in EFCG's own index of U.S. and Canadian E/C companies rose a whopping 400% from Dec. 31, 2002, through Dec. 31, 2007, outpacing the S&P 500 by a factor of five. Price to earnings (P/E) ratios hit incredible highs of 28X after-tax. These types of valuations have provided a tremendous purchasing advantage for public companies in the M&A game, as the aggressively acquisitive behavior of **AECOM Technology Corp.** (Los Angeles, CA) (www.aecom.com) and **Stantec** (Edmonton, Alberta) (www.stantec.com) demonstrates. If anything, these two companies have stepped up their acquisition pace in 2008.

"The high P/Es give publicly traded firms the ability to afford higher valuations for the right strategic acquisitions," EFCG said in its *Overview Letter*. "Furthermore, Wall Street's high expectations for earnings growth embedded in current valuations exerts additional pressure on public firms to buy in order to meet those growth expectations." Moreover, it added, most E/C firms "have fairly de-levered balance sheets with substantial debt capacity for acquisitions."

Stock prices have fallen back a bit in 2008 as the economy has softened. ZweigWhite's O'Brien, however, points to the challenge of sustaining the public C&E firms' outstanding earnings performance and sees cause for sobriety rather than gloom. The stock declines reflect a correction rather than a tumble, he suggested to *EBJ*, and "I would say that the correction was needed, absolutely. The risk profile for sustaining that earnings performance potential gets risky. The correction we are seeing in the marketplace is bringing a lot of these companies back to reality." He added that the need for qualified technical personnel

will help drive the urge to acquire. "As long as there is a capacity constraint on talent, you'll see more M&A activity as a way to staff up."

Noting that public market valuations had been at all-time highs, EFCG's Avelini expressed confidence that the market correction shouldn't deter deal-making. "Lots of drivers are in place to indicate that 2008 will be active on the M&A front. The P/E ratios might come down, but they will still be very high. Say it falls from 27X to 22X—that's still higher than the 8X to 10X they are buying at, so the deals are still accretive. So I don't see a stark drop in activity in 2008."

In fact, the prospect of future declines in valuations could accelerate the pace of deal-making, according to Grant Ferrier, president of **Environmental Business International, Inc.** (San Diego, CA) (www.ebiusa.com). "Fear that valuations could fall further has the potential to push prospective sellers into the marketplace earlier than they might otherwise have done," he observed. "The thinking is, better to sell now and maximize the return than to sell later when sale prices might not be so rewarding."

Another factor driving the frenzied pace of transactions is the activity of foreign buyers in the U.S. market. There has been no shortage of deals involving these buyers over the past several months. In September, the U.K.-based environmental consulting firm **SLR** acquired **SEACOR** in a reunion of sorts, as both firms had previously been spun out of **Secor International**, which itself became part of **Stantec** in February of this year. In October, New York City-based **Chas. H. Sells**, an E/C firm specializing in transportation engineering, was acquired by the British firm **WSP Group**, and in December, U.K. environmental consultancy **RPS** purchased Texas-based **JD Consulting**. Just this February, Minnesota-based **Delta Consultants** was acquired by the Dutch consulting and engineering firm **Oranjewoud N.V.**, one of Delta's partners in the **Inogen Alliance**.

Foreign companies have long coveted U.S. markets in a variety of sectors—the environmental market especially—and favorable exchange rates are currently giving them a boost through a purchasing advantage over U.S. competitors, according to **FOCUS's** Doug Rogers, whose firm is

participating in an increasing number of deals involving the engineering sector. In 8 of the past 20 deals facilitated by **FOCUS**, he told *EBJ*, the buyers have been non-U.S. companies. In one recent deal, a U.K. firm came in and swept up a U.S. company for \$25 million, whereas the highest bid made by any U.S. suitor was only \$18 million.

Although the above examples demonstrate that European firms are making their mark in the United States, watch out for India. "U.S. firms will see more inquiries from India," said Rogers, whose firm is representing at least one Indian engineering concern. "The Indian stock market is one of the most active in the world right now, and a lot of firms over there have been able to find liquidity through the public markets." In previous years, Indian companies were offering to outsource certain business functions for U.S. firms; now they are seeking to buy businesses to establish operations in the United States and support operations in other parts of the world, according to Rogers. "They are not trying to buy a lot of engineers; they have plenty of engineers in India. They are looking for strong business development and strong client relationships. The Indians want to control their own destiny, and right now they can afford to do so."

Rogers sees the M&A arena as a strong seller's market now and well into the future. Indeed, one other "push" factor that stands to stoke the fires for more deals is the growing number of Baby Boomers who are reaching retirement age and need to facilitate an ownership transition. About 50,000 Baby-Boomer business owners retired in 2001 and, citing an estimate by **NFO World Group**, Rogers noted that 750,000 are expected to retire in 2009. Lots of these businesses will be grocery stores and dry cleaners, but engineering firms certainly will be among the mix.

Credit crunch or no credit crunch, then, executives at middle-market A/E/P and environmental consulting firms should expect to keep getting those calls from potential suitors. ■

IS THE CREDIT CRUNCH CRUNCHING THE ENVIRONMENTAL DUE DILIGENCE MARKET?

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Ah, the credit crunch. Turn on the TV or listen to the radio and chances are it won't be long before the subprime mortgage mess is mentioned. Bad news about the economy dominates the business pages. The Federal Reserve Bank and Washington have begun to respond to the aftermath of the credit crunch brought on by the subprime mortgage crisis. As we head into 2008, analysts' predictions about where the economy is headed have taken a turn for the worse, and lenders and the investment community are understandably jittery—as are the environmental consultants who support real estate transactions.

As the first quarter of 2008 draws to a close, the future of the economy is anyone's guess. What is certain is that the subprime market turmoil is impacting businesses nationwide—the environmental due diligence industry included.

In 2005 and 2006, commercial real estate investing was soaring. At this time last year, there were huge profits to be made as properties were bought and flipped in record time. Lenders were skimping on pre-purchase due diligence in order to meet the frenetic pace of deals with multiple bidders and remain competitive with other banks. The commercial mortgage-backed securities (CMBS) market, which allows big banks to sell their loans and use the proceeds to lend even more, was instrumental in serving as the force behind several record-setting quarters of real estate deals.

The slowdown began last summer. As the mortgages packaged into Wall Street securities, particularly subprime residential loans, began to foreclose, investors became skittish and suspicious of any assets backed by real estate. The CMBS market took a steep downturn, leaving major lenders no