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9 Common Disconnects Between Private Equity's Risk Perspective and AEC Firm Leadership

by Gregg Bundschuh, JD

Receiving capital from a private equity (PE) investor or joining a PE capitalized Architecture, Engineering and Construction (AEC) firm can be a great opportunity for an AEC firm. It can transform the business, create liquidity for the owners, help you scale up fast, expand to new markets, and boost your profitability.

It also ushers in complex challenges since PE firms will often have a specific time frame earmarked for a targeted return on their investment. As a result, the AEC firm needs to learn how to anticipate and navigate the expectations of PE investors to build and maintain a strong working relationship over time.

Over the last three years, more than 400 companies have been acquired annually, a pace unprecedented and twice the rate observed a decade ago.[1] While the frequency of PE mergers and acquisitions (M&A) has leveled off in the last 12 months, it's not going away, with 2024 anticipated to be another year with over 400 acquisitions. If your firm is considering a sale to a PE- backed firm or taking on PE investors, there's a lot to think about to ensure the path to what's next is a smooth one.

What You Need to Know About PE Investment in AEC Firms

The number one job of the AEC firm CEO is to increase shareholder value. Most CEOs understand that explicitly and yet some may not intuitively see the connection between "risk" and "reward" and the need to quickly create shareholder value so they can achieve a successful exit and ROI. Other CEOs — by their actions or inactions — might even inadvertently diminish shareholder value.

When CEO and PE investors are not aligned around strategy, disconnects or misunderstandings happen, and the AEC firm can fail to achieve its aggressive growth objectives. Here are some of the most common disconnects between an AEC firm leadership and PE investor goals, and what you can do to bridge the two.

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[1] Morrissey Goodale "Debunking M&A Myths by the Numbers," February 12, 2024.

1. PE firms avoid asymmetrical risk ventures.

PE investors and CEOs may not align when a firm considers taking on a project or investment that spans several years, and the upside is too limited compared to the possible downside.

For example, a PE investor might believe that at-risk contracts such as engineering, procurement and construction contracts are risky, and that the firm cannot recover from a potentially large hit to retained earnings. Because of this, CEOs need to understand the risk-reward trade-off on a five-year investment. The PE firm is trying to generate certain results within a specific time frame, and the CEO needs to understand that constraint.

2. PE firms prefer repeatable, master service agreement-type contracts.

Large, episodic project revenue leads to risk, "lumpy" revenue projections, and discounted valuations. PE investors want their architecture and engineering firms to show smooth, steady revenue. CEOs might need to adjust the firm's marketing and sales strategies accordingly to make sure they're pursuing the right types of projects with recurring clients.

3. Uninsurable risks without indemnity are outside PE appetite.

AEC CEOs need to take a big picture view of risk management and think about it from the PE investor's perspective. Think broadly and proactively about how to account for risks, and enact a comprehensive risk management program to protect their investment. For example:

- What are some unlikely but potentially costly risks affecting your business, industry, or geographical locations where you operate?
- What are some unanticipated events that would be catastrophic?
- Is your firm at risk of losing or gaining opportunities from wildfires in the Western U.S., from floods, or from other natural disasters?
- What resources does your firm need to be competitive and innovative in your market?
- What if you suffered a data breach or infringement of intellectual property?

4. No leadership succession among C-suite = lower valuations.

Many AEC firms do not have a detailed leadership succession plan in writing. If a top executive leaves the firm on short notice, with no clear successor ready to step into that role, it can cause confusion within the business and hurt shareholder value. It can also cause the business to incur additional costs, such as those associated with hiring a recruitment firm for an executive search, added hiring costs, and costs of diminished productivity, lost contracts, or missed opportunities while the executive role is unfilled.

AEC CEOs need to understand the value of succession planning — not view it as an optional/non-essential activity, or as a threat to their position. Natural attrition and proper succession planning helps reduce expenses, minimize disruptions to the business, and creates a more cohesive leadership team that can take the business to its next level of growth.

5. Internal and external reputational risks are not tolerated.

PE investors have no tolerance for reputational risks; they are trying to help your firm grow, increase its value, and make your firm attractive to a new potential buyer or investor within the next few years. AEC CEOs need to think carefully about any possible partnerships or business relationships that could damage the reputation of the firm, including international risks and joint venture relationships. CEOs should be aware that the firm is under a higher level of scrutiny and a lower tolerance for reputational risks.

This applies to internal leadership teams as well. More than ever, firms cannot play fast and loose with ethics, misconduct, or poor professionalism among the management team.

Coddling dysfunctional leaders and turning a blind eye to bad behavior, even among "star performers," can hurt shareholder value in the long run. When leadership teams are dysfunctional, it results in lost opportunities and operational inefficiencies, which ultimately impact the firm's financial performance. PE investors want your company to be a tightly run ship, with a healthy culture of engaged, high-functioning people. The CEO needs to set the example, starting from the top.

Remember: Top talent doesn't want to work for bad bosses. When your best people see bad behavior or ethical lapses get rewarded, they will either leave for another company or become disengaged.

6. Don't be too slow to pull the plug — or take a new risk.

Some CEOs wait too long to cut their losses on a failed strategy or a bad investment, or to engage in a potentially profitable deal.

Whether it's a business unit in a dying market, a supposedly innovative idea from a rising leader that's been sucking cash flow for years, or an overpriced acquisition that was an abject integration failure, CEOs need to know when to pull the plug. PE investors will want to stop the bleeding and redirect resources to new opportunities for growth instead of losing money on a bad venture.

On the other hand, for PE firms, profitable growth is the name of the game, and organic growth is only part of the formula — sometimes acquiring another firm is the best way to grow faster. Shore up your M&A pipeline and due diligence process.

7. The two parties may not agree to appropriate levels of insurance.

Architecture, engineering and construction firms have complex, industry-specific needs for insurance, and often purchase coverages that may not adequately protect their interests. The key mantra is to "protect the house," and insurance risk transfer across all coverage lines is a cost-effective way to accomplish that. Almost always, a PE firm will procure higher limits of insurance to do so.

PE investors need to understand the risk factors and insurance-related aspects of running the business, along with the other strategic decisions. Similarly, CEOs need to ensure their PE investors are aligned around expectations for insurance and risk management.

CASE STUDY: Pinpointing the Right Coverage Reduces Budget

After evaluating one engineering firm's insurance program, it was discovered the firm had insufficient cyber, professional liability and umbrella/excess coverage. To cover these deficits, Greyling recommended group captive insurance to help save on insurance costs and increase dividends, establishing a five-year timeline to achieve these goals.

In the first year, the group captive for workers compensation, auto, and general liability was implemented, which helped the organization save on insurance costs from the onset. It also created incentives through Insurance Premium Allocation, helped integrate acquisitions, and implemented better loss control measures for the firm's fleet and workers compensation policies. The savings generated in through this alternative approach created the opportunity to increase limits for other policies without increasing the total cost of risk.

By year five, the firm's shareholders started receiving dividends from the distribution of captive profits.

8. The leadership thinks risk management is a "cost center."

Some AEC CEOs still view insurance premiums and risk management training as expenses rather than investments. But risk management is not an area where organizations should curtail costs or relegate to an HR and finance function. Instead, risk management should be viewed as an investment that is central to the power of the firm's brand.

Effective risk management helps demonstrate your firm's commitment to quality, contingency planning, and industry expertise. A total cost of risk approach provides a metric for measuring risk and reward and the effect of investments in training on that equation. PE investors are often focused on the risks facing the business. CEOs need to be ready to discuss risk management as a central strategic factor that can help support the business's growth and success.

AEC CEOs should consult experts in a particular area when necessary to make the correct risk management action. For example, when reviewing high value or "non-traditional" services contracts for risk exposure during due diligence, including complex structures with a higher risk profile, consider bringing in a risk management consultant or lawyer with the expertise necessary to untangle these contracts to appropriately evaluate the risk exposure.

For higher level execution of risk management, firms should consider an Enterprise Risk Management (ERM) study or the implementation of the role of Chief Risk Officer.

CASE STUDY: Due Diligence Helps Engineering Firm Grow

In 2006, one global consulting, engineering and construction management firm was valued at $265 million, but wanted help increasing revenues and reducing their insurance costs and risk.

After an initial assessment of the firm's policies, Greyling was able to fix coverage gaps and consolidate the program before it came time to renew policies. This first step saved the company $1 million in that first year.

Another early initiative rolled out was a company-wide risk survey. The results were used to pinpoint areas for improvement and training, which the firm started implementing in that same year. The firm also established a chief risk officer position, helping to define the role and approach to enterprise risk management, and established a total cost of risk methodology for board level reporting.

Greyling also supported general counsel efforts to settle civil and infrastructure legacy claims, which helped keep renewal costs down as the claim issues faded. In addition, Greyling educated the organization's board on its general liability, auto and workers' compensation claim problems, which helped motivate the firm to develop safety and strategy goals and earmark staff to execute objectives, and recommended the use of specific policies to reduce cost, including the use of a group captive.

As the firm expanded, Greyling assisted with the organization's M&A activities and started providing risk advice to manage construction exposure.

Ultimately, the engineering firm achieved a loss ratio of less than 30% by 2021 — a significant reduction from its start with the organization when it was over 100% — and increased revenues to $1.4 billion.

9. CEOs should identify their organization's "special sauce."

Consider the following when identifying your organization's niche:

- What's your firm's special competitive advantage in the market that can command a premium valuation to future buyers?
- Does your firm offer expertise in infrastructure; energy; renewables; environmental, social and governance issues; or sustainability?
- Are you active in fast-growing markets or locations?
- Do you have hard to replicate experience or expertise, or a great reputation among a niche client base?

Think strategically about what makes your firm a premium brand and how you can position the business to emphasize these unique strengths.

Working with PE investors can help take a firm to the next level of growth, but the CEO and leadership team need to be aligned with the unique expectations and perspectives that PE investors bring to the table. Stay focused on creating shareholder value, understand the risks confronting your business, and be agile and eager to capitalize on new opportunities. This way, your firm can boost your valuation, achieve big ROI, and put the company on a stronger trajectory for years to come.

Want to learn more about PE in the AEC space?

Contact Gregg Bundschuh (gregg.bundschuh@greyling.com) for more information about our next PE forum.

Let's Talk

Greyling Insurance Brokerage & Risk Consulting, a division of EPIC, is a specialty national brokerage and risk management consultant representing professional services firms in the construction and legal industries.

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