AIA Best Practices:
How much is your firm really worth?

Excerpted and adapted from an AIArchitect article by Michael Strogoff, FAIA

Summary

Deciding when and how to transfer ownership is a complex decision, made even more so with the intricacies of a design firm. Architecture firms rely on the creativity and experience of their employees for success, which makes financial valuation difficult.

One possible valuation method considers different quantitative valuation metrics to arrive at a valuation range and then looks at a firm's qualitative aspects to determine whether to use the higher or the lower calculated values.

Start with a specialized consultant

Want to know what your firm is worth? There are plenty of good resources about how to value architecture, engineering, or design firms. Consulting firms that specialize in ownership transitions develop a fair market value based on a handful of factors including adjusted net worth (book value), weighted net income, weighted net fees, projected fees, and backlog of unearned fees.

These factors produce a range of a firm's value. For example, some consultants value a firm at between 1 and 1.5 times adjusted net worth for an internal transition or between 2 and 3 times for an external sale. Other consultants value a firm at between 3 and 5 times weighted net income or apply a percentage of their average earnings to their backlog of unearned fees.

The mystery is how to narrow these ranges to gain a more precise indication of the value of your firm. Few consultants will pinpoint a firm's precise value because doing so entails highly subjective judgments and in-depth understanding of that firm's strengths and weaknesses, knowledge about how that firm compares to its competitors, and an ability to forecast how that firm will likely fare in the future.

Find out how your firm stacks up

Once you have a valuation range, you can develop a more precise fair market value by ranking your firm against the criteria below. If you rank extremely high across the board, you can safely use the high end of the valuation range. Likewise, if your firm is struggling and ranks low against these criteria, use the lower end of the range.

Ability to obtain new business and deliver it profitably. The quantitative factors commonly used to value a firm assume that a firm's recent history is a good indicator of its future. While this assumption is true to some degree, these qualitative factors also affect a firm's ability to garner future work and generate future profits:

- Reputation in the marketplace
- Ability to differentiate itself from competitors
- Quality and depth of portfolio
- Extent of contacts and resources
- Current and potential market penetration
- Skills and experience of its key people
- Breadth of client base and geographic reach
- History of repeat clients
- Special areas of expertise
- Delivery methods and efficiencies

Steady growth and healthy backlog of work. Firms blessed with recent and steady growth, and a healthy backlog (usually six months of work or more), command a higher value than firms on a sideways or downward trajectory and without a backlog to keep its staff fully billable. When looking at backlog, the amount of work under contract is more valuable than work not yet under contract or awaiting authorization to proceed.

Resources, assets, and cash flow. Firms with a solid infrastructure of equipment and software, good cash flow, and access to capital have longer staying power and are better positioned to respond to new opportunities and weather market cycles. On the other hand, undercapitalized firms are more vulnerable and, therefore, of reduced market value.

Strong skill levels. The design, technical, and management skills of a firm's staff directly influence the quality of its work, the premium fees it can negotiate, and its risk management. Evaluations of a firm's QA and risk management programs, professional training programs, awards, professional recognition, and management resources and experience are strong indicators of the firm's overall technical, design, and management skill level.

Appropriate lengths of time current owners can, and will, stay during a transition. The value of professional service firms is inextricably linked to their leaders. Firms with well-planned transition plans that ensure effective uninterrupted leadership are worth more than firms whose future leadership structure is unknown. On the other hand, owners who remain beyond their productive years (or at the expense of the development of incoming owners) reduce the firm's market value.

Depth of key staff, including next generation of owners in place. Firms with a wide range of staff skills and depth command higher prices than firms dependent on a handful of leaders and senior staff. Likewise, firms with future owners on board who are committed to the firm's future are better positioned to expand and prosper and, therefore, are worth more.

Amount and quality of intellectual capital. Firms with the expertise, resources, and tools to give them a strong marketing edge over their competitors; deliver higher-quality services; and produce high-quality work more efficiently will command a higher value than firms lacking such intellectual capital.

History of litigation and claims. The value of firms with a history of litigation, settlement claims, or bad debts, or whose book of business might cause a buyer's insurance premiums to jump, will be discounted to account for higher-risk profile.

Valuation amounts differ

Valuation amounts differ widely based on actual circumstances. For example, highly strategic external acquisitions are typically valued higher than internal acquisitions, and ownership transitions executed over several years with the current owners remaining are typically valued higher than acquisitions based on the current owners retiring or phasing out of the day-to-day operations. Valuations also differ based on the motivations of buyers and sellers, and the terms negotiated between the parties. For example, some buyers place higher values for opportunities to enter new markets, acquire specialized knowledge, or gain access to specific clients. Other buyers place greater importance on a seller's history of cash flow and profitability. Likewise, sellers often vary their asking price based on a variety of issues, such as the ability to retain their identity and day-to-day control, the amount of guaranteed payments versus earn-out payments, and the terms of their employment or consulting agreements after the sale is completed.

The bottom line: buyer-seller agreement

As with any business transaction, fair market value is eventually determined by discussions between a willing buyer and a willing seller, and is subject to the actual terms of the ownership transfer. However, using the above criteria can help guide these discussions and provide a rational way of agreeing on the true value of an architecture firm.

About the contributor

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About AIA Best Practices

AIA Best Practices is a collection of relevant, experience-based knowledge and expert advice on firm management, project delivery, contracts and more, aligned with the *Architect's Handbook of Professional Practice, 15th edition*. See the full AIA Best Practices collection at aia.org/aia-best-practices.

This article corresponds to:

Architect's Handbook of Professional Practice, 15th edition Unit 1 - The Profession
Chapter 05 – Organizational Development
Section 06 – Ownership Transitions