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Digest

High Performing Firms: By the Numbers

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SUMMARY

Yes, architecture & engineering firms can make good profits – over 20% Operating Profit Rates – and provide stockholders a very good returns on their investments – over 30% Pre-tax Returns on Equity.

A valuable source of Key Performance Indicators (KPIs) is the *Deltek Clarity Architecture and Engineering Industry Study* on financial performance. (Click here for the full 35th Annual report.) The report breaks out specific KPIs for "High Performing Firms", as well as KPIs for the industry as a whole, A & A/E firms, E & E/A firms, and different size firms.

For 2013, using criteria of a *minimum* 20% Operating Profit Rate and *minimum* 3.00 Net Revenue Multiplier, a full 25% of the firms were categorized as "High Performing Firms":

- **28% of the Small (1-50 employees) firms,**
- **23% of the Medium (51-250 employees) size firms, and**
- **20% of Large (251+ employees) firms.**

Further, there is credible evidence to indicate that many of these firms repeat as High Performers year-after-year.

As a CFO and a collaborator on the survey, I was particularly interested to see what other financial KPIs could – and those that did not – point to other specific success factors. This article discusses primary KPIs for "High Performing Firms".

BY THE NUMBERS

As mentioned, the criteria for "High Performing Firms" were a minimum 20% *Operating Profit Rate* and minimum 3.00 *Net Revenue Multiplier*. The actual median KPIs for the "High Performing Firms" were:

	All	High	All Other	% Δ HPF
	Participants	Performers	Firms	vs. Others
Operating Profit Rate *on Net Revenue*				
2013	**11.1%**	**22.1%**	**7.8%**	**183.3%**
2012	10.1%	25.0%	8.3%	201.2%

We start with this KPI because it is the one with which virtually all owners are most familiar and pay first attention. Again this year, High Performers almost tripled the *Operating Profit Rates* of "All Other Firms". The other KPIs to be discussed will provide more insight into how such results were achieved.

	All High	All Other	% Δ HPF	
	Participants	Performers	Firms	vs. Others
Net Revenue *per Employee*				
2013	**$127,098**	**$149,765**	**$121,133**	**23.6%**
2012	$121,902	$144,133	$117,484	22.7%

One of the primary reasons "High Performing Firms" were able to achieve such high *Operating Profit* results was because of the efficient and effective billable production these firms derived on average from each employee. *Net Revenues*, which do not include any consultant, direct expense (whether reimbursable or not), or any bad debt or write-offs, are 20% to 25% higher per employee for "High Performing Firms" than for "All Other Firms".

	All High	All Other	% Δ HPF	
	Participants	Performers	Firms	vs. Others
Net Labor Multiplier				
2013	**2.99**	**3.33**	**2.88**	**15.6%**
2012	2.91	3.43	2.86	19.9%

The high *Net Revenues per Employee* achieved were a result of firms actively managing their way on projects to these Net Labor Multipliers. Recognize that these multipliers are the overall results from all projects worked on during the entire year. It is not possible here to determine whether the results were because of higher fees, greater effectiveness & efficiency, staff mix, technology, or other reasons, but, because the High Performers comprise a full quarter of respondents, it is probably a combination all of these – applied continuously project-by-project. Collectively, the reasons could be summarized by calling it ***better overall project management***.

It is important to note that this high production was *not* automatically the result of higher *Utilization Rates* or *Direct Hours per Employee*. These KPIs are only fractionally higher for "High Performing Firms" compared to the more extreme differences in *Net Revenue per Employee*, *Operating Profit Rate*, and *Net Labor Multiplier*, but the differences help.

	All High	All Other	% Δ HPF	
	Participants	Performers	Firms	vs. Others
Utilization Rate				
2013	**59.4%**	**61.5%**	**58.8%**	**4.6%**
2012	59.9%	60.4%	59.5%	1.5%
Direct Labor Hours *per Employee*				
2013	**1,275**	**1,319**	**1,261**	**4.6%**
2012	1,246	1,324	1,227	7.9%

Utilization Rate deserves a bit more discussion. It is a commonly-held misnomer that *Utilization Rates* should be maximized. Based on research by *PSMJ Resources, Inc.*, *Utilization Rate* has only an 11% statistical correlation to *Operating Profit Rate*. The *Net Labor Multiplier*, as seen above where "High Performing Firms" far exceed "All Others", has a 27% correlation, but the *Total Labor Multiplier*, below, has a 47% correlation.

Utilization Rates measure Direct Labor vs. Total Labor (Direct + Indirect Labor). Granted, Indirect Labor includes Vacation, Holiday & Sick time, but it also includes administrative (back office) staff & time, continuing education & professional development, and – most importantly – *marketing* time. These activities, especially marketing, are necessary and appropriate. Also recognize that marketing is usually conducted by higher ranking (i.e., higher paid) staff, and the *Utilization Rate* is dollar weighted. As such, *Utilization Rates are something to be optimized rather than maximized*.

	All High	All Other	% Δ HPF	
	Participants	Performers	Firms	vs. Others
Overhead Rate (w/o bonuses)				
2013	**161.1%**	**154.1%**	**163.4%**	**<5.7%>**
2012	161.6%	161.8%	161.2%	0.4%

Here again, "High Performing Firms" do *not* have markedly lower *Overhead Rates* (Indirect Labor costs being the largest component of total overhead expenses). As broken out in the survey, there are *no* markedly different per employee expenses on the other major Overhead components, either: Other Salary-Related & Other Staff Expenses, Facility, Corporate, or even non-labor Marketing Expenses.

Further, High Performers do *not* markedly overpay employees – except when it comes to Bonuses per Employee:

	All High	All Other	% Δ HPF	
	Participants	Performers	Firms	vs. Others
Compensation *per Employee*				
Direct Labor	$42,456	$44,153	$41,720	5.8%
Indirect Labor	$28,914	$28,139	$29,280	<3.9%>

Total Labor per Employee	**$71,370**	**$72,292**	**$71,000**	**1.8%**
Salary-Related Exp., e.g., P/R Taxes,				
Group Health/Life, 401(k), etc.	$14,590	$14,782	$14,542	1.7%
Bonuses	*$4,336*	*$12,699*	*$3,224*	*393.9%*
Total Compensation	**$90,296**	**$99,773**	**$88,766**	**12.4%**

Even their Salary-Related Expenses, including insurance programs, and 401(k) matches or pension contributions are consistent with All Other Firms. [Note: These other Salary-Related Expenses add an average of about 20% to all employees' salaries. In other words, on average, each employee is actually paid their salary plus another 20% for statutory & fringe benefits.]

	ALL HIGH	ALL OTHER	% Δ HPF	
	PARTICIPANTS	PERFORMERS	FIRMS	VS. OTHERS
Total Labor Multiplier				
2013	**1.74**	**2.02**	**1.68**	**20.2%**
2012	1.75	2.09	1.70	22.9%

As mentioned above, PSMJ cites the *Total Labor Multiplier* as the one KPI most highly correlated to *Operating Profit Rate*. Without going through the mathematics, the Total Labor Multiplier is the product of Net Labor Multiplier times Utilization Rate. The High Performers achieve their significantly higher result by managing projects towards higher Net Labor Multipliers while optimizing their Utilization Rates.

DO HIGH PERFORMING FIRMS CONTINUE TO OUT PERFORM YEAR-AFTER-YEAR? THE DATA INDICATE, YES.
The Deltek report comments:

> "*We recognize that some High Performers are probably just 'one-hit-wonders,' having a good year before reverting back to the mean. However, in Deltek's experience working with thousands of A&E firms, we've also found a top tier of companies that meet these high standards year in and year out."*
>
> "*A common thread is that these High Performers closely monitor their operating metrics, and their better visibility into the business gives them the insight to manage risk through good times and bad. The result: They do a better job managing projects for clients, can charge higher fees, and are able to reward and retain their best people."*
> [Author's Note: PSMJ has the same experience and draws the same conclusion.]

I draw the same conclusions as *Deltek* & *PSMJ*, however, it is based in more evidence from the "High Performing Firm" data. Below are metrics that come from the Balance Sheet, and generally reflect the amounts of money that Stockholders have invested and retained within the firm to finance operations and growth, particularly growth of staff. (Each individual new hire generally requires an additional $20K to $25K of additional Working Capital.)

	ALL HIGH	ALL OTHER	% Δ HPF	
	PARTICIPANTS	PERFORMERS	FIRMS	VS. OTHERS
Working Capital *per Employee*				
2013	**$29,037**	**$38,399**	**$25,842**	**48.6%**
2012	$26,953	$44,849	$25,214	77.9%
Retained Earnings *per Employee*				
2013	**$21,822**	**$29,752**	**$20,992**	**41.7%**
2012	$19,935	$25,115	$19,030	32.0%
Total Equity *per Employee*				
2013	**$32,584**	**$43,340**	**$27,991**	**54.8%**
2012	$27,805	$47,394	$26,718	77.4%

Somewhat surprising was the extent to which each of these amounts are relatively the same for all firms -- *regardless of size or type of firm* -- with the exception of the High Performers. And we are not talking about slight variances. The High Performers have 50%+ higher amounts of *Working Capital per Employee, Retained Earnings per Employee*, and *Total Equity per Employee*. The higher *Retained Earnings per Employee* shows that these firms already started the year with these higher investments, which substantiates that argument that they already were previously in the High Performers category.

This article started with the statement, “Yes, architecture & engineering firms can make good profits and provide stockholders a very good return on their investment.” We have seen that “High Performing Firms” had triple the *Operating Profit Rate* of “Other Firms”, but even after paying employees essentially triple as much in bonuses, the “High Performing Firms” still realized a *Pre-Tax Return on Equity* almost triple that of “Other Firms”:

	ALL HIGH	ALL OTHER	% Δ HPF	
	PARTICIPANTS	PERFORMERS	FIRMS	VS. OTHERS
Pre-Tax Return on Equity				
2013	**18.1%**	**37.1%**	**12.7%**	**192.1%**
2012	21.8%	46.5%	17.1%	171.9%

Are these returns good? Yes, because this is a number that one can compare to stock market, 401(k), and most other financial investment types.

Lastly, this year’s “High Performing Firms” plan to keep up their above average profit performance. With basically the same Net Revenue growth estimates (6%) for 2014 as “Other Firms”, the “High Performing Firms” forecast continued *Operating Profit Rates* in excess of 20%:

	All High	All Other	% Δ HPF	
	Participants	Performers	Firms	vs. Others
Operating Profit Rate ***on Net Revenue***				
2014 Forecast	**11.4%**	**20.7%**	**8.4%**	**146.4%**
2013	11.1%	22.1%	7.8%	183.3%

CONCLUSION

A recently published AIA *Best Practice*, "*7 Characteristics of High Performing Firms*", states it best: ***"Inherent in [High Performing Firms] is a business mindset and discipline to grow revenue and make a healthy profit year after year. … In a High Performing Firm, attention to these financial performance issues becomes as much a focus of the leaders and managers as does design and managing the practice. Having a principal or a Chief Financial Officer with a strength in financial management is not just a huge asset, but a necessity for monitoring and maintaining the financial health of a High Performing Firm."***

ABOUT THE AUTHOR:

Mike Webber started A/E FINANCE (www.aefinance.net) after years as a CFO. He works with A&E Principals, PMs and Boards on project & overall operations management, firm-wide & operating unit benchmarking & financial analysis, strategic planning & turnarounds. He also has filled interim CFO & other assignments for firms across the country. He has been Chair of AIA Chicago's Practice Management Committee, an AIA/ACEC Peer Reviewer, and is on ACEC's Management Practices Committee and AIA's Best Practices Committee. He can be reached at mawebber@aefinance.net.