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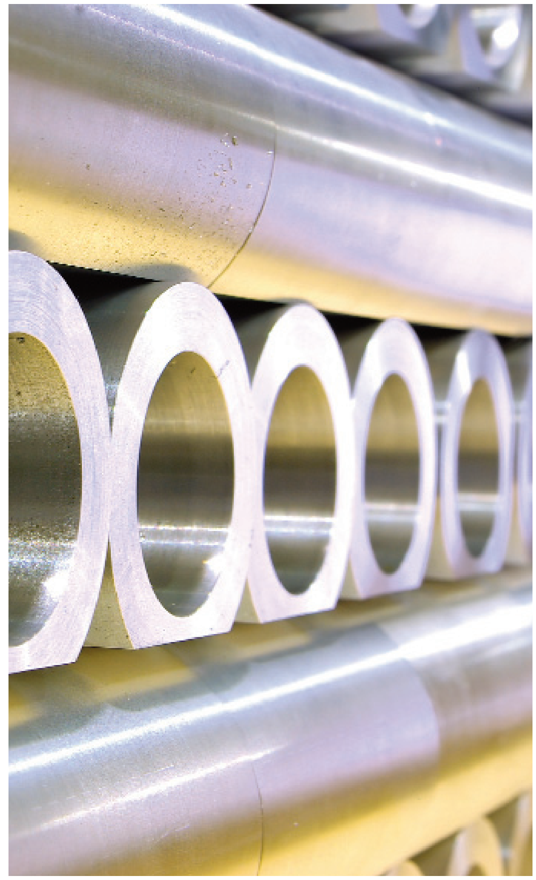
A/E FIRMS RESPOND TO SOME BAD P/L

The first quarter of 2009 saw a continuation of the steady downward trend in the billings of architecture and engineering (A/E) firms across the U.S.[1] Throughout 2008, billings declined in each consecutive month, and the modest optimism of the late third quarter, when the rate of decline slowed, evaporated with the onset of the current financial crisis. Non-billable hours are causing overhead costs to spiral out of control.[2]

Firms of all specializations are struggling. The institutional segment, which was holding up reasonably well, has now frozen. Overall, business conditions remain weak in all regions of the country. Firms in the South report the weakest conditions, and business in the Northeast and Midwest continues to worsen. Backlog at the majority of A/E firms is either modestly or substantially lower than at the beginning of the year. Backlog now appears to be in the five- to seven-month range – at best. Most A/E firms have seen a rapid decline in staff utilization rates. Many firms with budgeted utilization in the 80-85% range are posting actual rates of 45-55%.

At the moment, cash flows appear to be holding up. Rapidly deteriorating backlog, however, will have a drastically destabilizing impact in the next few months. Moreover, it appears that aged receivables (in excess of 120 days) are rapidly increasing and verging on bad debt – a cause for considerable concern.

A/E firms are responding to the bad news in a number of ways.



RESPONSES

RAISES AND BONUSES

Many senior management teams are deciding or have decided that there will be no raises in 2009, nor bonuses for year-end 2008. With current bonus accruals typically in the range of $2000 to $2800 per employee (based on total headcount), firm managers are looking to retain cash as they assess the amounts that may be needed for severance programs (estimated to be in the range of $2700 to $3500 per employee) and bad debt accruals.

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[1] *This summary is largely based on the AIA "Work-on-the-Boards" monthly reports, 2008*

[2] *Based on conversations with A/E industry clients and prospects, Q4 2008 and Q1 2009*

LINES OF CREDIT

Many firms are discussing credit line structures with their commercial banks. The banks appear willing to approve lines of credit for one, two and three years at reasonable rates (one month LIBOR plus loan spread of 1.75% to 2.35%). Firms seem to be leaning towards locking in the longer-term options due to economic uncertainty.

STAFF REDUCTIONS AND REASSIGNMENTS

Significant layoffs are not yet endemic, but many firms are looking to reduce staff by approximately 10%. Due to the decline in work in all segments, these reductions appear to be uniform across most disciplines (with the possible exception of firms in the environmental sector). During late 2008, underperformers were the principal target for layoffs. Now cuts are going much deeper.

Multidisciplinary firms are looking at options that avoid layoffs: interdepartmental transfers of staff and workload sharing. These short-term tactics may buy some time, but by mid-year we expect most firms will have reduced staff by 10-15%.

CONTINGENCY PLANNING AND ACTIONS

Because few A/E firms have ever undertaken structured contingency and scenario planning exercises, many are caught off guard when they face financial problems. A number of firms have recently assembled task forces to determine steps they might take. Under consideration are:

- Elimination of non-billable related overtime (e.g., accounting and administration), with the exception of business development or marketing
- Aggressive weekly monitoring of financial performance
- Review of cell phone usage
- Review of services currently performed by sub-consultants that could be brought back in-house
- Reduction in travel and discretionary expenses
- Salary reductions
- Furloughs
- Changes to 401(k) contributions
- Office closures

INSURANCE MARKET ISSUES

A rapid increase in aged receivables and bad debt historically contributes to a spike in Professional Liability claim activity, because some project owners allege negligent performance as a tactic for avoiding paying fees or for obtaining a negotiated resolution of outstanding account payables.

In response to the large volume of design and construction activity over the past few years, 2008 saw an increase in claim activity. While we have not yet seen significant hardening of insurance premiums, there are signs that London underwriters are looking to increase rates on 2009 renewals. Any increase in claim activity as a result of the economic downturn will put further upward pressure on rates.

For most large account Professional Liability renewals in 2009, we anticipate a rate increase in the 8-12% range, coupled with a reduction in exposure base of roughly 5-10%. The stability of several key Professional Liability markets – and the impact that will have on rates – is still unclear.

STIMULUS HELP

Thanks to the federal stimulus package, the transportation and alternative energy segments may be the first to rebound. This could spur a resurgence in activity as early as Q2 2009 for civil engineering, structural engineering, survey, environmental and electrical/mechanical engineering firms.

The high percentage of relatively small construction jobs in the project lists submitted for consideration for stimulus funding is likely to benefit small and mid-sized A/E firms to a much greater extent than was generally anticipated. On the other hand, the large number of projects that have been designed but put on hold in the past quarter will slow recovery.

We expect that residential, retail and commercial activity will remain flat for the bulk of 2009, and that architectural firms will need to focus on the opportunities that may become available in institutional markets (K-12, college and university and health care). As the past decade has seen increasing specialization in the delivery of design services to the institutional market, any resurgence will likely favor the established specialists.

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