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High Performing Firms

Using Profits to Attract, Keep the Best Employees

BY CATHY CECERE

If you understand the overall financial positions of the A/E industry (at the median level of performance), you can use the knowledge as you consider your firm's compensation strategy. Cash compensation is only one part of the story when it comes to employee engagement and attracting and retaining staff; however, making sure you adequately and fairly pay staff is fundamental to keep your firm in the running for the best talent.

Based on their financial performance, high-performing* (HP) firms report nearly twice the profit, 30.1% on net revenues, compared to the overall industry, which reported a median profit of 16.2% in 2016. And, HP firms come in all sizes, and from all practice areas across the country.

High performing firms have mastered basic business skills—they do the fundamental tasks of running a firm well. HP firms are well managed, they can rely on a loyal client base, and their leaders are responsible as they strive for sustainable success.

These firms also fastidiously monitor and measure performance, keeping their eye on key results. This high level of profitability gives HP firms opportunities related to compensation, in any economic environment, that “average” firms just can't afford.

Financial Performance and Compensation

HP firms' processes, systems, and practices lead to a level of profitability that allow them the ability to compensate staff to a level average firms are just not able to reach. They also can provide other new opportunities for staff and new hires. These firms may have the ability to:

- Invest in the firm, whether through growth that ensures a firm's future or internal ownership/leadership transition training that promises stability and consistency.
- Develop a way to reward performance through a

* High performing firms are 2016 Circle of Excellence firms, the top 20% of participating firms in the PSMJ 2016 A/E Financial Performance Benchmark Survey that are successfully managed, based on 13 key performance metrics that demonstrate outstanding achievements in profitability, overhead, cash flow, productivity, business development, staff growth, and turnover. High performing firms include both engineering and architectural firms.

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bonus system. Bonuses may allow for increased productivity and/or creativity.

- Offer atypical benefits above and beyond the average firm. A/E professionals at HP firms are looking at benefits that help create a better life-work balance.

Being profitable is often influenced by the conditions of the economy. And, the quarterly change in gross domestic product (GDP) has generally indicated positive growth since early 2013, after a positive uptick in early 2012 (Figure 1).

Where We Stand

With another year complete and new data available, let's look at the latest numbers to see where we stand, and how much improvement the industry actually experienced in the past year. The tables and figures that follow report the median for each metric (the midpoint of a set of data, not the average). (See Table 1.)

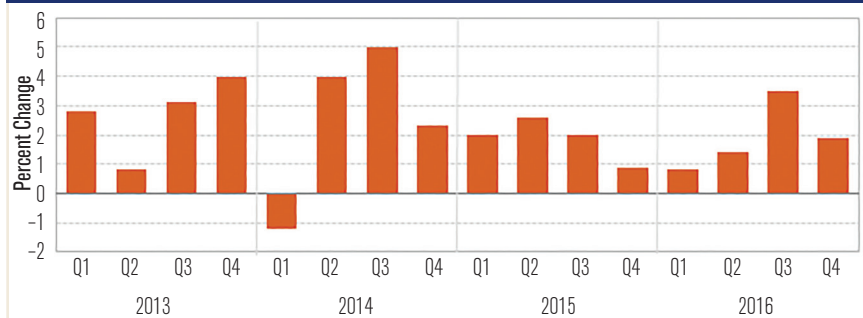
The overall results for the industry are very encouraging! Net revenues per staff are up, profit is up, overhead costs are down, and staff growth was positive. Yet, when we examine HP firms, their achievements are even higher:

- Significantly higher net revenue
 - Nearly \$20,000 more per total staff
 - Nearly \$10 more per direct labor hour;
- Overhead rate is nearly 23% lower than the industry median;
- Growth in revenue is more than double the median at 22%; and
- Growth in staff, again, is more than double the median at over 11%.

For both groups, revenues and profits are continuing to rise faster than expenses and labor costs, while still experiencing growth, which is great news. A detailed historical comparison of several of these key financial indicators is provided in Figure 2 and Table 2.

Every firm has the ability to be a HP firm with consistent monitoring and measuring of key performance indicators that allow management teams to be proactive. There are no secrets to reveal—except the tip to have solid business processes in place that allow management teams to manage their firms in a way that results in high

FIGURE 1 Real GDP: percent change from preceding quarter.



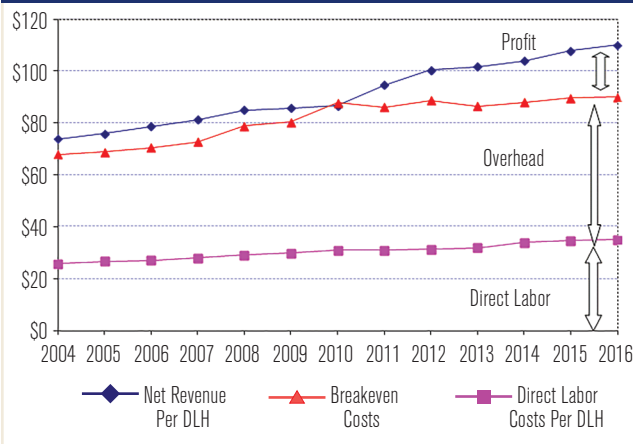
Source: U.S. Department of Commerce, Bureau of Economic Analysis

TABLE 1 Comparison of key indicators to 2015.¹

(MEDIANS)	2015	2016	PERCENT CHANGE	MEDIAN FOR HP FIRMS
Net Revenues Per Total Staff*	\$134,839	\$138,352	3	\$158,222
Net Revenues Per Direct Labor Hour	\$107.78	\$110.15	2	\$119.87
Direct Labor Costs Per Direct Labor Hour	\$34.68	\$35.03	1	\$34.74
Total Costs Per Direct Labor Hour	\$89.55	\$90.00	1	\$82.39
Equity Per Total Staff	\$33,363	\$35,298	6	\$45,751
Operating Profits (EBBT) Percent Net Revenues*	14.28	16.23	14	30.1
Operating Overhead Rate Percent (Before Incentive/Bonus)*	160.68	157.01	-2	134.2
Labor Utilization Rate Percent (Payroll Dollars)*	58.76	59.84	2	66.4
Backlog Change (Percent)	9.00	10.00	-	22.00
Gross Revenues Percent Change*	10.00	9.00	-	22.0
Staff Size Percent Change*	3.71	4.91	32	11.6
Net Direct Labor Multiplier (Achieved)*	3.09	3.09	0	3.46
Average Work-in-Process Days	16.10	15.29	-5	11.00
Accounts Receivable Collections (Days)*	67.01	69.92	4	64.40

* These metrics are some of the 13 key performance metrics used to select PSMJ's Circle of Excellence (COE), the year's most successful (high performing) firms. For more information on PSMJ's Circle of Excellence, see pages 11, 38, and Table 98 in the "Historical Trends and Patterns" section of PSMJ's "A/E 2016 Financial Performance Benchmark Survey Report."¹

FIGURE 2 Direct labor benchmark trends.¹



profitability, which, in turn, provides the key ingredient for compensation—cash.

Compensation Trends

An annual management compensation survey that solicits data from both engineering and architectural firms for 18 management positions, from chairman of the board to project manager, shows that total compensation reached a five-year high in 2009/2010, and profit was at an all-time high as well, at 15.2% of new revenue. Total compensation fell to a five-year low in 2011/2012 for most positions, and profit was less than 10% from 2010 through 2012.

Historical total compensation for the past five years is presented in Table 3. Compensation rates generally increase with firm size, so use Table 3 with caution. To demonstrate trends, this table is very good.

The newest results are very exciting. Total direct compensation for the majority of senior-level roles (chairman of the board, CEO, COO, etc.) have finally recovered to 2009 numbers. More production-focused positions (department head, senior project manager, and project manager) continue to increase and exceed pre-recession total compensation amounts as early as 2012.

The survey does not report compensation rates for HP firms, but note that direct labor costs per direct labor hour (DLH), as well as their total costs per direct labor hour are less than the 2016 overall median. Compensation is not the key to their success.

TABLE 2 Comparison of key financial indicators 2011 to 2016 (medians).¹

	2016	2015	2014	2013	2012	2011
Net Revenues Per Direct Labor Hour	\$110.15	\$107.78	\$103.95	\$101.66	\$100.32	\$94.69
Direct Labor Costs Per Direct Labor Hour	\$35.03	\$34.68	\$33.84	\$31.90	\$31.31	\$30.99
Total Costs Per Direct Labor Hour	\$90.00	\$89.55	\$87.91	\$86.50	\$88.73	\$86.06
Operating Profit	16.23%	14.28%	12.97%	11.42%	9.31%	9.86%

Bill Rate Trends

Compensation is directly related to hourly billing rates, which are intended to recover all design firm costs (including direct labor and overhead) and provide for profit. For example, if a highly billable senior project manager is paid \$50 per hour (excludes labor burden or fringes), and the firm's overhead rate is 160% on direct labor, then the break-even billing rate would be $\$50 \times (1+1.6) = \130 per hour per hour. A billing rate of \$150 provides for about 13% profit $(3.0 - 2.6) / 3.0 = 0.13$. Reimbursable expenses are recovered from the client directly and not included in these billing rates. If compensation rates exceed what can be

TABLE 3 Historical total direct compensation results.¹

(MEDIANS)	2016	2015	2014	2013	2012
Chairman of the Board	\$213,750	\$191,772	\$201,392	\$215,000	\$212,066
Chief Executive Officer	250,000	235,812	236,700	265,342	233,000
COO/Executive VP	231,559	206,845	206,560	203,913	221,933
Senior VP/Senior Principal	199,917	183,748	185,645	198,674	200,000
Other Principals/Partners	157,500	146,750	144,000	145,000	143,415
CFO/Director of Finance	180,000	176,250	159,968	175,000	184,538
Controller	107,000	100,060	100,000	100,807	101,109
Business Manager	75,344	80,986	64,745	78,972	78,630
Director of Administration	83,377	103,500	83,500	140,246	128,750
Director of Operations	141,500	163,500	137,750	146,000	137,510
Director of BD	139,213	133,000	119,000	135,229	120,800
Director of Marketing*	91,250	95,746	94,000	N/A	N/A
Director of Human Resources	108,730	97,500	97,314	102,231	100,000
Director of Computer Ops.	110,100	104,001	104,257	104,589	97,000
Branch Office Manager	132,736	130,115	123,513	125,521	125,377
Department Head	121,985	124,163	123,355	120,000	120,560
Senior Project Manager	111,708	106,823	103,537	102,000	98,315
Project Manager	91,748	86,000	82,035	78,285	77,000

*This was a new position for 2014; data for previous years is not available.

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TABLE 4 Historical billing rate results.¹

(MEDIANS)	2016	2015	2014	2013	2012
Chairman of the Board	\$210	\$203	\$205	\$197	\$195
Chief Executive Officer	205	200	198	200	195
COO/Executive VP	190	185	180	185	185
Senior VP/Senior Principal	195	195	190	195	190
Other Principals/Partners	185	180	180	186	172
CFD/Director of Finance	175	160	153	160	175
Controller	100	92	100	97	124
Business Manager	85	73	73	105	105
Director of Administration	82	112	100	95	120
Director of Operations	165	174	171	175	170
Director of BD	175	163	165	160	150
Director of Marketing*	95	105	127	N/A	N/A
Director of Human Resources	152	110	115	112	111
Director of Computer Ops.	120	125	130	117	125
Branch Office Manager	165	165	165	164	154
Department Head	153	159	165	157	155
Senior Project Manager	154	150	150	144	140
Project Manager	130	130	126	122	120

*This was a new position for 2014; data for previous years is not available.

recovered in billing rates, profits may be negatively impacted.

In the 2016 results, billing rates continue to track with total compensation (*Table 4*). Many of the senior-level roles (COO and senior VP) still have yet to fully recover to pre-recession rates, while more production-orientated positions (senior project manager, project manager) exceeded pre-recession rates as early as 2012.

Conclusion

The numbers tell the real story. The achieved direct labor multiplier of 3.09 is on the rise and closer to target than ever, net revenues are increasing, and expenses are holding steady. Compensation is seeing mixed results between management and production positions and has essentially caught back up to pre-recession rates. The financial position of the A/E industry, as interpreted through various financial metrics, is positive, and HP firms demonstrate what is possible in the A/E markets.

References

1. PSMJ Resources, Inc. 2016. "A/E 2016 Financial Performance Benchmark Survey Report." <http://store.psmj.com/2016-financial-performance-benchmark-survey-report-psmj/>. ■