Hire or Acquire?

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Adding some rigor to the decision of whether to hire versus acquire employees.

There are a number of reasons why buyers acquire companies. Buyers often use acquisitions to expand and diversify into new geographic or vertical markets; gain client access, master agreements, and project resumes; acquire intellectual property, brands, or products; gain scale and scope advantages; or simply grow revenues and profits. Although there are usually multiple reasons for an acquisition, buyers are placing increasing importance on the acquisition of talent. Among other things, acquisitions can provide buyers immediate access to a large, well-functioning, skilled, and tenured employee base.

In this article, we explore how companies may consider acquiring an employee base in a single transaction (or series of transactions) versus hiring and building an employee base over time. Of course, in almost all real-world scenarios, the strategic decision to buy versus build goes far beyond considerations about employees. Factors like access to clients, corporate brand, corporate culture, project resume, market position and intellectual property must also be considered carefully before such decisions are made. Nonetheless, the employee base is often an important component of the buy versus build analysis, and we believe it is sometimes useful to isolate this component for evaluation.

A Simplified Analysis

The actual analysis underlying a decision of whether to buy an operating company or build such capabilities (i.e., a "buy versus build" analysis) is highly complex and involves numerous factors beyond the scope of this article. Nonetheless, for the purpose of highlighting the "hire versus acquire" component of this decision, we have set forth a simplified illustration below. In this example, we assume that a company wants to enter a new geographic market and is evaluating two options:

Option A – Acquire a target company that has assembled a well-performing employee base; or

Option B – Hire and train multiple employees.

Our specific financial assumptions for both options are set forth in the example below.

In our simplified scenario, the company can estimate the breakeven point between buying a target company with the required employees (Option A – shown in Exhibit 1a) or hiring and training the workers over time (Option B – shown in Exhibit 1b). The company can also run sensitivity analyses on the underlying assumptions to better understand the impact of those assumptions on the breakeven point. Although many non-quantitative factors must be taken into consideration for a final decision, we find that companies gain some useful insights via this exercise.

This type of exercise highlights at least three factors that must be evaluated in a hire versus acquire analysis: costs, risks and timing. These factors apply to both acquiring and hiring and are summarized in Exhibit 2.

EXHIBIT 1a HIRE VS. ACQUIRE EXAMPLE
$THOUSANDS

ACQUIRE	YEAR 1	YEAR 2	YEAR 3	YEAR 4	YEAR 5
Personnel					
Employees Acquired	100	–	–	–	–
Cumulative Employees	100	100	100	100	100
Financial Build					
Annual Revenue (1)	$10,000	$10,000	$10,000	$10,000	$10,000
Employee Costs Fully Loaded (2)	8,000	8,000	8,000	8,000	8,000
Pre-Tax Earnings	2,000	2,000	2,000	2,000	2,000
Taxes	(800)	(800)	(800)	(800)	(800)
After-Tax Cash Flows (2)	$1,200	$1,200	$1,200	$1,200	$1,200

(1) Assumes revenue of $100,000 per employee.
(2) Each employee costs $80,000 fully loaded.

EXHIBIT 1b

HIRE VS. ACQUIRE EXAMPLE
$THOUSANDS

HIRE	YEAR 1	YEAR 2	YEAR 3	YEAR 4	YEAR 5
Personnel					
Employees Hired (1)	50	50	25	–	–
Percentage Retained (2)	80%	80%	80%	–	–
Net Employees Hired	40	40	20	–	–
Cumulative Employees	40	80	100	100	100
Financial Build					
Annual Revenue (3)	$1,500	$5,000	$8,250	$9,750	$10,000
Employee Costs Fully Loaded (4)	1,700	5,000	7,350	8,050	8,000
Incremental Recruiting/Training Costs (5)	500	500	250	–	–
Pre-Tax Earnings/(Loss)	(700)	(500)	650	1,700	2,000
(Tax Expense)/Tax Benefit	280	200	(260)	(680)	(800)
Net After-Tax Expense	($420)	($300)	$390	$1,020	$1,200

Note:
(1) Employees are hired evenly throughout year and a maximum of 50 per year can be hired.
(2) 20% of initial hires do not result in productive employees and are terminated after 3 months on average.
(3) Employees generate $100,000 of revenue per year after a 3-month start-up period.
(4) Each employee costs $80,000 fully loaded.
(5) Each emloyee costs $10,000 to recruit and train.

HIRE VS. ACQUIRE	YEAR 1	YEAR 2	YEAR 3	YEAR 4	YEAR 5
Acquire – After-Tax Net Cash Flows	$1,200	$1,200	$1,200	$1,200	$1,200
Hire – After-Tax Net Cash Flows	(420)	(300)	390	1,020	1,200
Incremental Cash Flows via Acquisition	$1,620	$1,500	$810	$180	$–
Discount Rate	15%				
Breakeven Point*	$3,178				

* An acquirer can pay this amount, including transaction costs, and be in the same position as hiring. This simplified analysis does not consider the tax deductibility of purchase price and other factors.

Six Key Decision Factors

In practice, companies need to consider the following factors when deciding whether to hire or acquire:

Specialized Employee Groups

Some employee groups are harder to assemble than others. Certain specialty engineers, technical-based employees, or emerging sector employees (like solar or energy efficiency) come to mind. If you are hiring for extremely specialized jobs and responsibilities, and if acquired human resources are lacking in certain areas, then you will have to dedicate more resources to training and education.

EXHIBIT 2 THREE KEY FACTORS THAT MUST BE EVALUATED IN A HIRE VERSUS ACQUIRE ANALYSIS

	HIRE	ACQUIRE
Costs	• Multiple smaller costs (recruit, train)	• One-time larger acquisition cost
Risks	• Team formation • Bad hires	• All risks of acquisition • Cultural fit and integration • Team retention risks
Timing	• Increased optionally if market conditions or corporate strategy change • Miss near term revenue • May miss window of opportunity	• Immediate revenue capture • Instant market presence

Effective Teams

Good teamwork is necessary for any construction or engineering firm. Companies must be able to bring individuals together in a very effective manner to deliver multifaceted projects under tight schedules. Productive and efficient teams don't happen just by accident. Teams are efficient because their members work collaboratively, sharing and coordinating resources around common goals. The best teams are also productive because they have worked out ways to resolve conflicts and address challenges (both big and small) as they surface. Team formation takes time, and certain teams, such as business development or software development teams, can be difficult to assemble. The individuals that make up these teams may be highly skilled within their own disciplines, but their effectiveness is often only as good as their ability to participate in well-functioning teams.

Corporate Culture

Defined as the pervasive values, beliefs, and attitudes that characterize a company and guide its practices, corporate culture plays a key role in the success of today's construction and engineering firms. According to industry estimates, a strong culture can account for 20 to 30 percent of the differential in corporate performance when compared with "culturally unremarkable" competitors. This double-digit differential can give culturally-oriented companies a significant advantage in today's competitive business environment. However, achieving it can be more difficult than it looks. In most cases, a company's existing culture may be easier to extend to hired individuals than to an acquired group of employees. On the other hand, the acquired group may have developed a culture that is attractive to the buyer and may already be working effectively in the market.

Employee and Acquisition Market Dynamics

Often, employee markets are tightest when revenue opportunities are greatest. We can see evidence of this in the current, post-recession marketplace where certain sectors are experiencing high levels of growth and are in need of workers to help support that expansion. According to the Bureau of Labor Statistics, over the past 12 months, the number of unemployed persons and the unemployment rate were down by 1.1 million and 0.8 of a percentage point, respectively. These market dynamics can have a significant impact on a firm's ability to hire multiple employees at once versus acquire an already-stable base of workers. Likewise, acquisitions are often more expensive when labor markets are tight and economic activity is robust. Accordingly, the relative state of the employee and acquisition markets should be taken into account when deciding whether to hire new employees or acquire an existing company that already has an established employee pool.

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Staged Investments and Optionality

Hiring is a staged investment with built-in optionality. The strategy can be changed on short notice with limited sunk costs. Acquisitions are larger bets, with the benefits and risks of such a venture. If an organization is more comfortable with incremental changes, then hiring individual employees could be seen as a "safer" bet than adding multiple workers via aquisition.

Speed to Market

The counter argument to staged investments and optionality is the need to capture market opportunities quickly. In such cases, companies must consider the significant scalability opportunities associated with increasing human resource numbers with a single action such as an acquisition.

Tackling a Multidimensional Decision

In summary, the decision to buy versus build is complex and multidimensional. Increasingly, the embedded decision to acquire versus hire is an important component of a company's overall strategic analysis. Most real-world scenarios do not lend themselves to accurate quantification of hiring versus acquiring. Nonetheless, working through a high-level analysis can be a valuable exercise that highlights key assumptions and factors, indicates sensitivities to such factors and provides insights into relevant ranges and breakeven points.

Carefully considering the results of such analyses, while keeping an eye on the bigger picture and maintaining a healthy sense of the inherent limitations, gives decision makers a better perspective on the question of hiring versus acquiring. **Q**

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