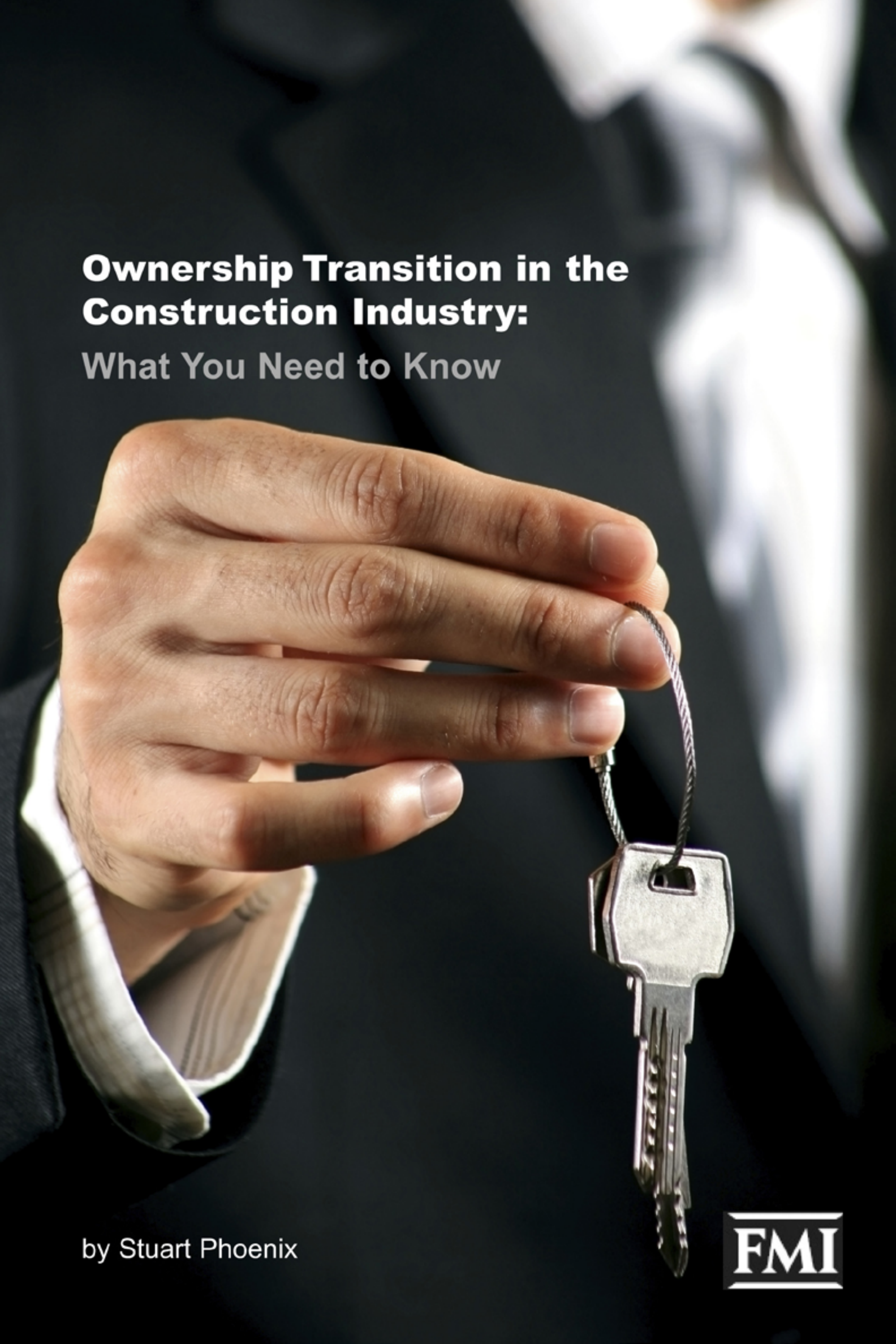


Ownership Transition in the Construction Industry:

What You Need to Know

by Stuart Phoenix

FMI

Ownership Transition in the Construction Industry:
What You Need to Know

by

J. Stuart Phoenix

FMI

Published by
FMI Corporation
5171 Glenwood Avenue
Suite 200
Raleigh, NC 27612

www.fminet.com

ISBN: 978-0-9648255-6-7
To order additional copies of this book, please call
800.877.1364.

Contents

Preface

FMI has been providing advice to engineering and construction firm owners on ownership transition for more than 40 years, beginning with our founder, Doc Fails. I have been with FMI for 25 years, and in my early years learned about ownership transition working with Hugh Rice and other FMI consultants. During its history, FMI has developed a body of knowledge and experience on ownership transition from our research and consulting experience. The articles included in this publication are a compilation of the articles I have written during my time at FMI for publication in "FMI Quarterly," its predecessor "FMI Construction Management Journal," various research projects and other third-party publishers. The articles reflect FMI's body of knowledge on ownership transition and FMI's point of view on the topic. We hope you find the articles useful in thinking about your transition. If you have questions or comments, please contact us.

Sincerely,

Stuart Phoenix
Chairman and Managing Director

Section 1

Ownership Transition:
The Problem and the Opportunity

Succession Planning Considerations

Business succession planning typically begins with a business owner contemplating an exit strategy. This presents questions regarding who can run the company and how to sell the firm. Answering these questions is important to business succession. However, our experience has shown that a successful business succession plan requires answering a much broader range of questions. This is because succession is not a single event but a process that affects every part of the business, its profitability, and ultimately changes the company culture. Thus, business succession planning should address much more than who will be the future owners and how the current owners will remove their capital.

Internal Issues

In our concept of business succession planning, owners must consider the following questions:

Who will be the future owners?
Our recommendation is that the owners of a contracting company should be the management team that will drive the business. This is because, unlike absentee ownership, active ownership has a way of focusing managers on both the risks and opportunities a business has.

Who are the future leaders of the business?
Note that we use the term "leaders" and not "managers." Leaders set strategy and drive the business, while managers execute strategy. Companies need both, but often the exiting owners were the only people providing the firm's leadership. Thus, successor leadership needs to be identified internally, or hired, and then developed. This is probably the biggest challenge in succession planning.

What affect will a change in ownership and leadership have on the company?
The culture of a company is defined by top leadership and encompasses the values and vision of the company's leaders in addition to incentives inherent in the reward structure. In a transition, much of this culture is changing despite efforts for continuity. New leaders bring their own values and visions to the table. If they have grown up in the current culture, these may be similar to the traditional values and visions, but there will be differences. New

ownership changes incentives at the top of the organization and will likely change incentives throughout. In addition, picking the new owners and leaders also means you are picking who will not be new owners and leaders, a process that can be disruptive to the organization. All of these changes combined create a new company culture.

External Issues

Having discussed the effects of a transition internally, our next few questions relate to external issues.

What strategy should the company have to be successful in the marketplace?
While the company is undergoing a cultural change due to transition, the construction world and competitors will not slow down. While it is tempting to focus internally during a transition and only worry about buying out exiting shareholders, an external focus is needed to develop a strategy to compete in the changing construction market. In fact, an ideal opportunity to do strategic planning is during an ownership transition. Exiting and emerging leaders should come together to review the strengths, weaknesses, opportunities and threats of the business. Emerging leaders may see the business from a perspective that they never considered, and exiting leaders have the opportunity to evaluate the emerging leaders' thought processes. This interaction enables the exiting leaders to help shape the new vision for the future, assist the next generation of leaders in developing leadership skills, and establish the future ownership and leadership structure of the company.

What other improvements can be made to the business?
Change is contagious. Stable ownership and leadership have their advantages, but a disadvantage is that processes often become dated. Progress and technology provide opportunities for firms, and their competitors, to advance if they are open to new ideas. The internal focus of an ownership transition is an opportune time to question old habits and re-evaluate some of the "untouchables" in the organization.

Traditional Concerns

Our final set of questions is more traditional to business succession planning.

What are the current owners' personal goals?
For a business succession plan to be successful, owners must know what they want to achieve and set reasonable goals for doing so. For example, an owner may want to be removed from all ownership and management responsibilities in one to two years; but this may be an unreasonable goal since successful succession plans generally take five to 10 years to complete.

What price or value should be placed on the stock to be transferred?
This question is one of the first that exiting owners ask us; but notice that this is one of the last questions on our list. The reason is that most of the other questions address how to make the company successful — a prerequisite for ownership transition to be successful. Many exiting owners have a price in mind that they "feel" is appropriate, based on the years they have spent building the company as well as a host of other subjective factors. A professional third-party appraiser can provide an objective valuation which may be quite detailed and complex. However, such theoretical values in an internal transaction are not as important as the successors' ability to pay and the future earnings of the company, since most of the funds used to finance the deal will likely come from ongoing profits.

How should a sale of the company be structured?
There are numerous techniques for structuring a sale. The right structure is situation-specific and dependent on factors such as the structure of the current company, the objectives of all parties and the financial performance of the business. Although the ownership transfer technique itself is always a point of focus for exiting owners, it is usually the easiest piece of the business succession plan to execute if the company has strong profits.

Conclusion

As the number and depth of the questions above indicate, business succession planning is far more involved and important than simply determining who the future owners will be and how to sell them the stock. Leadership development, strategy and succession planning are all interdependent. Addressing the questions above, in addition to the obvious questions of who and how, is essential to launching the next generation of owners and leaders and taking the company to the next level.

The Fundamentals of Business Succession Planning

Designing and implementing an exit strategy is a business owner's final and most important project. Although the task can be quite overwhelming, the planning process can be separated into several parts so that each individual aspect can be given the attention necessary to develop a winning strategy.

Objectives

Start the planning process by focusing on objectives. A plan will not succeed unless the business owner knows what he or she wants to achieve. Some of the questions to ask include the following:

- When does the business owner plan to retire?
- What does the business owner financially want to retire?
- Does the business owner want the company to remain private or be sold to a third party?
- If the business owner wants the company to remain private, who are the future leaders and when will they become owners?
- To whom and when will control and voting power be given?
- What level of training and development does the business owner's successors need, and how long will that take?
- What will be required of the business owner for indemnification purposes?
- Does the business owner want family members to inherit any stock?
- How will the business owner's assets be divided among the heirs?

These questions should be answered with consideration for the company as a whole and from the perspectives of both the business owner and his or her successors. Once the above issues have been thought through carefully, the owner will have a guide for the rest of the planning process.

Management Succession

Every part of the business succession planning process requires the owner to answer tough questions. For example, what are the chances of the owner being able to retire comfortably? What are the chances of the company continuing if several of the managers or other employees plan to leave the company because they are not happy about the contemplated changes?

Ensuring that competent leaders are in place to keep the firm moving forward is an essential part of the business succession planning process that the owner must attend to carefully. Many business owners ignore the people issues of business succession planning and focus only on the technical and financial aspects. Other owners see management succession as a necessary evil that is solved simply by picking a leader and moving on after the stock and money have been exchanged. Far from an event, management succession is a process in itself that requires much attention.

The first and often most challenging step in the management succession process is selecting the right future leader. In most cases, more than one person comprises the next generation of leadership, and major roles and responsibilities are realigned among them. To give the firm clear direction, one person must act as president or CEO, and that person must have the support of the other managers as well as the organization as a whole.

Generally, a gradual transfer of roles and responsibilities is best in order to mesh individual styles and abilities. A steady transition gives management successors time to grow into their new positions and allows the business owner time to learn how to trust, let go of the reins and get used to a diminishing role. Lead time is also important for a smooth transition of customer, banking and bonding relationships from the business owner to the new leadership.

Most business owners fall short in providing for management succession if they do not have a formal, written document. Creating a written document helps keep the management succession process under control and reduces the emotional and subjective aspects of dealing with people issues. In the plan, the business owner should document:

- The objectives of current and future management
- Feedback from field and office employees
- A schedule for training and development initiatives
- A schedule for the transition of roles and responsibilities
- Dates for follow-up

Putting action steps and other details in writing provides a means for review and modification.

Although there are no guarantees with people, the implementation of the business succession plan is sure to be more difficult if the business owner has not invested time in the employees and the management succession process. Addressing management succession appropriately will give the owner more ownership transfer alternatives and increase the probability of long-term success for the succession plan.

Ownership Transfer

Business owners have these options to exit the business:
(1) sell the company, (2) give the stock away or (3) liquidate the assets.

Selling the Company

If owners have management successors in place producing profits, then selling the company as an ongoing entity is a reasonable proposition. The company may attract "outside" buyers. Potential "inside" buyers also may be considered.

Outside Sales

Selling to an outside buyer can have its advantages. The seller usually is substantially cashed-out at closing, and ongoing financial risk and liability are reduced. Business continuity and management succession issues become the new owner's concern, although owner-managers are generally required to remain with the company to train management successors. A third-party sale is often the best alternative when a buyer can be found.

Inside Sales

Surveys indicate that approximately 70% of contractors end up cashing out by selling their firms to key employees or family. In most cases, one of the following techniques is used in an internal sale:
(1) direct sale
(2) stock redemption
(3) employee stock ownership plan (ESOP)
(4) Sub S buyout
(5) brother/sister companies or
(6) permanent joint venture.

An internal deal can be an extremely positive, flexible and lucrative arrangement for all parties.

Giving the Stock Away

Gifting generally is used in conjunction with an owner's personal estate plan. Gifting is most effective in providing business succession when family members are actively working in the business and performing management responsibilities and the owner has wealth outside the business. Gifting seems to work better when the recipients have or will "pay" for the gift in some form, even if the "payment" is "sweat equity."

Liquidating the Assets

When in doubt, selling the corporate assets and closing down the business is an exit alternative, although liquidation is often tough for business owners to handle emotionally. Many companies are not marketable to a third party, do not have managers with leadership potential or the desire for ownership, and/or do not have an owner who can afford to give the company away to provide for continuity. In such cases, liquidation may be the best option for cashing out of the business, though the cost of liquidation can be higher.

Valuation

Perhaps one of the most confusing parts of business succession planning for the owner is valuation. Unfortunately, the value of a company depends, in large part, on who is interested in the business. The IRS, an outside buyer, employees, family and the current owner will all have different objectives and opinions on the valuation of the same firm. A true corporate valuation is a complex and thorough exercise that is best left to an independent appraiser. However, a few broad points can be made:

- There are three generally accepted approaches to the valuation of a closely held firm. These are the market approach, the asset-based approach and the earnings-based approach. In an internal sale, the employees' ability to purchase a company is more important than any theoretical value of the company.
- The earnings capacity of the firm should allow a third-party buyer to earn pre-tax profits that are equivalent to a 15% to 30% return on investment.
- Buyers and sellers in the construction industry pay close attention to the underlying asset value of a construction company. The book value or adjusted book value of a firm may not provide a realistic value, but most buyers are not willing to pay excessive premiums above asset value, and most sellers are not willing to take less than book value in a transaction.

Assessments of value can be disparate depending on the perceptions. Unrealistic expectations will bring the business succession planning process to a halt for an internal sale. It is often helpful for a business owner to ask a simple question: "What would I pay for this company if I were just entering the business today?"

Contingencies

Contingency planning involves thinking about the "what-if" questions. The business owner can have the most thoughtful and best-made plans in the world, documented in black and white, and something totally unexpected can happen and wreck everything. Unfortunately, contingency planning, like management succession planning, is often overlooked or not given enough attention in the final analysis. Key aspects of a contingency plan that need to be addressed are:

(1) What happens if the owner dies or becomes disabled during the transition?

(2) What happens if the successors don't perform, quit, die or become disabled before the completion of the transition?

Contingency plans should be addressed in:

(1) Buy-sell agreements (specific value, valuation date, triggering events, terms and conditions, dispute clauses, noncompete clauses, gifting, stock redemption versus cross purchase arrangements, control issues, life and disability insurance funding)

(2) Compensation, noncompete and employment agreements

(3) Estate plans

(4) Retirement/lifetime income plans

The Living Plan

Once the owner has done the work of planning, covered the fundamentals and implemented a strategy, the business succession plan will take on a life of its own. Hours, days, weeks and months can be spent building financial models and making other projections, but the owner and the owner's successors will have to remain flexible and patient as time passes, the company grows and the organization changes to meet new and often unexpected demands. Business succession is dynamic in nature, but with reasonable expectations and logical assumptions, all parties can find satisfaction in the ultimate outcome.

Holding on to Your Employees: Do You Need to Implement Your Ownership Transfer Plan Now?

As the construction market improves, the war for talent is heating up, particularly since a lot of talent left the industry in the Great Recession. Combine that with the entrepreneurial drive of your young, capable managers, and holding on to talent is difficult. If your talent is to be part of your ownership transfer plan, you may want to consider getting your plan started now. Otherwise, the management succession portion of your plan may not be there when you need it.

Historically, the entrepreneurial drive to start your own company is strongest in your 20s and 30s. A current owner's cost of losing key employees is probably greatest when the employees are in their 30s and have gained experience and proven their value to the organization. In today's world with successes like Apple, Google and other garage-to-riches stories playing on CNN daily, the lure of ownership and opportunity is strong. The trick is to harness this entrepreneurial drive in your organization and have entrepreneurs help you drive your organization. To do that may require ownership. This might fit right in to your ownership transfer cycle and management succession planning.

Most owners tend to wait too long to consider their ownership transfer options. A typical ownership transfer plan probably works best if it can be completed over a seven- to 12-year period. By waiting too long, you may lose key participants, delay your eventual exit and, ultimately, cost you money.

Planning Your Future

Planning for ownership transfer starts with taking a long-term view of the role you want to play in management and ownership and what you want to spend your time doing later in life. Many entrepreneurs tend not to think in terms of disengaging from their business or even of retirement. However, it makes sense to plan for a changing role that will turn over increasing operating responsibilities to able younger managers.

How to Involve Employees in Ownership

There are numerous techniques for involving employees as "owners." Some of the more prevalent methods are listed below:

1. **Sale of Stock.** Selling stock to employees is a simple, obvious way to get started. The difficulty is that most employees have little money other than what they have been able to accumulate from what you have paid them. There also may be complexities to transferring your stock if you have non-operating assets in the business, such as real estate or other investments. In addition, there are certain benefits of ownership that you may have that a minority shareholder may not appreciate, such as expense accounts, compensation arrangements or uses of non-operating assets.
2. **Stock Bonus.** Providing compensation in the form of shares of stock is another way to put stock into employees' hands when they lack the money to purchase shares. This, coupled with purchases, can build employee ownership.
3. **Employee Stock Ownership Plans (ESOPs).** An ESOP is a retirement plan for all nonunion employees (in most plans) who invest in the stock of the company. It is a tax-efficient way for an owner to sell his or her stock. Although an ESOP encourages entrepreneurship among all employees, it does not target stock to the management team. In our experience, not all employees are entrepreneurs. If your goal is to motivate specific employees with ownership, the ESOP will not likely do that alone. A more concentrated ownership, in addition to the ESOP, is likely to be appropriate, or an incentive plan focused on management.
4. **Stock Options.** A stock option is a right to buy a share of stock at a currently determined, specific price, later. It is a popular technique with public companies. The hefty compensation packages we hear about for public company CEOs are largely driven by options. The difficulty with stock options for private companies is that it is hard to measure value of a company's stock in a way to make the option have the desired incentive. This is because private business owners

typically try to minimize taxation or may distribute earnings to build personal net worth. This has the effect of holding down the net worth of the business, which may be in direct conflict with the incentive of the option. Therefore, it is usually in special circumstances that we see stock options used in a private company.

Putting ownership in employees' hands is also a first step to providing an exit strategy for the current owner and a vehicle to remove herself or himself from the business.

Pitfalls to Sidestep

Listed below are pitfalls to avoid:

1. **Not leaving yourself an out.** New owners do not always work out. Have a clear buy/sell agreement so that you can undo the transaction if necessary.
2. **Having too many owners.** The percentage of the population that comprises successful entrepreneurs is relatively low. Too many owners can make for more difficult decision making.
3. **Having nonemployee stockholders.** In our experience, construction companies run best when owned by those who run the company. The buy/sell agreement should prohibit transfer of stock outside your employee base.
4. **Not maintaining control.** Employees need to grow into ownership, and the current owner needs to protect their investment during the transition.
5. **Not professionally managing your organization.** Your development of successor management will have much to do with your plan's and your successors' success. If you continue to make all decisions or override your managers' duties, they will not develop.

Structuring Your Exit and Sale

The thrust of this article has been to retain key successor management by using ownership. This can accomplish the first step of an ownership transfer plan, which is to develop key people and place some ownership into their hands. The next step is to develop a plan for your key people to buy all of your stock. There are numerous ways to accomplish this, such as:

- Subchapter S Buyer
- Brother/Sister Company
- Permanent Joint Venture
- Limited Liability Company (LLC) Plan
- ESOP
- Stock Redemption
- Utilization of Debt Notes

None of these will work, however, without completing Step No. 1 of developing key people.

Conclusion

The key to any successful company is a good organization and usually a few key people. As you contemplate your company's future, think about whom those few people will be and what you need to do to keep them making money for you. In today's world, ownership for these select employees may be the answer. Ownership for these employees may also provide the basis for a future successful transition.

Wealth Creation, Management and Utilization

It is not hard to start your own construction business — a pickup truck, laptop, some skills, a low bid and you are in business. Staying in the business however, is harder as proven by the experiences of some larger firms such as J.A. Jones, Encompass, Washington and Atkinson. In addition, getting out of a construction business is not an easy task, with most companies selling to family or employees, often leaving the next generation to struggle.

What you are trying to accomplish as a new owner of a construction firm, in addition to the satisfaction of ownership, is wealth creation. Following this notion, you can divide your ownership arc into three phases:

PHASE 1 **Wealth Creation**	Getting the business started, creating self-employment and sustaining profitability
PHASE 2 **Wealth Management**	Preserving and growing your business and personal wealth. Important considerations are: • Business management systems • Diversification — having investments outside the business • Risk management — personal and business
PHASE 3 **Wealth Utilization** (a.k.a. Your Exit Strategy)	• Retirement planning — financial and lifestyle • Realization of the value of the business you have created • Estate planning — what ultimately happens to the wealth you have created and managed?

Decisions made in phases 1 and 2 when starting and growing your business will affect your eventual exit strategy. FMI is often approached to address exit strategy when an owner needs out. Successful owners are often more occupied with becoming successful than planning what to do after they become successful. However, a little planning during phases 1 and 2 can go a long way. It therefore makes sense to think through your strategy as early as you can.

However, before we dive further into business-succession planning, let us review some fundamentals of our industry.

Fundamentals of Contracting

Contracting is a tough business, as are many occupations. Here are a few observations from our work with contractors:

Contracting is fragmented for a reason.

"Engineering News Record" (ENR), a construction trade magazine, regularly ranks top construction companies in various segments of the industry. In looking at the ENR Top 400 Contractors list, the top-400 companies perform less than 50% of construction in the United States. In addition to the top 400, there are hundreds of thousands of other contractors that also exist in the industry. Some of the reasons the construction industry is so fragmented include:

- Geography — The ability to travel is limited for most contractors.
- Lack of economies of scale — Contractors do not necessarily gain efficiencies or buying power with size.
- Propensity of the business of larger firms to unravel — As contractors grow, they often lose focus and discipline at the project level.

A construction company is principally a group of people who know how to procure, perform and be paid for construction services. Take a few top people out of most construction companies, and the organizations lose focus quickly. Key people can lose motivation, go to the competition or even start up as new competitors. The phrase, "Our people are our greatest asset," is particularly true for construction companies.

Market opportunities come in waves.

Five years is an eternity for business planning in the contracting world. It is not so much that the technology changes, but what is built does. Construction may grow overall with gross domestic product, but within the market for construction, sectors are going up and down constantly and sometimes radically. Therefore, a contractor must be able to change with the marketplace.

Contractors do not do very well in downturns.

Construction suffered severe downturns in the early 1980s as interest rates soared; in the early 1990s in the wake of the savings and loan crisis; again in the early 2000s, following the burst of the dot-com bubble, terrorist attacks and general downturn in the economy; and in the late 2000s with the Great Recession. These downturns bankrupted many developers and contractors. The economy is in a slow growth mode but expectations are that in a few years, another downturn will occur. One sign of a savvy contractor is the ability to get small when economic conditions call for it. Other considerations for contractors in downturns include:

- Contractors reduce margins due to falling backlogs.
- Contractors may lay off people needed in the subsequent upturn.
- Banks and bonding companies cyclically embrace, then later turn away, from the industry.

These fundamentals dictate the importance of conservatism in management and ownership strategy in order to deal with changing economies and opportunities.

Ownership Strategy for a Contractor

Combining the business owner's desire for wealth creation with the fundamentals of the industry, our prejudice is that those who drive the business, versus nonworking or passive investors, should own a contracting business.

The two most successful models of ownership, in our experience, are a single shareholder and multi-private shareholders. Most companies start with a single shareholder. There is no structure quite as efficient as a single owner who makes all the decisions. It works quite well as long as the owner "can touch everything," including all projects and people, and the owner makes "good" decisions. The downside of single ownership is the owner is the limiting factor. Growth is limited by the owner's ability to effectively work through other people and generate capital.

In addition, with an individual making all major decisions, selling or transferring the business is difficult because the value of the company is in the controlling individual. So if the strategy is to limit growth, make as much money as you can and shut it down when done, then this strategy can work very well. In fact, this is precisely what many small contractors do.

The multi-private ownership structure usually comes from either two or more people coming together to start a business, or a business owner bringing in partners or family as part of a succession strategy. Our experience is that some entrepreneurs like having partners and others avoid it at all costs.

We have seen both scenarios work and the success of either is dependent on the individuals. Partnerships in business are like marriages, often easy to get into and hard to get out of. If they work, they are great; if they do not, they can be messy. There are advantages to having multiple owners to provide greater "ownership brain power" and additional capital. Our advice is to follow your own instincts as to whether single ownership or multi-private partnerships make sense for you. Business succession plans often dictate selling to multiple employees and/or family members to make the transition financially feasible.

Second- and third-generation companies often sustain themselves as private companies by adopting an expansive employee-ownership model. Engineering firms often evolve this way, emulating other professional services firms such as lawyers and accountants. Kiewit is probably the most successful example of this, with more than 1,600 shareholders. Kiewit has an ownership structure and culture that obviously works and has many attributes worth following if you choose the broad ownership structure model. The keys to successful broad employee ownership include:

- A strong employee and leader development culture
- A conservative and consistent stock valuation methodology
- A buy/sell agreement that protects the company while rewarding employees
- A set of criteria for employees participating in stock ownership that incentivizes the right employees with the right behavior
- Good business management

Planning Your Exit Options

Exit options for a retiring owner are a sale to a third party, a sale to employees or family members, giving your interest away or shutting the business down. Shutting the business down is an appropriate strategy to follow in the scenario where one owner controls all decisions and activities. In other cases, it may be the worst avenue to pursue, as it is time-consuming and expensive to wind backlog down to zero.

Sale to a third party is viable for some firms and, in many cases, the quickest way to get out with cash. Since not all firms are salable, having an employee sale option provides an alternative. We therefore often suggest that clients prepare for both alternatives, and indeed many recommendations apply to both alternatives. For example, the key to both alternatives is profitability, depth and quality of management and experience in delegating responsibility.

Winning at succession requires developing your options. Ultimately, you will cash in your stock in a sale to a third party, employees or family. Alternatively, you may transfer your stock via gift or estate. Today, one or more of these options may not be viable for you. For example, if most of your net worth is tied up in your company, giving your company away may not be financially feasible for you. You may not be able to risk a sale to employees, as it typically will require selling over a period of years. A sale to a third party may not be viable if you make all the decisions and your organization is shallow. Succession planning develops your options to win.

Ideally, as you approach the time to exit, you have already accumulated a significant net worth outside the business, you have a strong organization within which there are candidates to whom to sell the company, and your organization and financial performance are strong enough that you can attract a third-party buyer. Therefore, your plan needs steps to develop those alternatives.

Components of Your Business Succession Plan

To win, your succession plan should have the following components:

- Development plans for your management team
- Structure for ownership transition if an internal sale is used
- Valuation methodology if an internal sale is pursued
- Management systems that enable better business decisions
- A third-party sale plan

Let us explore each of these in more depth.

Development Plan for Your Management Team

You need talent — entrepreneurs who help you drive the business. This, in our experience, is the biggest challenge for two reasons. First, it is a big step from being a good project manager or estimator to being an entrepreneur, manager of others and owner. In most companies, the biggest gap in the organizational ladder is this last step to the top.

Second, developing successors with entrepreneurial ownership skills works best with a deliberate effort on your part to provide the training and the responsibilities they need. That may require you to go against your instincts in order to share responsibilities and decision making with them. Skilled successors are vital to the success of the internal sale or sale to a third party.

Structure for Ownership Transition

For an internal transaction, a structure is needed to define how employees will purchase your stock, how and when you get your money out, and how you manage your risk during the transition.

The most common assumption at the beginning of transitions is that employees have minimal funds to invest initially. This is because you probably did not hire rich employees and did not compensate them enough such that after they paid for their lifestyles they were able to accumulate much wealth. We had one experience where the successor's father had won the lottery, but more often, limited funds are to be expected. That leads us to the reality that the funding vehicle for a transition is the company itself.

The challenge for an owner in a transaction is to decide how to allocate the cash flow to incent employees so that the buyout is funded in a reasonable time while the net worth of the firm can continue to increase and the owner receives a return.

Valuation Methodology If an Internal Sale Is Pursued

Beauty is in the eye of the beholder, and there is nothing quite as beautiful to a business owner as his own creation. Add to that the owner's typical desire for maximum value, and it is easy to understand how a business owner's value expectation in a sale of his or her business is usually aggressive. In a third-party sale, the marketplace provides the reality with a buyer bringing his or her own notion of value to the table. In a sale to management or employees, this reality often is not brought to the table, and the owner selling his business can fall into what we call the "valuation trap."

The valuation trap occurs when the value placed on the company exceeds the acquiring employees' ability to pay while sustaining a financially strong business. The eventual result is the failure of the company or a necessary sale to a third party. That is not to say there is anything wrong with a third-party sale. However, if a business owner wants his legacy company to continue as a strong independent business, the valuation trap has to be avoided.

Kiewit Corporation is a great example of a company that has avoided the valuation trap and has sustained itself as a private company through multiple generations of employee owners. Having more than 1,600 shareholders, Kiewit files an S-1 report with the U.S. Securities and Exchange Commission in which some of its inner workings are revealed. One of the interesting facets of its ownership structure is that the company's valuation methodology for the sale and purchase of stock to and from employees results in a value below book value. Nevertheless, the value of Kiewit's stock has grown over the years, as increasing earnings have added to book value in their valuation formula. Employees who are eligible to buy stock like the idea of buying shares at less than book value. As the company and its stock value grow, many of its long-term employee/stockholders leave or retire as wealthy people despite the lower valuation formula. We would argue that this is one important reason why Kiewit has been more than able to sustain itself as a private company. Kiewit's ownership arrangement and culture have helped make it one of the most successful companies in the construction industry.

Most business owners only sell or buy a business once in their lifetime. Therefore, unlike designing or constructing a building that they have done hundreds of times, owners come into a sale without a great deal of experience. It is therefore not difficult to get off track.

The typical valuation traps we see owners fall into, often with the help of other professionals, are as follows:

Valuation based on methods not relevant for contractors: For financial professionals, discounted cash flow (DCF) is a predominant method for valuation. The difficulty in applying this method to construction firms is that it relies on projections for a minimum of five years and up to 10 years or more. Anyone in the industry will attest that just forecasting what revenues and earnings will be in the next 12 months can be difficult. In addition, a terminal or sale value at the end of the projection period is estimated. This estimate is often more difficult to make than the projection. Therefore, while the DCF valuation method is used widely for many manufacturing and distribution firms, it is not really applicable to contracting businesses. There are other exotic methods such as excess earning or dividend capitalization, and many of these have a basis in financial theory, but in our experience, they are not a reality for the construction industry.

In FMI's experience from numerous acquisition transactions with buyers and sellers, we find that the most relevant methods involve a capitalization of historical earnings, possibly using a one- to two-year forecast and valuations simply based upon balance sheet assets and liabilities. Capitalization methods typically will use a conservative multiple of earnings, which can be derived from a required pretax return on investment of 20% to 35%. Balance sheet methods rely on the historical accounting net worth (book value) and the book value adjusted for the market value of assets. Asset values are important indicators, or benchmarks, of value in this industry as most construction firms have few assets that are unique for their operations. In virtually every negotiation that we have been involved in, the buyer instinctively values an opportunity based on expected return on investment and the underlying value of the assets. Again, the valuation trap for construction industry firms comes from using methods that do not relate to a rational return on investment and underlying asset value.

Comparisons to public companies: Another common method is to take valuation multiples for public companies, typically price-to-earnings ratios and price-to-book value multiples, and apply the multiple to a private company's earnings or book value. It makes sense in that the multiples represent market values. Three issues, however, make this problematic. First, there are not many publicly traded engineering and construction firms, and it is difficult to find public companies comparable to the subject private company. The public companies typically are larger and more geographically diverse and have deeper management teams and a different mix of work.

Second, public companies have different factors driving their valuation besides financial analysis. Recently, FMI met with a veteran construction industry securities analyst. We asked him about valuation and the classic metrics. He said that while they were relevant, far more relevant were anticipated trends to drive the industry. The majority of investors were institutions that looked for trends such as needs for construction related to the electric grid, highways, water or other waves of construction. They would then play the market by trying to buy into the trend early and sell before the wave subsided. Many of the investors were short-term, not staying invested long enough to see if earnings materialized. For institutional investment strategy, there is nothing wrong with this, but using multiples based on these investments as a guide to a long-term investor holding in a privately held company is likely misleading.

Lastly, there is no ready market for the stock of a privately held firm. Buy/sell agreements may be in place, but financing any internal stock transaction is always subject to the financial condition of the company at the time of sale. Internal sales usually have to happen on a long-term note or share-of-earnings basis. In contrast, owners of stock in public companies can sell their shares quickly and for all cash. Unless the private firm is sold to a third party in an acquisition transaction, valuations for internal stock sales have to be financially feasible and not strip the firm of its means for continuing its business. An example of such a problem situation would be a company with two shareholders deciding to use a valuation of two times the book value of the company for one shareholder to buy out the other. In order to do this transaction, the buying owner would have to use all of the book value of the company for the value of the other shareholder's 50%. Using the company to affect the transaction would only work if the stock can be bought over time and financed, with the company continuing to have strong and increasing earnings. This might be a gross assumption for a construction firm, given the cyclicality of earnings in the industry. The valuation trap in this case is that paying for high initial value may not work over time, eventually forcing a third-party sale.

Use of formulas that are unrealistic to sustain a private company:
To value stock in a privately held company for sale to employees or other internal transactions, a formal valuation done by a professional may be

impractical or too expensive. Therefore, a company may write a formula into its buy/sell agreement. The simplest formula is to use book value, and many companies do exactly that. Book value has the advantage of being easily measured and usually conservative. However, it does ignore the market value of assets and the earnings value of the firm. So companies often seek other formulas to represent market value better. Formulas can be developed on multiples of historical earnings, book value, revenues (as discussed previously) or combinations of all of these. However, a formula can create problems over time. First, the business may change such that the formula no longer applies. The financial metrics can unusually increase or decrease such that the results of the formula may not be representative. Arguably, the most serious problem is when the formula results in a value such that the company or employees will strain to buy out exiting shareholders. If the employees cannot pay for a seemingly justifiable valuation over a reasonable period, the buyout will not work. Thus, the parties face another valuation trap.

One simple method to help an owner understand the maximum value that he or she can practically realize from an internal/employee sale is to take the firm's current book value, add what the employees can initially invest and the estimated after-tax earnings over the years of the buyout, and then subtract the book value needed to run the company at the end of the buyout period. Stated another way, the maximum value is what the company has now plus what it makes during the buyout, less what you have to leave the employees to be independent of you. This maximum value is regardless of what other creative valuation techniques may tell you. Under this method, for example, if the buyout term is a 10-year period and ending net asset requirements are the same as in the beginning, the maximum price that can be paid will be the earnings over the 10-year period. The point is that employees of construction businesses and the companies themselves typically can obtain very little, if any, outside financing for an internal buyout. If they do obtain financing, it will need to be paid off directly from company cash flow or indirectly through payments in compensation or distribution to the employees. Therefore, the principal way such a transaction can occur is out of the earnings of the business over time.

Statistically, not many companies survive to the third generation of ownership because the market changes and the company does not adapt. Sometimes, a third party makes an offer that cannot be refused. More likely, for most private firms, is the inability to develop or attract successor management. However, many do not survive because of poor transition planning and unrealistic value expectations. Avoiding the various valuation traps already discussed gives the private company the opportunity to survive and prosper. An investment banker specializing in our industry recently said that most businesses in this industry should be private because the flexibility and incentives are more appropriate. Our experience is that exit options are limited in the construction industry. Thus, for a business owner in this industry we strongly recommend that he or she be realistic about the company's worth and its long-term survival and avoid falling into a valuation trap.

Management Systems

We are not going to dive into what strategies and tactics to use in running your business, but we are going to discuss how you run the company. How you run the company affects your succession plan and your ability to win. Three ways to run your company:

- Seat-of-the-pants management
- Opportunism management
- Systematic management

Companies with all these styles can be very profitable and successful. However to win at succession, systematic is the best.

Seat-of-the-pants management is efficient and low-cost. Typically, one person makes the decisions with minimal consultation with others. Investment is minimal in management, meetings and preparation. The difficulty for succession is that this skill is not easy to transfer, particularly when you are making all the decisions yourself.

Opportunism management is a level above seat-of-the-pants in that when you identify something to pursue, the owner or designated persons or group goes after the opportunity in some organized fashion. The opportunity could be a project, an acquisition, a client or a market, for example. The company is run seat-of-the-pants until you find an opportunity that you want to be more deliberate about.

Systematic management has, as its name implies, management systems that enable better business decisions. There will be an annual business plan and budget as well as a market plan and cash flow budget. The owner and CFO are involved as key management members. While the owner may make the final decision, key management is part of the process, providing the benefit of its input, and just as important, exposing it to a decision-making process that is also a learning process. This involvement allows the owner to assess and develop management's capabilities. It has the added benefit that managers get to know one another and develop working relationships. While it takes more time and money, it does provide a process for continuance as the owner reduces his or her responsibilities.

The systems do not have to be complex. As we said earlier, construction comes in waves, and change should be expected. Reaction time of opportunities and construction in the face of risk are key considerations. Therefore, modest management systems often work the best.

Third-party Sale Plan

Much of the prior discussion has focused on the internal sale, but, as we discussed, you should develop both options. This is because when the time comes, your employees may not want to buy. A third-party sale may be attractive when you are ready to sell. Therefore, it makes sense to position the company for sale in case the need or opportunity arises.

Positioning your company for sale can be compatible with preparing for an internal sale. Again, you want both options. The obvious things to do to prepare for a third-party sale are as follows:

- Make money
- Grow the business
- Develop your management team
- Develop a successor for yourself
- Establish solid, simple management systems
- Maintain clean financial statements

The last item bears additional discussion. Clean financial statements make valuations easier for a buyer and transactions simpler to structure. Avoid complex corporate structures that create awkward tax problems in a sale. Nonoperating investments should be outside the operating entity. It is often easier for both internal and external sales if real estate investments are in a separate entity and real estate assets are leased to the operating entity.

Thinking Through Your Strategy

Consider the three phases of ownership in light of succession planning:

Phase 1: Wealth creation

Phase 2: Wealth management

Phase 3: Wealth utilization

Phase 1, *wealth creation,* is obviously key because if you are not successful here, subsequent phases will not be necessary. Phase 1 is about starting a viable company. Succession planning considerations are minimal, but it is helpful to get good advice about corporate structure to minimize future tax problems.

Phase 2, *wealth management,* is where planning usually starts in earnest, having established a viable business. Plans for the company's and your personal financial growth are needed. Management plans are vital to building value for a third party as well as developing successors within your organization. Risk management plans address life insurance and business risk issues to protect your family and business.

Phase 3, *wealth utilization,* is your exit strategy. Planning in Phase 2 creates your alternatives for exit. Is your company salable? Do you have a nucleus of employees to run the company? Can those employees own the company? What will ultimately happen to your assets?

Step back further, and succession planning really addresses two issues:

- What do you want for yourself, financially and personally?
- What legacy do you want to leave?

The first question is about money and how you want to spend your time, when you have the choice.

The second question is really about values. What employment opportunities do you want to provide to your family? What wealth do you want to give to your family? What wealth-building opportunities do you want to offer to your management and employees? What do you want to happen to the company and the wealth you have created?

There are no wrong answers to these questions. Some owners answer by saying they want their children to get nothing, thinking they should make it on their own as did the owner. Some want all of the proceeds to go to family members. Other owners insist on a sale to employees, even when there are more lucrative third-party sale options. Some have no interest at all in a sale to employees or family.

In setting your course, these are important questions to answer. We do advocate that, at a minimum, owners provide financially for themselves to sustain their lifestyle under their own control.

Finally, if you want to accomplish something, first you have to dream it. First you have to imagine your desired outcome: What do you want when you turn over the keys? Your succession plan gets you to that reality.

Value Creation in the Engineering and Construction (E&C) Business

Value creation is a rational goal of any business owners. However, FMI finds that when the time comes for the business owners to sell, the potential buyers' assessment of the value created often disappoints them. Some of the differences between the seller's and buyer's opinions of value can be explained by human nature; however, in the engineering and construction industry, many of the differences can often be explained in how the business owner went about creating value.

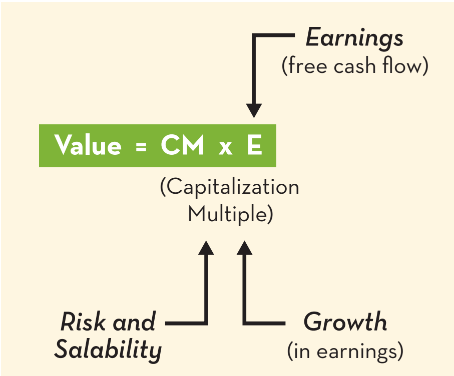
For discussion purposes, we will divide how the business owner went about creating value into three methods:

- Accumulation of earnings
- Growth in earnings
- Creation of goodwill

Using the accumulation of earnings method, the business owner makes money, but without creating an enterprise that is salable for more than its asset value. Most E&C firm strategies fall into this category, particularly smaller firms. The business is run to make money, and the owners realize the earnings of the firm by distributing earnings, selling the business for its book value (retained earning value) and perhaps an earn out based on future earnings, or liquidating the firm. Goodwill (in the financial sense) is not created, and the business does not have a value separate from the assets and liabilities it accumulates.

Alternatively, using the growth in earnings method, the business owner creates the business such that the value of the business is tied to its earnings capacity and that there will be a buyer who will pay some multiple of earnings for the business. Exhibit 1 shows a simple formula for the valuation of a business based on earnings. Creating value by this method is based on increasing the earnings capacity of the business. Public and many private firms fall into this category and they create value by adding to earnings capacity through strategies such as responding to a growing market, growing people or diversifying geographically.

Exhibit 1: What Drives Value?



Source: 2010 FMI Corporation

The creation of goodwill method includes the growth in earnings method, as goodwill is, by definition, the value of a business above its asset value. For our discussion, we will differentiate the creation of goodwill method from the growth in earnings method by defining it as creating value by making the unsalable company salable; making the company that would sell for book or asset value sell for a premium to book; or for making the company that sells for a multiple of earnings sell for a higher multiple. A company that used the growth in earnings method might be worth three to five times its pretax earnings, and through various strategies, earnings are grown. Then the increased earnings are multiplied by the same three to five multiple. Therefore, the value created is by the increase in earnings, not by an increase in multiple.

Empirical statistics cited for companies of all sizes in the industry show that 30% of companies will eventually liquidate, approximately 60% will eventually sell/transfer to family or employees, and approximately 10% will sell to a third party. Companies that liquidate created value by accumulating earnings. Companies that sell or transfer to family or employees mostly created value for their owners by accumulating earnings, though some may realize a premium to book as with the other two methods. Sale to a third party could be at asset value or greater. Again, it could use any of the three methods.

The implication of these statistics is that not many E&C companies create goodwill; most accumulate earnings. The reasons for this start with the fundamentals of the construction industry.

- The E&C industry is fragmented because:
  - Most building markets are local.
  - There are limited economies of scale.
  - Purchasing advantages vary as suppliers will often support the local business to avoid being too dependent on the national or regional business.
  - The effect of fragmentation is that the locally owned and managed business will often out-compete the division of a national or regional firm run by a division manager.
- Market opportunities come in waves. Five years is an eternity in the construction business, and what is built over time is cyclical. Successful firms are able to move with the waves of construction activity and to get smaller when needed.
- Businesses often struggle in downturns because of reduced margins, and banks and sureties that are often supportive in up markets turn away from E&C firms as clients in down markets.
  - About every 10 years, something happens, often external, to the E&C industry that negatively affects the construction markets. Some examples are the oil embargo in the 1970s, interest rates peaking over 20% in the 1980s, the savings and loan crisis of the 1990s and the World Trade Center attack and bank collapses in the 2000s. Each of these events caused dramatic downturns in construction, often confounding the best efforts of industry entrepreneurs in value creation and consolidation and usually resulting in some of the larger firms in the industry failing.

Combining these fundamentals makes value creation, beyond accumulation of earnings, difficult for the E&C firm. Growth by diversifying into somebody else's geographical market takes you against locally owned businesses. Growth by diversifying into a new type of construction runs the risk of getting into the wave at the wrong time and competing in an unfamiliar market. Investing in an acquisition strategy to consolidate a market runs the risk of the market turning down, struggling to integrate an acquired company or paying too much to an unmotivated seller or to a seller in the midst of an industry consolidation wave.

Owners of private companies often acknowledge the difficulty in creating goodwill in their buy/sell or stockholder agreements by using book value or asset value for their valuation. This may be a deliberate avoidance of including any goodwill in the business valuation, conservatism or just a desire to keep the valuation methodology simple by using the results of the balance sheet prepared by the accountant or an appraisal of assets.

With this thinking as a backdrop, how does an E&C firm create goodwill, that is, a business which a buyer will purchase and at a value beyond its assets and accumulated earnings value? What are the drivers that create goodwill in the E&C industry? FMI's observation is that they include the following:

- **An effective leadership culture.** A construction firm is a group of people who get, perform and are paid for the projects and services they provide. Take out the people and truly all you have are the assets and liabilities of the business. A leadership culture is one that develops people and therefore the business is able to grow by expanding the organization.
- **An ability to find and exploit opportunities.** The slow growth and cyclical E&C market is made up of numerous construction markets that cycle with intensity, and profit margins in sectors vary widely as well. The value-creating firm is able to find and move to and from opportunities.
- **Financial discipline.** In the article "Why Contractors Fail,"[1] an interesting finding was that while the nature of the E&C industry and the economy were contributing factors to failure, the primary reasons were poor strategic decisions or lack of financial discipline that led to capital erosion. Bad things are going to happen to businesses in this industry, and there is no substitute for a strong balance sheet and financial discipline to enable a business to get to the next set of opportunities.

1 Rice, H. & Heimbach, A. (2007). Why Contractors Fail: A Causal Analysis of Large Contractor Bankruptcies. FMI Quarterly, 2007 (2), 53-73.

Taken together, these three drivers can create value in the buyer's mind. They can provide the potential buyer with the confidence that there will be the leaders and organization to facilitate growth. Contrast that with many businesses where the selling owner is the sole driving force in the business. These drivers assure the potential buyer that the business will be able to find and exit markets when the company's current market cycles. Contrast this with a business that has been successful only in a single service, market sector or geographic market. Finally, the buyer will assign greater value if the business has financial systems and controls to identify problems early and the decision-making skills to react appropriately.

These drivers justify the payment of a premium in the form of a higher multiple or goodwill. Numerous, successful companies accumulate earnings with great business fundamentals. Many do not test the market to see if a buyer will recognize their value, as they prefer to remain independent. Going to market is the ultimate test for the creation of goodwill.

Ownership Structure for Value Creation

To realize goodwill in the valuation of a business requires adopting an ownership structure to exploit the opportunity. Exhibit 2 shows five ownership structures. First is the private structure. This is the least likely structure to result in payment for goodwill to owners. In fact, goodwill in a valuation for a business's private ownership structure may work against the survival of the business as a private firm. This is because if the stock price is too high, a sale to employees or back to the company may put financial strain on the business, leading to a loss of financial discipline and capacity.

The other four ownership structures — private equity, strategic sale, public IPO/SPAC and ESOP — all offer the opportunity for a valuation and sale of stock at a value that includes goodwill.

Private Equity

Private equity is a pool of funds provided by investors that is managed and invested by a management firm. The investors in private equity typically include high-net-worth individuals, endowments and pension funds. There are thousands of private equity funds investing pools of money in

Exhibit 2: Ownership Strategy Alternatives

Ownerhip Structure	Private	Private Equity	Strategic Sale	Public IPO/SPAC	ESOP
Management Succession	Need 30-50-year-olds • To buy stock • To become successor leaders	Need 30-50-year-olds • To become successor leaders and owners	Need 30-50-year-olds • To become successor leaders	Need 30-50-year-olds • To become successor leaders Need a "Public CEO and CFO"	Need 30-50-year-olds • To become successor leaders
Timing	5-15 years Develop a perpetual solution	1 year for initial transaction 3-7 years for second transaction	1-2 years	1-5 years • When market timing is right	5-15 years • To retire ESOP debt
If Bonding Required	Need to maintain a bondable balance sheet Need succession plan for surety	Need to maintain a bondable balance sheet	Buyer needs a bondable balance sheet	Need to maintain a bondable balance sheet	ESOP debt counts against bondable balance sheet
Valuation	Defined by what is practical • Need to complete buyout in a reasonable time • Support perpetual model	Driven by ROI (return on investment) Constrained if bonding required Participation in second sale adds to value	Negotiated	Comparables to public companies	Formal third party Needs to be sustainable for ESOP to meet repurchase obligations
Terms	Payments are over time Payments are at risk of performance of the business	Payment at closing but likely to include subordinated note Additional payment at second sale Continued participation by management is required	Cash with likely hold back/escrow and/or note Earnout possible	Partial cash, significant stock Management must maintain a significant stake or analysts / investors lose confidence	Driven by owner objectives and balance sheet requirements
Strategic Implications	Emphasize leadership succession and development Emphasize high ROE strategies versus capital intensive strategies • Acquisitions difficult • Asset or working capital intensive businesses difficult	Requires second exit strategy (IPO, SPAC, P/E, management sale, strategic sale) Requires coherent story and growth strategy Leadership succession is a prerequisite	Limited candidates Make money Address leadership succession	Coherent story and growth strategy required Need to want to be public Need a "Public Management Team" that is committed to growing and presenting the Company	Board and management team have "public like" fiduciary responsibilities Need focus on management succession Capital may be limited for growth in short term Sub S ESOP defers tax on income Need to create "control owner-like" entrepreneurial incentives

all types of businesses. A segment of these funds invests in engineering and construction firms.

Private equity provides two opportunities for sellers to realize value from their business. First, if a company meets their investment criteria, they will pay a multiple of your earnings or cash flow for a portion of your business. Typically, they will not buy 100% of your business.

Private equity managers will then encourage and possibly help the business increase its value by increasing earnings and making the company more salable. The second opportunity for the seller to realize value is from a second sale, typically three to seven years after the first purchase, wherein both the current private equity fund and the participating managers realize capital gains.

Private equity is selective about where it will invest. It likely will pay for goodwill in a purchase and its hope and intent is to increase dramatically the goodwill realized in the second sale.

Strategic Sale

In a strategic sale, a business sells to a third-party buyer, such as a larger private company, public company or a private-equity-backed company. Value is driven by the profitability of the business, its asset base and intangible and strategic factors. Buyers have their own motives and interests for an acquisition, and this will drive their view of value. Strategic purchasers may seek to enter new markets, consolidate a market, build out a national footprint, or choose a host of other strategic intentions. Ultimately, value is negotiated between buyer and seller based on both parties' interests and motives.

Public IPO

An Initial Public Offering (IPO) is a process whereby a business can sell a portion of its stock to the public. The public, as used here, includes institutional and individual investors. After the IPO, the stock of the business trades on an exchange. Valuation is driven by the underlying fundamentals of the business, industry and market trends and comparable stocks within the same industry.

ESOP

An Employee Stock Ownership Plan (ESOP) is a retirement plan for company employees who invest in the company's stock.

Conclusion

E&C business owners toward the end of their careers seek to realize the value of what they have created in the course of business life. They are often disappointed to discover that the value of their business is tied more to its asset value or a nominal multiple of earnings that result in a value they could exceed by retaining the company for a few years. It is often difficult to explain to these owners that their notion of goodwill does not hold in a buyer's mind because the goodwill is overly dependent upon the selling owner as a person, or that the buyer sees risk where the owner sees opportunity. Therefore, the buyer's valuation is tempered.

Creating value and goodwill above accumulated earnings value requires more than making money; it requires building an organization that makes money with or without the owner. It requires a corporate culture that is continuously developing people to expand the capabilities of the organization. It requires a culture that is forever in search of new opportunities in the industry with the ability to take advantage of those opportunities. The organizations that can build the culture of developing their people and create processes to constantly identify and exploit new opportunities are those that are most likely to create value and goodwill.

(If You're Not Careful) There's a Hole in the Bucket

Modern portfolio theory calls for diversification of an investor's assets as a means to protect and grow them. Economist Harry Markowitz presented modern portfolio theory about 50 years ago, and it has served as a basis for financial advice since that time. However, contractors find it hard to work within this framework.

The difficulty for most contractors is that almost by definition, contractors' assets are not diversified. Most contractors created their net worth through concentration of their financial resources in their companies, not through diversification of investments. In fact, diversification for many contractors would have prevented them from becoming wealthy.

Another difficulty in investment diversification stems from the fact that contractors maintain a significant exposure of their net worth to bonding companies and banks, risking catastrophic loss on a single, large project. Contractors become numb to risk; it is part of their life.

Still, the fact that many contractors have become wealthy by concentrating their investments does not mean it is a guarantee of continued financial success. On the contrary, the industry is littered with former contractors that signed for bonding companies or banks too long or went one job too far. The 2007 article "Why Contractors Fail" details the downfall of many large and seasoned contractors.[1]

So what is a contractor to do? First, the financial strategy that helped build wealth may not be the one that keeps you wealthy. It has been said that you concentrate to get rich and diversify to stay rich. However, for the contractor, there is more to it.

In a 2006 white paper published by Merrill Lynch titled, "Beyond Markowitz," author Ashvin Chhabra adds to the diversification model in a way that can help contractors better plan their finances. Chhabra breaks down risk into three dimensions: personal, market and aspirational.

1 Ibid.

Personal risk is managed to preserve a basic standard of living. Market risk is managed similar to modern portfolio theory by seeking a market return on diversified assets. Aspirational risk is represented by get-rich investments such as private business ownership.

To facilitate financial planning, Chhabra suggests classifying assets into each risk "bucket." This provides a useful model for contractors. Into the personal-risk bucket go a contractor's cash, house, insurance and other low-risk assets. In the market-risk bucket go market investments such as a 401(k), pension plans and other tradable investments. Market-type assets are what financial advisors want to see accumulated as contractors progress in their careers. Contractors may resist this because they understand less about market investments and see greater return from their concentrated investments. Into the aspirational-risk bucket goes the company, along with other concentrated investments.

Real estate could go into any of the three buckets. Homes would go in the personal-risk bucket. An office building or other investment real estate might go in the market-risk bucket. Development real estate might go in the aspirational-risk bucket.

Together, the buckets represent a risk allocation paradigm for contractors. The corresponding investment strategy is to fill and then protect each bucket from the bonding company and the banks. Exhibits 3 and 4 show the three risk buckets and the "risk/return spectrum."

Exhibit 3 shows performance expectations for each bucket, and Exhibit 4 shows the types of assets collected in each bucket.

How this model is used by investors will vary based on their particular asset base. For the well-paid executive, often the personal-risk bucket is filled first as a home is bought and a basic savings program is started. Next, the market-risk bucket is filled as investments are made in retirement plans and more aggressive market strategies. Contributions are made to the aspirational-risk bucket next as stock options or investment opportunities come along, or higher risk/return strategies are pursued.

Exhibit 3: Performance and Risk Measurement Basis for Each Risk Bucket

"Personal" Risk Basic Standard of Living	"Market" Risk Maintain Lifestyle	"Aspirational" Risk Enhance Lifestyle
Protective Assets	**Market Assets**	**Aspirational Assets**
Expected Performance Below market returns for below market risks	**Expected Performance** Market returns Market risks	**Expected Performance** Above market returns with high, targeted risks
Sample Benchmarks Consumer price inflation three-month LIBOR	**Sample Benchmarks** S&P500 Lehman Agg. Bond MSCI World Index	**Sample Benchmarks** CLEW Index Absolute return value
Risk Measures Downside risk Scenario analysis	**Risk Measures** Standard deviation Sharpe ratio Beta Scenario analysis	**Risk Measures** Upside return measures Manager alpha Scenario analysis

Low — Risk/Return Spectrum — High

Exhibit 4: Asset Classification for Each Risk Bucket

"Personal" Risk Basic Standard of Living	"Market" Risk Maintain Lifestyle	"Aspirational" Risk Enhance Lifestyle
Protective Assets	**Market Assets**	**Aspirational Assets**
Cash	**Equities** Broad size and style and sector exposure	**Alternative Investments** Private equity Hedge funds
Home Purchase	**Fixed Income** Credit quality and duration diversification	**Investment Real Estate**
Home Mortgage	**Cash (Reserved for Opportunistic Investing)**	**Investment Concentration**
Partially Protected Investments U.S. TSY (short duration) TIPS Principal protected funds	**Strategic Investment** Funds of funds	**Small Businesses**
Traditional Annuities to Provide Safe Source of Income and Hedge Longevity Risk	**Liquid "Non-traditional" Investments** e.g., commodities	**Concentrated Stock and Stock Option Positions**
Hedging Through Calls/ Puts/Collars		
Insurance		
Human Capital		

Low — Risk/Return Spectrum — High

For some investors, an inheritance may fill the market-risk bucket first. Next, they may fill the personal-risk bucket to secure their lifestyle, before filling their aspirational-risk bucket to garner greater returns or to be more active in their investments.

In another scenario, the business owner or contractor is likely to fill the aspirational-risk bucket first, often jeopardizing his or her personal-risk bucket. Once these business owners achieve a measure of success, there are several investment strategies they might pursue. First, many continue to reinvest in the business, not worrying about the other two buckets. Others are serial entrepreneurs and seek other aspirational-risk opportunities. Still others may begin to fill their personal and market-risk buckets.

Financial Planning for Contractors

The risk-bucket model proves useful for contractors' financial planning in several ways. First, when allocating assets strictly on return, the aspirational-risk bucket always wins since expected returns in a construction business typically range from 15% to 30%. Of course, achieved returns could be far different due to risk.

FMI's Investment Banking Group's experience indicates that contractors sell for three to six times pretax adjusted earnings. This means in a slow-growth industry, construction owners will get a 17% to 33% return on the expected valuation of their business. If the owner's choice is between the 17% to 33% return and a market-risk return — historically on the order of 10%, depending on the asset classes and the timing — the owner will invest in the business.

Said another way, a business owner considering a new opportunity will seek an above-market risk return to justify that investment. Therefore, it is almost self-fulfilling that business owners will choose the aspirational-risk opportunity over the market-risk opportunity.

The key for contractors making the allocation decision is risk. When do you stop focusing solely on increasing wealth and work on ensuring that you stay wealthy? When do you stop putting personal assets at risk? When do you start accumulating market risk assets to assure your lifestyle in retirement or to protect against a hit to your aspirational-risk assets? When do you say "no" to the bonding company or banks or to the aggressive project manager/estimator wanting to take on a high-risk project?

The risk-bucket model can help business owners consider these questions as thinking moves beyond just reinvesting in the business regardless of the risk. Another benefit is the model's use in separating out a business owner's personal balance sheet to facilitate work with advisors. For example, the business owner is responsible for the aspirational-risk bucket and typically will have a chief financial officer and other employees to assist with this portion. The business owners, and perhaps other advisors, are responsible for the personal-risk bucket, protecting the home and other low-risk assets. The market-risk bucket is where business owners are likely to look for help with assets accumulated beyond a retirement plan such as a 401(k). A more traditional modern portfolio theory might apply to this area of the model.

Separating the buckets in this way for management may also make sense for the business owner. Conventional thinking says the percentages in each bucket are crucial, in the same way the percentages of asset allocation are for each bucket. Yet it could be argued this is less true for business owners than it is for the nonbusiness-owner investor.

After business owners have achieved a certain level of financial success, it makes sense to secure the personal-risk bucket, at a base level that protects the home and maintains a level of liquidity. This bucket may not necessarily grow in size as the owner's net worth grows; after all, its purpose is to act as a safety net of assets, not necessarily as a percentage of net worth.

As business owners mature or take money out of the business, the market-risk bucket is next for securing. Again, the purpose of this bucket is to ensure or provide a lifestyle at less risk than the aspirational-risk bucket. Similar to personal risk, the size of the market-risk bucket may not vary in proportion to the owner's net worth since the purpose of the aspirational-risk bucket is return, while the purpose of the market-risk bucket is to manage risk and endow a lifestyle. The aspirational-risk bucket represents the owner's growth money, and growth usually requires more investment. That is especially true for serial entrepreneurs who may achieve their diversification by owning multiple aspirational-risk businesses.

Market-risk Bucket Management

Many business owners are late to the market-risk bucket because of the demands and opportunities of the aspirational-risk bucket. In addition, owners have typically had bad experiences in smaller market investments. As with most things, larger investment capital provides more investment opportunities and, generally, commands more experienced successful advisors. There are many choices of asset categories that vary in performance from year to year. Modern portfolio theory dictates diversification of the asset classes and within each asset class. An experienced investment advisor can help with this. Concentration in some cases may yield higher returns, but concentrated assets belong in the aspirational-risk bucket.

Bonding

Not all contractors perform bonded work, but a significant portion do. Not all contractors that perform bonded work sign personally, but a large number do. Contractors who do not sign should keep it that way. Contractors who do sign should work toward getting away from personal indemnification as a career goal.

Personal signatures are second nature for many contractors. These contractors signed to get started in the business because it was necessary and there was not much to lose. Later on, it makes sense to limit liability because bad things can happen. The risk-bucket model can help contractors think through this. As contractors start out, not much is in any of the buckets and everything is at risk.

As contractors fill the buckets, the goal should be to limit which buckets or assets are exposed to personal signatures. The company or the aspirational-risk bucket may always be exposed. The first goal should be to remove exposure of the personal-risk bucket, followed by the market-risk bucket.

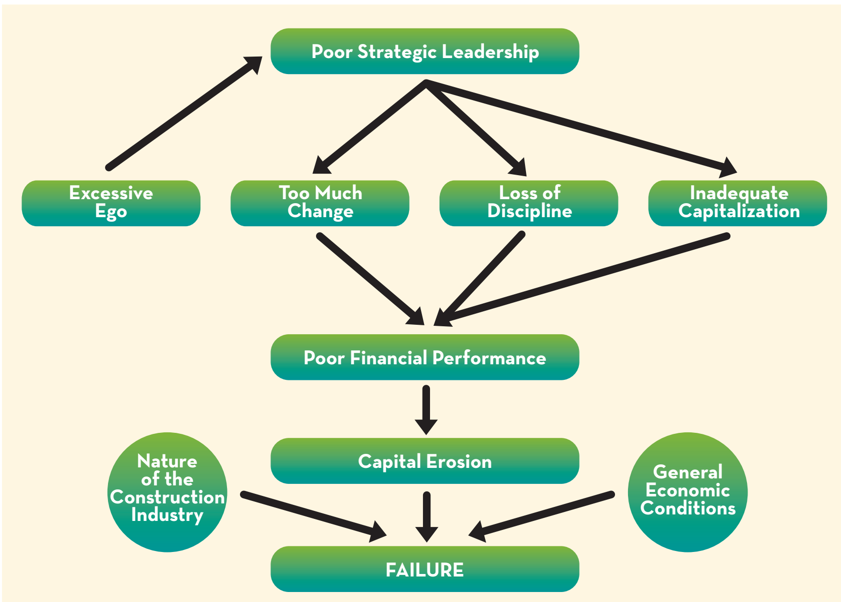
The Icarus Effect

Engineering News-Record published FMI's article "Why Contractors Fail" and termed the reasons for contractor failure, "The Icarus Effect." [3] According to the article, "A typical contractor is an individual who is driven to grow, numb to risk, extremely opportunistic, overconfident and action-oriented." That personality, combined with other factors such as inadequate business practices, difficult economic conditions and rapid change, has caused many a successful contractor to fail.

3 Korman, R. (2007). The Icarus Effect: FMI on Why Contractors Fail. ENR.

Exhibit 5 illustrates the failure chain reaction model and the cycle into which too many firms fall. Contractors should pay attention to how to avoid this effect in their own business. Few firms are immune to failure so contractors should fill the personal and market risk buckets in the good times and protect them from the bad times.

Exhibit 5: **Chain Reaction Model: Critical Root Causes**



Contractors assess and manage risk every day for their clients, while consideration of their own financial risk often takes a backseat. The risk-bucket model provides a simple way to segregate personal assets for analysis and management. While this is important for the contractor's personal financial health, it is also important to the contractor's family, employees, advisors, bonding company, bank and, ultimately, customers.

Your personal financial health prepares the way for succession planning when selling to employees or a third party. It provides security to your family in case something happens to you. In addition, it helps keep the business healthy, which is good for everyone.

The Art and Science of Business Succession

In FMI's experience, business succession is both a simple art and a complicated science. As an art, it can be understood as a "play" on the word succession, which is derived from the word succeed and is defined in Merriam-Webster's Dictionary as "the act or process of following in order." If looked at as a play on the word success, however, the art becomes clear. Success is defined in Merriam-Webster's as "favorable or desired outcome" or "the attainment of wealth."

Success and succession together define what business succession is at its essence. Success in business implies strong profitability coupled with client and employee satisfaction. Succession in business is the act and process of transitioning the business to the next generation of managers and owners. Success in business makes succession possible because the company's profitability will likely finance the transition, and its organization will provide future ownership and management.

Thus, the art, at its simplest, is the business owner "painting" his or her succession by making the business successful and developing the organization that is necessary to continue its success as he or she phases out of direct leadership of the firm. Where many business owners fail is that while they can paint a portrait of success with themselves at its center, it is difficult for them to envision a successful business that does not include them at the helm. That brings us to the science of succession, which can often become complicated.

The Art of Succession

Contractors have a way of being pragmatic in the face of decisions. Succession is an exercise that can be done simply or in a laboriously complicated way. Although the simple solution is generally preferable, there is always a risk that it may not work. For example, the designated successors may be incapable of becoming entrepreneurs and leaders, or corporate performance may not generate the profits to fund the owner's vision of value, and thus, therein lies the art of succession.

The art of succession is being able to balance the pragmatic with solid business practices. It is important for entrepreneurs facing a transition to recognize this is different than other business challenges they have faced in the past. It is an issue of nuance and subtlety rather than black and white. The fact of the matter is that succession depends on others, principally the next generation. For many owners, succession means letting go of some of what they have worked so hard to achieve, namely, their job, company and all the profits that they are so accustomed to keeping. Furthermore, this is not a project that can be delegated. Although help is available, the owner must be involved in the process, since a change in his or her role is integral to succession.

As one might suspect, these transition activities are not separate and distinct activities. We have seen a number of tax-efficient, equity transfer plans that have made no business sense. Similarly, we have seen management succession plans whose equity transfer plan eventually forced the company to be sold or it undermined the organization.

Therefore, managing succession requires the owner to pull the transition activities together pragmatically, such that they support the business being successful, provide incentives for the right behaviors in the organization, and provide desirable exit options for the owners. This calls to mind a definition of management from many years ago as “the art of getting others to do what you want them to do without knowing what you want them to do.”

Managing succession is like this because it is very difficult for an owner to understand all the technicalities of structuring a transaction, valuing the business, identifying successors and transitioning from being an owner to being a coach, mentor and partner. There are many moving parts that require a diversity of knowledge.

The Science of Succession

The science of succession can be divided into two categories:

- How to be successful in business
- How to transition a business

The science of how to be successful in business is taught in classic business education and training. It addresses topics of strategy, people and organizational development, finance and productivity. Entrepreneurs learn how to be successful, often in an artistic and instinctual manner, through either education or experience in business, or a combination of both. Many will fail, and for those who do, succession is not a concern.

As success brings one to the point of worrying about succession, the science of how to transition a business comes into play. This science focuses on leadership development for successors, financial tactics for transferring and selling a business, and strategies for continued business success while leadership and ownership are transitioning.

Leader development has been a hot topic in recent years. The complications start with the fact that a successful leader's path to success is usually not easy to duplicate. It is sometimes forgotten that for every leader we try to emulate, there are many who have not been successful, whether they were trying to start a business or rise in an established organization. The difference between those who "make it" and those who do not is the Holy Grail that management gurus are searching for.

An obvious goal is a list of characteristics that a prospective leader should possess or a process prospective leaders should go through to make themselves great leaders. A wide array of theories and varying methodologies regarding leadership development can be found in books, classrooms, boardrooms, organizations and in the minds of organizational experts. Sorting through these theories and methodologies can be quite time-consuming, and, in reality, this is not the type of problem that can be easily solved. The odds of success should improve markedly, however, with a more systematic leadership selection and development process as compared to one where leaders are selected on instinct and training is done in the school of hard knocks.

An additional problem in trying to emulate the traits of a particular leader in another organization is that his or her style is, in all likelihood, not transferrable to another company. Every contracting firm has a unique culture, strategy and marketplace within which it works. There is no such thing as an "off-the-rack" leadership style. Leaders must be developed within the cultural confines of an organization.

The science of financial strategies for transferring and selling ownership pertains to how to transfer ownership from one set of owners to another, including valuation of the business. This is often where business owners start when contemplating succession, and it is often the easiest piece of the transition puzzle. However, this assumes that the two prerequisites for a transition are met — the business is successful, meaning it has a good business strategy and profitable future, and there are prospective leaders. If this is the case, a structure for transition can be developed. There are numerous ways to structure a transition such as selling stock in a Subchapter S corporation, redemptions, deferred compensation plans, brother/sister companies, permanent joint ventures and Employee Stock Ownership Plans (ESOPs), to name a few. The structure that is best-suited for a particular business depends on factors such as corporate structure, tax history for the corporation and owners, risk profiles, individual objectives of owners and prospective owners, timing and other financial considerations.

Where Is the Door?

This topic may be interesting to you, but if you are an "artist," you may be asking how it can help you. The primary message is that succession in most cases is something that should not be delegated or done alone. You may need help with the science of it: understanding the nuances of transfer techniques, assessing your organization and developing your people. It is not unusual for owners to need help changing how they relate to their organization and how they involve others in decisions. You also have to pull it all together "artfully," balancing technical issues with people issues as well as your personal objectives. Advisors can help you with that, but the total picture of succession is something you have to paint yourself.

Succession for Boomers

FMI has helped contractors plan for ownership transition for more than 30 years. Our succession planning practice grew out of our management consulting business with the familiar story of soldiers returning from World War II, starting a construction business and, by the 1970s, trying to figure a way out. Much of what business owners need in planning a transition is the same as it was when we started. However, with the boomer generation, we are seeing a number of changes that make planning more complex and require the planning to be more comprehensive.

Some of the changes in succession for boomers are:

- Companies are larger. Growth in the American economy has meant greater opportunity for the construction industry. Successful companies are therefore larger in revenues, profits and assets.
- People are living longer. Longer life spans means longer retirements, or people can work longer.
- The industry is more complicated. There is more regulation, a more diverse labor force and owners who are more sophisticated. The businesses are therefore more complex to manage for the next generation.
- Generation X and Y employees are different from boomers to manage. Attracting people to the industry and providing effective leadership is always a challenge.
- Boomers want to retire differently. Retirement used to involve ceasing to work and perhaps moving away. Boomers may want to retire earlier or stay and reduce their role. In addition, when they retire, they may seek another career or activity to keep them engaged.
- Investment alternatives are more confusing. Boomers selling their business are looking for less risk and more diversification. Stocks, bonds, cash and real estate used to be the prime categories for investment. With the difficulties of the markets, particularly since 1999, hedge funds, international investments and private equity, among others, have increasingly been sought as investment vehicles.

- More third parties say they want to buy construction businesses. The mergers and acquisition community is active, and most business owners are inundated with inquiries.
- Tax law effecting ownership transition has changed. Tax rates, estate law, S Corporation, LLC and ESOP rules have all changed, making planning more simple in some cases and more complex in others.

The changes listed above have created new challenges to succession planning. Let's consider them one by one.

Companies Are Larger

It takes more money to buy out the selling stockholders and greater management/leadership capabilities in the next generation to run the business for larger companies. Some of the largest companies have developed a culture around employee ownership. Kiewit and PCL are examples of this with broad employee ownership and a detailed mechanism covering share pricing and who is offered stock. They obviously have made this method work, and are great models for privately held companies that want to remain private.

Two pieces of the puzzle that help make this work are an arguably conservative valuation for stock transactions and the company's ability to develop its people. Conservative valuation puts less strain on the company's balance sheet in a transition, and developing people provides succession in addition to a management team to drive profitability.

Size and success have also attracted more exotic structures such as ESOPs and recapitalizations with the help of private equity. There are numerous ESOPs in the industry. For some companies, ESOPs have become a dominant owner and a culture-changing vehicle for broadly held ownership. For others, ESOPs are a competitive buyer for a selling owner and may or may not be a long-term owner. We often see ESOP companies later sold to third parties or bought out by the company.

Private equity for a narrow segment of companies in the industry has provided a lucrative means of transition. Companies with $3 million and up in annual earnings before interest, taxes, depreciation and amortization (EBITDA) may attract this type of capital. However, this type of investor is most interested in companies with a legitimate growth plan, strong successor management, limited bonding needs and high net margins. If you meet these criteria, this may be a viable means to achieve a strong valuation and reasonably quick liquidity, although you likely will be expected to continue with the company and roll over some investment.

Strategic buyers and international firms also have gradually increased their activity in acquiring in the industry. Initial Public Offerings come in cycles, but have generally been a more frequently used strategy with the increasing size of firms.

In short, size has created more options for companies in need of ownership transition while demanding improved management and leadership. We find a large number of contractors have made a lot of money, and there are increased options for them to consider.

People Are Living Longer

This trend, coupled with some owners wanting to retire earlier, has created some interesting dynamics. Since people live longer, company owners are concerned with funding a longer retirement that includes health costs. Some define themselves so closely with the business that they just own the business longer. This can be frustrating for the next generation family or employees who want the reins, but have to wait until later in their careers.

At the other extreme, some may want to retire early or slow down. To maximize their financial security, this owner may ask a greater price for the business or sell stock more slowly as his role is reduced to maintain an income stream.

It is hard to predict how much money one needs to retire, or, more importantly, how much money one wants in retirement. Living to 90, or even 100, is not out of the ordinary today, and added to a longer life, health costs continue to increase. Thinking through the financial and personal issues is important for owners contemplating a transition.

The Industry Is More Complicated

Safety, federal, state and local regulations, construction methods, technology utilization, longer-distant competitors and the changing banking and bonding industry are some of the areas of your life that may be more difficult today. What this means to boomers is that their successors need more time and training to learn what they need to know to operate in today's environment.

In the past, plans may have focused more on the stock sale or transfer issues. Today, people issues are more important than ever. Hiring the right people is essential. Hiring the wrong people causes a double whammy; not only do you not have the right people to succeed you, but also you have lost the development time for as long as it took you to figure out they were the wrong people.

Training and development also becomes more important as there is much to learn to run a company in today's environment, and failure to provide training may also result in losing today's next generation leader.

Management systems, including financial reporting, planning facilitation and communication systems, are an important part of countering complexity. In the past, you may have made decisions based on your experience with little consultation with others. If successors are to take over decision making, management systems can provide a framework for their learning about the business, your teaching them about your decision making, as well as an opportunity to observe their thinking.

Generation X Employees Are Different Than Boomers to Manage

Most have heard extensive discussion of the differences between the "greatest" generation that grew up in the Depression and emerged from World War II to build the modern economy and the boomers that grew up in prosperity and social turmoil. These are generalities, but Generation X, which also grew up in prosperity, as well as Gen Y, seeks more out of work than a paycheck.

Just as the greatest generation was challenged to lead the boomers, the boomers are now challenged to lead the new generations. There are numerous alternatives to construction as a career for the newer generations. It is in the interest of the boomer generation to recruit generations X and Y and keep them.

Our experience is that successful construction firms are doing just this. We see more training and development, and leaders seeking additional education on what leadership is and how to be a good leader. Generation Xers need to be wanted and involved. The challenge to business owners in need of successors is to stay on the offensive to attract the next generations, develop the talent they currently have and hold on to all of them. Firms that get this and work on this are most likely to succeed.

Boomers Want to Retire Differently

We find business owners coming to us younger and younger to discuss transition, and they are often less certain about what they want to do. They often have made a lot of money, but seem to be midcareer and often at the peak of their earnings years. Many see things other than work they want to do, such as spend time with family, pursue other business opportunities and travel, among other things. Others are tired of the cell phones ringing at all hours and the constant demand for attention that modern communication allows. Though they may be "away" and travel more, they really are never "away," because they are always reachable, and their clients and employees know it. They do not necessarily want to retire and stop cold turkey as many of the older generation did, but they want to change the dynamic of their working lives. This could mean taking a lesser role at the company, being more of a chairperson versus a CEO, starting a new venture or becoming a philanthropist. Many who try retirement just do not like it, and some fear it.

Retiring while not retiring is not as easy as it might sound. Paying less attention to a construction business you own can be dangerous. Selling too soon means giving up income and value. Empowering the next generation may put you in its way. Figuring what is next when you make this transition in not easy, and what if you do not like what you try next? The process of going from successful engaged business owner to what is next takes some soul-searching and experimentation. There is not a one-size-fits-all answer.

Investment Alternatives Are More Confusing

Once, conventional wisdom was to put your nest egg in a combination of cash, land and real estate, and stocks and bonds. Two things have happened. First, market volatility has dictated diversification as a central strategy to protecting your nest egg. Second, private ownership of a business usually provides you better returns than your diversified investments.

There has always been market volatility, but three events have hit boomers. The first was the real estate meltdown in the early 1990s. This took down many developers and hurt many with real estate investments. The second event was the bursting of the technology bubble in 1999. The NASDAQ fell by half and the stock market went flat for several years. The third event was the Great Recession of 2008 and 2009 with the financial crisis and resulting reduction of value of virtually all asset classes. These three events sent investors looking for other investment vehicles, not that they were abandoning real estate and the stock market entirely, but they wanted other ways to earn returns that were not correlated to real estate and stocks.

Asset allocation became a prevalent strategy in the 2000s and continues today. Historically, stocks and bonds have earned 9% to 10% per year on average. Some decades are better than others are, but if you look at it over the last 80 years, this is the result. So to put asset allocation simply, investors started looking for other ways to make 10% per year, so if you hit a down year or flat period in stock or real estate, you still showed positive returns. Large investors such as university endowments, pension funds and high-net-worth individuals were the first to go into alternative asset classes in the late 1990s and 2000s. In the last 15 years, investment has greatly expanded in international stocks, hedge funds and private equity. Strategies within each of these vary tremendously, providing a diversity of vehicles to achieve returns at varying correlations. Asset allocation is used by investors to protect them from the downside while they seek the upside.

Some business owners have shunned the asset allocation strategy for two reasons. First, they have achieved better returns in their privately owned business, and second, they understand their business or local investments, such as real estate, better. That strategy makes sense except for one reason — risk, such as your business having a problem or your local real estate market turning upside down.

The further problem in construction is that those two events could be correlated.

FMI's counsel generally is to continue to invest in your own business because that is usually where the best returns are, but to allocate some of your income to diversified investments to protect your nest egg. Alternatively, as one investment counselor worded it, have your get-rich money to seek high returns and the remainder in a diversified portfolio to keep you rich.

The reason private companies outperform most investment vehicles over time is twofold. First, entrepreneurs are driving the business, and there is no substitute for enterprising individuals motivated by ownership. Second, private construction companies are typically valued at three to six times pretax earnings in acquisitions and other valuations. In a low-growth business, three to six times earnings imply a return of 17%-33% pretax return on the value of your investment. Contrast that with the stock market, where price-to-earnings ratios averages are often more than 20 on after-tax earnings. That implies a multiple of about 12 times pretax earnings, or about an 8% return excluding growth. For real estate, capitalization rates are typically in the range of 8% to 10%, meaning investors will pay 10 to 12 times cash flow. If you offered an investor a 17% to 33% return like most industry business owners effectively receive, they would be after it in droves. Indeed, that is exactly what private equity is doing, buying private companies for their investment funds. The difference is that if you own private businesses through a private equity fund, you are paying tremendous fees to fund managers and buying businesses you do not know.

Following this logic, why would anyone want to own anything but a private business? The answer again is risk. Any business can turn upside down for any number of reasons. Hence, diversification makes sense to protect your wealth; but a healthy investment in your own business provides tremendous opportunity to achieve above "market" returns.

The take-away for boomers is to diversify assets outside the business in areas you understand or with a knowledgeable investment advisor, but hold on to your private investment as long as prudent and productive. Prudent, meaning as long as you can limit your liability from personal signatures on bonds and bank lines. Productive, meaning that you are not driving off management that drives future profits by keeping your stock away from them.

More Third Parties Say They Want to Buy Your Business

Most business owners FMI talks to receive regular letters and calls from people who say they want to buy their business. This type of solicitation has increased dramatically in recent years, with the increase in merger and acquisition activity in the industry and the expanding number of private equity firms. It is flattering and sometimes the interest is real. However, much of the time the contacts are from brokers trying to drum up business, or inquiries from people who do not understand your company.

Until recent years, inquiries in the industry were fewer and probably easier to sort out if one cared to investigate. Now it is easy to operate under the assumption that there is a buyer out there when there is not, or to ignore a buyer that may be real.

The difference today is that the odds of a strategic buyer having the wherewithal and interest to purchase your business have gone up, and if you fit a private equity firm's criteria, you may have the opportunity to take significant money off the table while retaining an interest in your business. This changes an owner's thinking. If internal sale is the only option being considered, lining up the next generation or contemplating a shutdown is more front and center in an owner's mind. If a third-party sale is possible, the owner may hesitate to prepare the internal sale option even though it may be needed.

Tax Law Effecting Ownership Transition Has Changed

It may be hard to believe, but tax law has, in many ways, become friendlier to ownership transition in recent decades. The big change was when Ronald Reagan came to office and cut tax rates first in 1981, followed by the 1986 overhaul that substantially cut personal rates. In 1986 the drop in personal rates below corporate rates caused many owners to change their corporations from C Corporations to S Corporations, removing the problem of double taxation. It also led to more companies using the Limited Liability Company (LLC), a pass-through entity for taxes like an S Corporation, for their business structure.

ESOP tax law has also become friendlier over the years as Congress has sought to increase its utilization. One of the most beneficial changes to contractors came in the 1990s when S Corporations were allowed to have an ESOP as an owner.

Tax rates have crept back up to 35% since Reagan left office, but overall, with more firms using S Corporations and LLCs, planning has not necessarily become more complicated. Even if rates go somewhat higher, S Corporations and LLCs should remain popular. If C Corporations and tax rates were to drop as both political parties have discussed, you could see C Corporations for private agencies make a comeback. One area that is more complicated is transfers of stock among family members. There are IRS Chapter 14 rulings that require transfers be done at fair market value, which does add compliance costs to a transfer.

What is a Boomer to Do?

Given all these changes, our advice to the boomer-generation owner contemplating his or her future ownership includes:

- Pay more attention to leadership in your business. Spend more effort understanding and developing your leadership skills. Spend more time hiring the right people to work for your business and more time understanding how Generation X and Y think. Finally, spend more time and invest more money training your next-generation leadership.
- Use your management systems. Know your costs. Have a planning model involving next-generation leadership. Communicate with your team. This is to manage your risk and develop your successors.
- Manage your personal balance sheet and indemnifications. Grow your business, but also grow your balance sheet outside the business. If you need help for investment outside the business, get help.
- Control your exit strategy. Do not be forced to sell when you are not ready. Develop the next generation versus running them off. You need them whether you sell to them or a third party.
- Wrestle with how you want to retire, if you call it that. Do you want a clean break? Do you want to transition slowly? Do you want to go out with your boots on? Is your spouse ready for your retirement? What are your other interests? Is the nonprofit world fulfilling or tedious for you? Put your toe in the water.

Wrestling with the personal transition is probably the least comfortable piece of the puzzle. Do you really want to have more free time to do what you want to do? When you find it, will you like it? Do you have enough in your nest egg to give up your compensation and returns from your business? How much do you want? How will you shift your energies? Succession for a successful business is a good problem to have, but not easy.

Five Steps to Continuing the Business

To do a successful job of arranging for the continuation of a firm after the existing owners are gone, a plan is needed. A five-step process, developed by FMI, plans for the future ownership and management of the firm.

Step 1: Understand the problem

A business continuation problem is easy to ignore. FMI's experience is that about half of industry firms will indicate that they had plans in place to ensure the future continuation of the firm. Further analysis reveals, however, that most of those plans are no more than simple wills leaving everything to spouses or trusts.

Most owners believe that their businesses will last into the second generation. Statistics revealed, however, that only 20% of them will make it.

Several significant obstacles prove to be major impediments to a successful transition if the owner:

- Is unwilling to delegate
- Fears development of younger successor
- Believes one man is better than a team
- Fears lessening of his/her importance both in the company and community
- Fears retirement will drop his/her income and standard of living
- Is reluctant to make decisions regarding family members
- Does not want others to learn the company's true financial position
- Is unaware of, or misinformed about, equity transfer technique

Note that all of these reasons are psychological fears. They reflect the typical producer personality: results-oriented, takes charge, domineering, in control, aggressive — the classic entrepreneur. The producer is a player, not a coach. Consequently, he or she tends to do a poor job of training and developing competent successors.

Step 2: Define objectives and parameters

Address the 10 issues below to build a blueprint for the future. Document your ideal outcome in each area.

1. Business continuation. Should the business continue, be sold or liquidated?
2. President. Who is the heir apparent? When will it be determined?
3. Stock ownership. Will stock be owned by family, non-family, employees or non-employees?
4. Treatment of children. Will any get stock? Will there be equal bequests via a will?
5. Voting control. Who should have it? Should it be one person or a group? When should control change?
6. Financial objectives. What are your objectives in retirement and for your family in the event of your death?
7. Buy-sell agreement. Will it be a death buyout with family involvement or a lifetime buyout? What are the price and terms?
8. Indemnification. Will you sign personally? Will you sign after selling stock?
9. Retirement. When will you retire and to what extent? What role do you want to play in the company?
10. Contingency plan. What plans do you have in the event of death or disability?

Now that you have answered the questions, "What, when and who," the next step is to implement your vision.

Select one outside advisor who has the assigned mission of implementing your plan. Resist the temptation to get information from numerous outside sources yourself. You will only find yourself creating and becoming the victim of confusion.

Step 3: Determine the firm's value

The controlling question in the valuation of a firm is "Who's asking?" Is it the IRS? A third-party buyer? The employees? In the context of business continuity planning, all of these may be viable interested parties, but the value will be different to each of them.

A detailed treatise on corporate valuation is beyond the scope of this article. However, a few key points should be made:

- The value of the firm will ultimately be such that a buyer paying that price would be able to earn, via the after-tax profits, a reasonable return on investment (15% to 20%).
- Book value or adjusted book value may or may not be a reasonable value for the firm. It depends on the profit levels.
- In selling stock to employees, the abstract value is much less important than the ability of the employees to pay.

Before going any further in the planning process, determine a reasonable, defensible value for the business.

Step 4: Initiate appropriate compensation/retention techniques

Sometimes the decision is made to keep the stock in the family or to sell only to a small group of people. If a key employee cannot be a stockholder, what compensation techniques can you use to retain this employee?

There are several ways to assist key employees in their efforts to accumulate long-term wealth without making them stockholders: deferred compensation, phantom stock, off-balance-sheet partnerships, profit sharing/pension plans and incentive bonuses.

The key characteristic of each of the techniques is the ability to reward those employees who remain with the firm.

Step 5: Institute proper equity transfer techniques

To put it in simplest terms, there are only three options for getting rid of shares of stock that you own:

1. Liquidate. Sell everything that is salable and take the money.
2. Give it away. A common occurrence is to give the company away to family members. This option has its advantages and disadvantages and should be investigated very carefully.
3. Sell. This option is exercised most frequently. You can sell to an outside third party or sell to family members or key employees.

An out-and-out sale to a third-party buyer can be structured to allow you to remain in a management position for a period of years, give you a healthy income during that time and provide a strong future for your company by allowing you to train your successor.

There are a number of ways to structure a buyout and keep your management team intact. It does not have to threaten the careers of any valuable personnel. In fact, it may offer new opportunities and an expanded future because of the new financial commitment to success.

Selling to a third party may sometimes be the best alternative even if you have children who wish to remain in the business.

Many producers, however, choose to sell their companies to sons, daughters or key employees. They are interested in accomplishing their own financial objectives, family objectives and corporate objectives, not forgetting to throw in a concern with tax consequences.

In trying to meet these demands, experts have applied a lot of creativity to tax law and laws governing stock ownership. There are now quite a number of approaches that can be used to sell stock:

- ESOP
- Stock bonus
- Stock redemption
  - Leveraged buyout

- Parent subsidiary
- Be acquired
- Buy-sell freeze
- Direct sale
  - Restricted stock
  - Installment payments
- Stock options
  - Incentive
  - Non-qualified
- Recapitalization
- Permanent joint venture
- Spinoff/split-off/split-up

Making it work

If you can envision what the future should be for yourself, your children, the key people in your business and the company into which you have poured so much of yourself, there are techniques that will allow you to meet your objectives. Insist on answers that will work. Do not accept a lot of reasons why your visions cannot be realized.

Managing Your Speed of Change

The results of FMI's study "Why Contractors Fail" [4] found that a contributing factor to contractor failure was "pushing the rate-of-change speed limit." Exhibit 1 illustrates this concept in a construction company. You may wonder what this has to do with succession planning, especially since the study focused on companies that failed. FMI thinks it has a lot to do with it. When companies implement ownership transition and succession plans, many things are changing, and, in fact, changes are being implemented that affect all parts of the organization. The following list represents just some of the areas companies change through succession plans:

- Who owns and runs the company
- Top-management incentives
- Who markets for the company
- Financial strength of the company
- Who makes hiring and compensation decisions
- Who plans and speaks for the business
- Who makes decisions about opportunities to pursue and how to price them
- Who interacts with the company's financial and professional partners

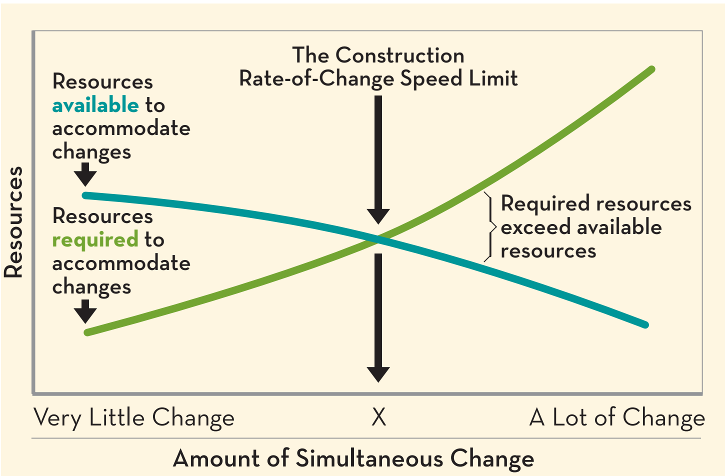
If you consider this list, you will realize change affects most of the organization, and therefore the culture of the organization is likely to change as well. Consider also that change has led to the failure of many seemingly successful large contractors, and it becomes apparent that change is a potential problem that should be managed. Putting into practice a rate-of-change speed limit starts to make sense.

FMI has helped hundreds of companies plan for ownership transition and succession. Most of these plans were implemented at an orderly speed, allowing change to be managed. Part of this is because employees have little money to fund a buyout in a typical transition plan. This dictates a transition period where the selling owner or owners stay involved to ensure the financial wherewithal for their ownership exit. During this transition period,

4 Rice, H., op cit.

the selling owners are participating in decision making, slowing the speed of change. This is one reason internal sales provide many of the most successful transitions in the industry.

Exhibit 6: **Contractor Resource Equilibrium vs. Rate of Change**



Look at the transition as a process rather than a transaction.

A sale that takes a number of years works in favor of the transition being successful. It provides time to:

- Involve successors in business planning and decision making.
- Enable successors to see how you make decisions and run the business.
- Provide further development of successors.
- Enable you to see successors make decisions.
- Allow you to turn over your responsibilities gradually.
- Help clients become comfortable with the changes.
- Change horses if some successor candidates do not work out.
- Stop the transition if it is not working.
- Work with banking and bonding partners on the transition.

Plan early and implement slowly.

- Internal transitions typically take seven to 12 years, so waiting until you want out is too late for staying within the rate-of-change speed limit.
- Implementing slowly helps to maintain a good rate of change.

A slow transition probably means more money for you.

- Valuations of construction firms for an internal transition are typically three to five times earnings. If you sell over time, you will continue to retain some ownership, providing a typical return on investment of 20% to 33%. While selling will reduce your risk, earning a 10% return from a non-entrepreneurial investment is more likely.
- Selling slowly allows you to continue to earn a good return, while easing out of your responsibilities.

Focus on managing your risk as well as your return.

- You are most likely selling because you want to do something else or to reduce your risk.
- In either case, you are probably at a point in life where keeping what you have made is more important than making more. Therefore:
  - Take yourself off the bonding and banking lines as soon as possible, and replace yourself with your new partner(s) on these credit lines.
  - Keep your hand in project selection and pricing to monitor risk.
  - Monitor your successors' business thinking.

Good luck with your transition!

Section 2

Sale Structures

Traditional Sale Structures for Ownership Transition

The appropriate sale structure for a transition is driven by the situation of the sellers and buyers and the nature of the selling entity. A seller might want to retain certain assets, such as real estate or a part of the business. A buyer may have very little capital but be crucial to a successful transition. The business entity could be a C corporation, S corporation or LLC. A number of structures may work to facilitate a transition, but usually after analysis, one will emerge as most appropriate.

Direct Sale

The direct sale is a sale of stock from the owner to the employees. One hurdle for implementing this approach is that the owner must first have employees who are interested in buying stock.

To implement a direct sale, employees normally fund the purchase to the extent they can with their personal net worth and to the degree they can borrow funds. Over time, they may supplement the funding of the purchase with a portion of their compensation and share of profits. Business owners can also accept a note to be paid from the company's earnings over time.

The biggest problem with this technique is that employees typically do not have much money or a large borrowing capacity to make an initial payment. Business owners are understandably reluctant to give up their stock and control without being paid substantially. In addition, surety issues are created by the employees now owning the business; they typically do not have the net worth and experience to satisfy the bonding company without the prior owner's guarantee.

Owners using this technique are likely to have covenants on any notes accepted to provide protection should the employees not perform. They are also likely to remain involved in the business for a transition period to satisfy bonding and banking requirements and to help with management succession issues. The reality is that in selling for a note, the owner retains the risk of the performance of the business; therefore, other techniques discussed are often used.

Subchapter S Buyout

The premise for a Subchapter S ("Sub-S") buyout is that an S corporation pays no tax at the federal level because it is a pass-through entity. The corporation's income is allocated to the corporation's shareholders on a pro rata basis, according to the shares owned. This allocated income is included on the shareholders' individual tax returns. Further, the shareholders' basis in their S corporation stock is what was paid for the stock plus their share of earnings that are retained in the company. This contrasts with a C corporation, where a shareholder's basis is what was paid for the stock or originally invested in the business. Retained earnings do not add to the basis in the stock of a C corporation.

Another flexibility that an S corporation affords is that the company may distribute current income or the accumulated adjustments account (AAA) without affecting its taxation. The AAA represents a shareholder's share of a Sub-S corporation's retained Sub-S earnings. In contrast to the S corporation, when the C corporation distributes earnings, the earnings are taxed as dividends. In the S corporation, retained earnings can be moved in and out of the corporation freely without creating a taxable event.

The procedure typically used in structuring a Sub-S buyout is something like the following:

1. **Distribute excess capital to the owners.** For example, if the company has a $5 million net worth and only $2 million is needed for bonding and operations, $3 million could be distributed to the owners. Distributing retained earnings makes the company smaller, which makes it easier to sell it to the employees.
2. **Allow the employees to buy as much stock as initially feasible.** This may not represent a large amount of money to the sellers, but it puts employees' "skin in the game." Funds may come from employees' savings or proceeds from a home equity loan.
3. **Distribute all or most of the profits as compensation or Sub-S dividends annually.** Net worth will remain fairly level for a period, and most of the earnings will be paid to selling and buying owners as

Sub-S distributions or compensation. If the company is in a growth period, an amount of the profits may be designated to be retained.

4. **Allow the employees to buy additional stock from the current owner, annually, after paying tax on their distributions and compensation.** The selling owners retain their share of distributions and compensation and sell stock to employees. By doing this, most of the earnings have gone to the selling owners by distribution and employees taking their share, paying taxes and then buying stock from the owners.
5. **Repeat the above procedure until the selling owners are bought out.**

In practice, if employees can achieve 20% ownership, then repeating the buyout can achieve a complete buyout in a reasonable period of years. Sub-S buyouts usually take a minimum of five years to complete; they can take 10 years or more, depending on profitability. The key to moving along the transition is the return on equity and a fair valuation.

This technique works well as it aligns the seller's and buyer's interests. It is in the owner's interest to drive profitability, because the higher the profitability, the faster the buyout proceeds and the more money the owner receives. The higher the profitability of the business as the plan unfolds, the sooner the employees will own all of the shares.

Selling 5% to 20% to the employees is typically the maximum that is feasible as a starting point. Therefore, the owner typically still owns 80% to 95% of the company after the initial sale. The typical result is that control does not change hands for several years. This transition period is an excellent time to train employees, give them more responsibility and get them involved in business development and planning, so the selling owners can gradually reduce their activities in the business.

Some other considerations in setting up a Sub-S buyout should be noted:

1. If control is an issue, and it is desirable for selling owners to maintain control beyond when their ownership drops below 50%, a second series of nonvoting or lesser-voting stock can be sold to employees. Alternatively, the selling owners can be issued a series of stock with super voting rights.

2. The Sub-S transaction typically is done with little debt. In this industry, where maintaining a strong balance sheet is important because of volatility and bonding needs, a minimally leveraged transaction makes sense.
3. If growth is anticipated, instead of distributing all of the earnings, some earnings can be retained to fund additional working capital or to expand bonding capacity. This may slow the transition, but it protects the business.

One final point to cover on the Sub-S buyout is the selection of a valuation method for the buyout. The example discussed above used book value (or net worth per the business's financial statement) as the valuation methodology. More often than not, companies use book value in their buy/sell or shareholders' agreements. A third-party valuation or other valuation metrics can also be used. However, if the valuation is too aggressive, it can be self-defeating to a successful transition. If a transition is modeled based on profitability and the balance sheet required, and it takes 15 to 20 years to complete, the employees are not going to buy into it. The valuation should be such that the transition will take place in a reasonable time frame, such as five to 10 years. Further, it should be sustainable such that when the next-generation employees retire, the plan will work again using the same valuation methodology. Having a conservative valuation to begin with will increase the odds of the plan succeeding.

Selling owners also are encouraged to consider not just the value received for their stock, but also the proceeds from the distributions and compensation as well as the AAA distribution prior to sale. If all these proceeds are added together, the total often compares favorably to a third-party sale.

The Sub-S buyout is a flexible technique and requires minimal legal agreements. A buy/sell or shareholders' agreement is required. Most companies with multiple shareholders already have these agreements. Beyond that, legal agreements are not required. FMI recommends that the selling and buying shareholders agree to a plan defining objectives, procedures and models describing the buyout. The following examples explain why binding legal agreements are not recommended. The first assumes that there was a legally binding agreement for employees to buy stock and, after a year or two, employees say, “I don’t want to do this anymore; it’s not working for me. I don’t want to be an owner.” In this case, it does little good to have them legally bound, because if they do not want to own it, they are not likely to be effective at running the business. An alternative assumption is that, two years after starting the transition, the owner feels these employees are not stepping up, they are not turning out to be good owners, and the owner does not think they can be successful. The selling business owner needs the option to say, “Wait a second; this is not working,” and slow or stop the process.

Recapitalization

Recapitalizations sometimes are used with C corporations. Unlike S corporations, C corporations pay tax on their income at the corporate level, and dividends to shareholders are taxable. In this technique, the stock of the company is “recapitalized” into two classes of stock. Class A is typically a preferred stock that receives a fixed return on investment. Class A stock will be owned by the selling owners. Class B stock is typically common stock that receives the earnings after Class A gets its fixed return. In essence, the return is being fixed for the selling shareholders, providing them a fair return for their equity. Then, assuming the company is profitable and creates increasing earnings beyond the Class A allocation, the common stock is allocated a significant amount of earnings. This enables the buying employees to build up equity and drive the growth of the business. After the value of the Class B common stock builds to where the company can function without the equity in the Class A stock, the selling owners can redeem their Class A stock for cash.

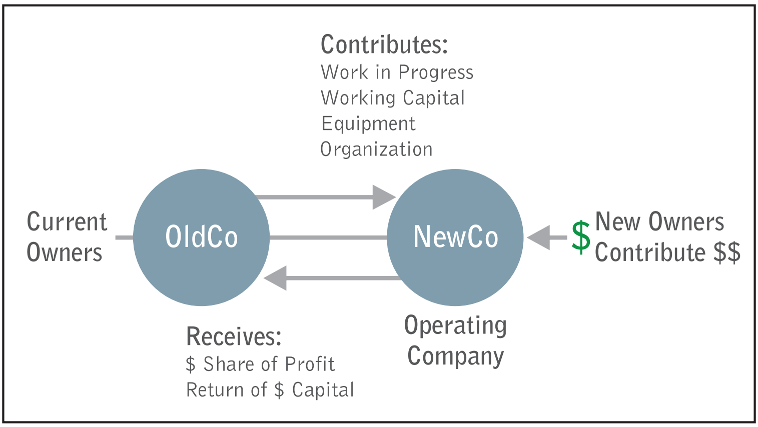
From a technical standpoint, there are no immediate tax consequences for recapitalizing the business to provide for two classes of stock. This technique is used only occasionally, as the C corporation has been in less favor in the last 25 years due to the Tax Act of 1986, which lowered personal tax rates below corporate tax rates.

Oldco/Newco Strategies

In conventional strategies, the stock of the existing company is sold to the next generation. In Oldco/Newco strategies, the next generation of employees forms a new company (Newco) and the selling generation retains the old company (Oldco).

As shown in Exhibit 7, the new owners will set up Newco and contribute what money they can. Again, as with the Sub-S buyout, this is limited to what they have saved or can generate from a home equity or other type of loan. Oldco will also be an investor in Newco, but instead of contributing cash, it contributes work in progress, including contracts and working capital, such as receivables and payables and equipment. Then all or most of the organization moves to Newco as well.

Exhibit 7: Oldco/Newco LLC



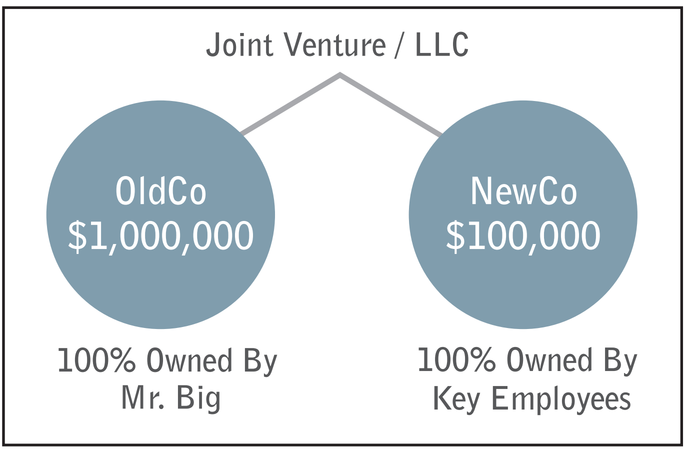
Newco typically is set up as a Limited Liability Company (LLC). The operating agreement defines the profit split between Oldco and Newco. Profits are usually split according to the value of the contributions of Oldco and the Newco investors, but can be slanted to the new owners in recognition of their "sweat equity" if desired. In practice, LLCs allow flexibility when determining how profits are divided between parties.

As Newco goes forward and makes money, the new owners in Newco accumulate earnings to increase the company's net worth. Generally, distributions are made to the Newco shareholders only in order to pay their taxes. Oldco will receive distributions of its share of the earnings and return of capital. After a period, Newco accumulates sufficient capital so that Oldco's support is no longer needed.

The advantage of this technique is that the selling shareholders can retain any nonoperating assets in Oldco. For example, the business's office building might be owned in Oldco, and there is no need to sell that to the employees, because that would only make the transaction larger. Alternatively, perhaps there is another business in the Oldco that the selling shareholders want to retain and the employees do not need to buy. The selling shareholders can also defer taxation on the sale or liquidation of Oldco because Oldco is still active.

Another potential advantage relates to family situations. When family members sell stock to other family members, Internal Revenue Service (IRS) rules require the price to be "fair market value," or the stock may be deemed a gift. In the Oldco/Newco structure, new shareholders are not purchasing shares, so valuation risks are lessened.

Exhibit 8: Permanent Joint Venture



Oldco and Newco can continue their relationship indefinitely, but typically, the relationship will end once Newco has a sufficiently strong balance sheet with adequate working capital to operate and bond its work. In essence, the Oldco/Newco structure is a method to increase the profit participation of the employee group, without selling any stock of the existing company or major investment by the employees. This technique is used frequently and works very well in the construction industry. Because it has many characteristics of a joint venture, accountants and tax lawyers serving the industry are familiar with the accounting and legal aspects of operating this structure.

A variation on the Oldco/Newco technique is the Brother/Sister structure. With the Brother/Sister approach, the employees capitalize a new company, Newco. Instead of Oldco investing in Newco, or Oldco and Newco entering into a joint venture agreement, there are separate agreements where Oldco may lease or rent fixed assets to Newco, or Oldco may lend money or capital to Newco. Oldco might provide loan guarantees or bonding for Newco. Oldco and Newco could also joint venture on select jobs. Oldco might keep certain accounting functions and may provide those services to Newco. Oldco may also retain some employees. This is an arms-length relationship where Oldco is just assisting Newco in getting started, but not investing in Newco. The disadvantage of this technique for the selling shareholders is that they are giving up the upside, but they still have the risk of Newco's performance and ability to generate sufficient profits in order to pay the owners of Oldco for their services.

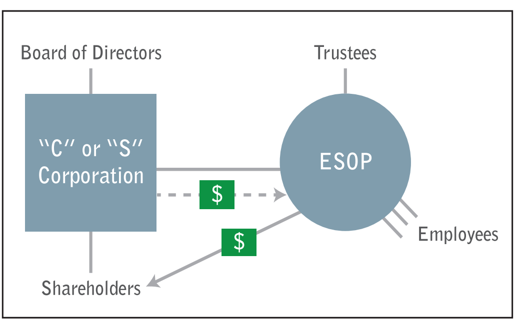
EMPLOYEE STOCK OWNERSHIP PLAN (ESOPS)

An ESOP is a qualified retirement plan that invests in the company that sets it up. It is regulated by the Employee Retirement Income Security Act (ERISA) of 1974, as are other retirement plans such as 401(k) or profit-sharing plans. ESOPs are generally set up for the benefit of all nonunion employees; in some cases, union employees may participate. ESOPs may not discriminate as to which employees may participate in the ESOP and are subject to a vesting schedule. Employers contribute to the ESOP for the benefit of employees, prorated to the employees' compensation up to a maximum set by the IRS.

The company may contribute up to 25% of eligible payroll to the ESOP annually. Usually contributions are not this high, as this reduces the profitability of the business. Contributions sometimes are made in lieu of a 401(k) and sometimes as a complement to a 401(k) or profit-sharing plan.

Exhibit 9 illustrates the ESOP structure. The board appoints a managing trustee for the ESOP. The company can be a C corporation or S corporation. The ESOP will often borrow money guaranteed by the corporation to purchase the selling owners' stock, or sometimes accumulate contributions to purchase stock later. The corporation will typically make annual contributions to the ESOP. The ESOP uses the contributions to pay down ESOP debt or to purchase stock from selling shareholders. If the ESOP borrows money to purchase the stock, the debt goes on the company balance sheet as a liability, which affects the bonding capability of the company.

Exhibit 9: ESOP Structure



An ESOP company often starts by purchasing 30% to 50% of the company and may later become a 100% ESOP. The advantage of starting at less than a 100% ESOP is that less debt is needed initially, which helps with bonding capacity and generally puts less leverage on the firm. If the company is an S corporation, using an ESOP can be a very powerful technique for generating capital. As an S corporation, the company does not pay taxes, and since the S corporation is owned by a retirement plan (ESOP), it does not pay taxes when the income is earned. Taxes typically will be paid many years later, after employees retire or are terminated by the company, roll over the proceeds into a personal IRA, and then make distributions from the IRA in retirement. With combined federal and state taxes likely to be in the 40% to 50% range, this means there will be close to twice the capital in the near term to fund the buyout.

A primary issue affecting the success of an ESOP is nonfinancial. Engineering and construction businesses are usually owned and driven by entrepreneurial leadership. FMI's observation is that contractors seem to function best when there is an active owner who is making the business decisions and setting the direction for the business. Since ESOPs may not discriminate among employees, a company with many employees may have ownership dispersed such that no employee owns more than a small percentage of the company. In this case, the question arises, who is the entrepreneur driving the business? Who makes the decisions for the business, and who signs the bonds? FMI's experience is that ESOP companies follow the vesting schedule minimum guidelines provided by ERISA, as shown in Exhibit 10. The vesting schedules will tend to work in favor of longer-term employees. In the first schedule illustrated, employees do not vest until after two years, and then they vest over the next five years. Employee vesting schedules must be at least as aggressive as shown.

Exhibit 10: ESOP Vesting Schedules

	% Vested		% Vested
Year 1	0		0
Year 2	0		0
Year 3	20		0
Year 4	40	OR	40
Year 5	60		100
Year 6	80		
Year 7	100		

Alternatively, the plan can be set up to have employees not vested until the fourth year, and then they can step up from 40% to 100% in years four and five. The effect of these schedules is that if the business has high turnover, as is often the case in construction, the ownership will tend to concentrate in the hands of longer-term employees.

Exhibit 11 lists advantages and disadvantages for construction industry ESOPs. In summary, the ESOP is a technique that is used a fair amount in the industry, and many companies like it, but many companies buy it out or sell to a third party. The ESOP is usually the most tax-efficient way to sell stock from one generation to the next. However, if the business owner is going to use an ESOP, he or she should understand the issues and complexities that surround the ESOP.

Exhibit 11: Advantages and Disadvantages of Construction Industry ESOPs

Advantages:

To the selling stockholders, an ESOP:

- Creates an "internal market" to sell stock
- Allows seller to defer capital gains if the ESOP purchases more than 30% of outstanding stock in a C corporation
- Allows federal income tax to be deferred, increasing capital available to purchase stock, pay ESOP debt or grow the company, in an S corporation
- Lets non-ESOP shareholders continue to control the company
- Allows stockholders to diversify personal assets

To the company, an ESOP:

- Can be a positive incentive for employees
- Can increase capital available to the company

To the employee, an ESOP:

- Can build a retirement asset
- Provides ownership incentive
- Defers dividend taxation for stock held by the ESOP until retirement

Disadvantages:

- Retirement funds are being invested in one construction company.
- There is repurchase liability for shares owned by ESOP.
- Downsizing can cause repurchases.
- For bonding, ESOP debt is treated as a liability of the corporation.
- Stock must be valued annually by a third party.
- ESOP trustees have fiduciary liability.
- There are many stockholders with minority rights.
- DOL and IRS reporting is required.

FMI expects the percentage of companies using the ESOP to remain about the same or perhaps increase as industry participants get larger. It is a tax-efficient technique; however, the complexities make it less desirable for smaller companies. It also does not meet the objectives for owners who want their companies to remain owned by family members.

THE SECOND-GENERATION ESOP

Numerous construction industry firms have used an Employee Stock Ownership Plan (ESOP) to facilitate the purchase of the founders' and other shareholders' stock in their company. ESOPs offer the most tax-efficient technique for a company's owners to sell their stock while also providing an incentive to the company's employees.

While implementing an ESOP is a significant change to the ownership culture of a contractor, the effect of the change often is not felt until the selling owners have left the company and the debt used to fund the transaction is retired. This is because while the owners may have sold all or much of their stock, they typically remain with the company during the transition and still act as the "owner." The ownership culture change is strongest when the original "controlling" owners turn over executive leadership to the next generation management team. This transition typically occurs many years after the original ESOP transaction and is what FMI calls the "second-generation ESOP." After an ESOP is installed, the actual "voting control" is held by the board and the ESOP appointed by the board.

The challenge for the second-generation ESOP is to maintain the business focus that an owner with a controlling ownership position provides. In FMI's experience, contractors are most successful when there is an "owner-like" incentive provided to the leadership group responsible for making decisions about the business opportunities and risks. Our observation is that most successful construction firms depend on a few key leaders to drive their strategy. In most cases, these leaders are the owners of the business; however, occasionally they are key employees who do not have an ownership stake. This leadership group makes decisions, such as what markets to pursue, how to price the company's services, whether to make acquisitions, how to respond to a downturn and how to respond to growth opportunities. The culture of the organization is defined by the way in which it collectively makes these decisions and how it interacts with the market and its employees. The loss of a leadership group can cause a company to flounder, and, conversely, assemblage of the right leadership group can cause the company to prosper.

Ownership is the simplest "owner-like" incentive. It provides a wealth-building opportunity, a direct correlation between the success of the business and individual reward and the risk that the value of the company can be lost. Personal guarantees for bonds and/or bank loans provide further incentive to manage risk effectively. Ownership also provides status in the organization, market and community. Our observation is that private companies working under this ownership model often outperform and outlast public firms in the industry.

In a company with a second generation ESOP, ownership opportunity generally is divided among all nonunion employees according to their pro rata share of compensation (subject to a maximum threshold and vesting schedules). Unless the company has relatively few employees, high turnover or the management team has direct ownership in the company outside the ESOP, the management team will have a relatively small amount of ownership in comparison to a more typical private firm that does not have an ESOP.

While many second-generation ESOPs flourish, many also struggle. We therefore recommend that ESOP companies have a conscious "ownership strategy" to provide control-owner-like focus for the management team. To lay the groundwork for this, let us review the objectives and strategies for the stakeholders in our second-generation ESOP company including the company itself, the employees, the board of directors, the management team and the ESOP trustee. The following is a listing of the stakeholders, their objectives and strategies the company might pursue in order to help them obtain success.

The Company

Objective: Maintain a strong balance sheet with adequate working capital to fund operations and provide bonding capacity so that the company can generate profits and grow.

- Strategy – Retain earnings to provide strong balance sheet.

The Employees

Objective: Receive a fair wage for productive activity.

- Strategy – Provide competitive compensation and benefits to employees.
- Strategy – Provide education and training for employee safety and development.

The Shareholders

Objective: Receive a return on investment and have a market for their stock.

- Strategy – Appoint a board and management team to manage the company to make a profit to provide funding for growth and redemptions.

Company Leadership

Objective 1: Provide entrepreneurial leadership.

- Strategy – Provide performance-based incentives to attract, retain and incentivize the management team continually to increase the value of the firm.
- Strategy – Provide a process to develop and select the leadership on an ongoing basis

Objective 2: Enable future leaders to become shareholders and increase their ownership.

- Strategy – Fund the ESOP to enable newer employees to increase participation.
- Strategy – Allow for the leadership incentive plan to add new leaders.

Financial Priorities to Support Stakeholder Objectives

To achieve the objectives of the stakeholders, we define the priorities for the company's financial resources based on the premise that:

1. The company must thrive in order for the stakeholders to meet their objectives.
2. The management team must be incented to provide "owner-like" leadership for the company to succeed in the long term.
3. The shareholders should be rewarded for success.

We define the priorities as follows:

Enable ongoing operations

- Offer competitive employee base compensation
- Retain earnings to build equity

Incent Management Team

- “Owner-like” compensation based on performance
- Ownership through an ESOP

Reward Shareholders

- Distributions and retained earnings for existing owners
- ESOP contributions for current employees/future owners

FMI’s Recommendation for Second-Generation Ownership Strategy

Based on the stakeholder’s objectives and the financial priorities discussed above, we propose the following as an ownership strategy template for the second-generation ESOP:

Earnings Retention Policy – In order to provide capital to fund growth, we suggest:

- Retain earnings, if positive, in an amount that would allow the book value of the company to grow by a defined percentage each year. The percentage to be retained would be predetermined by the board and management team.

Risk Underwriting Compensation – In order to compensate the principals fairly for the risk associated with signing indemnity bonds, the company will:

- Compensate the guarantors for underwriting the risk, if the surety requires personal guarantees from the management team for bonding purposes.

Management Team Incentive Plan – The management team should receive an incentive bonus based on the profits earned by the company. The incentive bonus could be based on some threshold return on equity (ROE) for the company and could be determined as follows:

- Annually, the board should determine who will participate in the management team bonus, the minimum ROE and pursuant pool funding, how the bonus should be allocated among team members, and if there are to be any changes to the management team incentive plan.

- The company might also consider a stock-appreciation-type bonus for the management team to incent longer-term behaviors to create additional value.

Once Earnings Retention Goal Is Met (Distribution/Retention Policy) – Annually, the management team will make a recommendation to the board for its approval regarding the following three items:

1. The amount of contribution to be made to the ESOP by the company
2. Additional earnings to be retained by the company
3. Earnings to be distributed by the company to the ESOP

Considerations include:

- Employee participation in the ESOP
- Funding for the future repurchase liability
- Funding for growth
- Funding for potential acquisitions
- Diversification of ESOP participants' holdings in alternative investments

Other Issues to Address in the Ownership Strategy Management Succession

One of the jobs of a management team is to replace its members as they retire. This is often difficult for management, as its success is based on the ability to run the business on a day-to-day basis, not necessarily on the ability to train successors. History shows that many contractors do not survive to the second and third generations of leadership, which is particularly true for many companies with ESOPs. Those that do survive are somehow able to pass the baton of leadership to successive generations of leadership. This transfer is accomplished best through the deliberate efforts of management.

As discussed, it takes a thoughtful effort to develop the next generation, which goes beyond what is required simply to manage the business for near-term profit.

Actions that may be taken to develop leaders, while not affecting the daily operations of the business, include:

1. Attending internal and external educational and training programs
2. Participating in industry associations and local civic organizations
3. Participating in peer groups
4. Conducting one-on-one sessions with executive team members
5. Having structured appraisal systems
6. Participating in business or strategic planning
7. Being exposed to financial performance information
8. Changing jobs within the organization

Organizations that are able to generate new leaders are the ones that are most likely to survive to successive generations and prosper. Again, many of the activities listed above may not impact the organization today; however, using a more formal business and/or strategic planning process, for example, may provide a forum for the next generation to learn about the business and owner's decision making, while also providing an opportunity for the executive team to observe the thought processes of potential successors.

Repurchase Obligation

The IRS requires nonpublic, ESOP-owned companies to have an independent annual valuation performed and to make a market for participants' stock. Additionally, participants who turn 55 years old with 10 years of participation in the ESOP have the right to request that the ESOP diversify a portion of the company stock allocated to their accounts. The obligation to honor the buyback and to provide cash to the ESOP when participants exercise diversification rights is collectively referred to as the repurchase obligation.

The timing and magnitude of the company's repurchase obligation depends upon the provisions in the ESOP plan document, the demographics of its employee population and the value of its stock. The prospects of the company are a wild card in this equation. With a downturn, layoffs and ensuing redemption obligations create an unplanned drain on the balance sheet. The timing and form of distributions from the plan and the vesting schedule have the greatest impact on the repurchase obligation.

The primary demographic characteristics that affect the repurchase obligation are age distribution and turnover. A lumpy age distribution will create spikes in distributions as those employees reach retirement. Likewise, if the workforce tends to turn over quickly or the company goes through a downsizing, repurchases will be accelerated.

The company's ownership strategy needs to incorporate the repurchase obligations into its thinking. Actuarial projections can be very helpful in putting together a plan that supports financial strength.

Conclusion

For the private company without an ESOP, the ownership strategy is usually self-evident; the owners make the rules. For the second-generation ESOP, the ownership strategy is not self-evident. It can range from democratic employee rule to a trustee-dictated strategy.

The following are some questions for annual review that we recommend for the ESOP company board, trustee and management team:

Management Team

- Who will comprise the company's management team?
- How will the company incentivize its management team?
- What do we, as trustees, need oversight of?

Earnings allocation – How much of the company's earnings should the company:

- Contribute to the ESOP?
- Retain in the company?
- Distribute to the ESOP?

ESOP

- How will the ESOP meet its repurchase liability?
- What is the appropriate amount of annual ESOP and other benefits to be provided to employees?
- Should the ESOP diversify its holdings beyond those required by law?
- Should the ESOP entertain offers for the company from third parties?

The Company

- How does the company achieve profitable growth and increase shareholder value?

FMI recommends that the trustees and board define an ownership strategy that makes sense for its company. Such a strategy should support company growth and include a level of risk management appropriate for the construction industry.

Third-Party Sale, Private Equity and Public Options

There are three options for a sale not involving employees or family members: (1) sale to a third party, (2) recapitalization with a private equity partner, or (3) reorganizing to become a publicly traded company. Each option is very different with its own nuances.

Sale to a Third Party

Many construction industry owners assume they can sell their companies when they are ready. The reality is that only about 10% of companies sell to a third party, with about 60% of companies sold or transferred internally to employees or family. The remaining 30%, particularly small companies, liquidate. Therefore, the first question a business owner who wants to sell should ask is if a third-party sale is feasible for his/her company.

Alternatively, if the owners are not ready to sell, what will a third-party buyer look for in the owner's business, and how can the owner position the business for a third-party sale?

Fundamentals of the Construction Industry

Before addressing what makes a business salable and how it might be positioned in the market, some of the fundamentals of the construction industry that affect the marketability of industry firms will be reviewed.

First, the construction industry is fragmented; across the country and internationally, there are tens, if not hundreds, of thousands of construction businesses. Despite numerous consolidation efforts, the industry has remained disjointed. One reason for that fragmentation is that most construction markets are local. There are some consolidators, like EMCOR and Comfort Systems, which have built national businesses; but one could argue that even those businesses are made up of numerous local businesses, having local managers with local relationships in their markets.

Another reason the industry remains fragmented is that there are limited economies of scale in the construction industry. There may be buying advantages for the larger player, but larger companies often lose their entrepreneurial emphasis. There is nothing quite as focused as an owner in a local market making things happen versus a large corporation with a division manager in a particular market. Often the local company is found to out-compete the national company. Suppliers will also often support local companies so they do not cede control of the market to larger companies, and often margins are better for the suppliers from the smaller companies.

The second fundamental of construction is that market opportunities come in waves. Currently, a wave of construction is going on in the energy space in infrastructure for oil and gas production from hydraulic fracturing alternatives and upgrades to the grid. In the 2000s, there was a wave of residential construction. That wave washed ashore in 2007/2008. In the 1980s, there was a wave of commercial construction of office buildings built to support growth and incentivized by then-liberal depreciation schedules. In the last 50 years, numerous waves in the economy have affected the construction markets. As each wave moves through the economy, it creates threats and opportunities for growth. Successful companies will move from wave to wave at strategic times.

The third fundamental of construction is that construction firms often struggle during downturns. When times are good, businesses become more selective in their pricing and margins go up. When times are bad, businesses try to maintain backlog and keep employees busy so margins go down. Some companies may bid at or below cost and get away with that for a while. Inevitably, unanticipated events take down some in the industry. Banks and sureties tighten their lending and bonding criteria during downturns. Together, all these trends exacerbate the cycle and put the weaker contractors in jeopardy.

These fundamentals, fragmentation, market waves and the susceptibility to downturns all affect the feasibility of a sale and the price a buyer is likely to pay when acquiring a business. Industry fragmentation means that there are many companies a buyer could purchase, and many of them will have continuity problems or other reasons to be motivated sellers. Why should a buyer particularly want a specific company? Market waves signal to the savvy buyer that the market might be very different in five years. The buyer of a construction business should therefore look for a business that has a sound organization and a history of finding new opportunities as the market changes. If a construction firm struggles in the downturns, seasoned buyers will factor inevitable downturns into their decision and valuation of the firm. Construction is a slowgrowth business subject to economic cycles. Taken together, these fundamentals lead to conservative valuations relative to many other industries.

What Drives Value and Salability in the Construction Industry?

What do buyers look for in an acquisition and what drives value? First, all buyers are looking for profitability — a return on the investment they might make. Therefore, when analyzing a potential acquisition, they like to see a history of profitability or a good story as to how the business will make money going forward. They want to understand any volatility in earnings history as well as opportunities for recurring revenue from service or other means.

Second, a third-party buyer will want to see a good organization with a management succession plan in place. Dr. Emol A. Fails, the founder of FMI, preached that a construction company is a group of people who know how to get work, do work and get paid for the work they do. The key is the people that make the business work. Take the people out of an HVAC company and what do you have? Take the top-three, -four or -five people who drive the business out of the business, then what do you have? The answer to both of these questions is, not much. Therefore, the first key to making a company salable is to have a strong organization of good people drive the business for its new owners. Many businesses are very successful, but if the main driver of the business is the owner who wants to sell and leave the business, buyers beware.

Third, the business needs momentum. There needs to be a backlog and an asset base to sustain the business. The business must have good prospects for success going forward.

Fourth, the business owner needs a workable valuation expectation. A construction company is usually worth more to the owner than it is to anyone else. The reason for this is that owners understand their company better than anyone does; they understand the risks and they live and breathe the company every day. However, both buyers and sellers must realize that sales to a third party often hurt the value of the company, just by the fact that ownership changes hands. This is because the company, under a new owner, will likely experience change in management if the seller exits the business, and the buyer generally brings some change and uncertainty in a transition. In the end, these changes may be healthy, but in the short term, change can be distracting.

The Realities of Buying and Selling Contractors

In FMI's experience, there are a few realities that govern the buying and selling of contractors. First, relatively few transactions are completed each year. As previously discussed, 10% or fewer construction industry firms change hands through merger or acquisition. Second, contractors tend to be bought by other contractors; occasionally, private equity or investors will buy a contractor. About 10 years ago, electric utilities went on a buying spree for construction firms, but they have largely exited the market. Most buyers of contractors are other larger contractors seeking to expand geographically or into a new market or service. Third, people and organizations are the most important assets to a buyer. Equipment and backlog can be purchased, but it takes a strong organization to make money and grow a business. Finally, the reality is that deals need motivated buyers and sellers in order to be completed successfully. As previously discussed, valuations tend to be conservative in this industry except for the occasional consolidator, financial buyer or unique strategic circumstance. Because of this, the reason most owners sell businesses is that they want to retire, stop working or reduce their risk. There are occasional exceptions to this where a consolidator or other motivated buyer is paying exceptional prices.

Private Equity

A subset of a sale to a third party is a recapitalization by a private equity investor. A private-equity firm raises money to invest in private companies. The money typically comes from high net-worth individuals, pensions, foundations and other sophisticated investors seeking alternatives to traditional stock and bond investments. Private equity investors will typically own a business for three to seven years. Their usual strategy is to recapitalize a company with the management team retaining a stake and the private equity firm holding a portion as well. Debt often is used to leverage the transaction. The private equity firm then wants to see the management team grow the earnings and perhaps grow the business through acquisition. Eventually, the private equity firm is likely to sell the business to a strategic buyer or another private equity firm or perhaps prepare it for an Initial Public Offering (IPO).

Most private equity firms focus on manufacturing and distribution businesses, but there has been some investment in the construction industry. An example in the mechanical space is Limbach which has private equity investors. Most private equity firms are looking for companies that have a minimum pretax profitability of $5 million per year, although some private equity firms will look at annual pretax earnings as low as $2 million.

The advantage of private equity is that, for a business with the right characteristics, it creates an alternative buyer to the strategic buyer or internal sale. Private equity investors are very flexible on how to structure deals; however, maintaining the management team to run the business with some level of continued ownership is a requirement of most private equity investors.

The biggest complication with potential private equity transactions is finding private equity firms that are interested in the construction industry. A typical private equity firm looks at hundreds of deals a year and makes only a few.

Private equity firms often use debt in transactions to leverage their returns. Debt can create problems for a cyclical business or a business requiring bonding. Without debt to leverage the transaction, private equity valuations will be more conservative.

Going Public

Another alternative in the sale is to become a publicly traded company. There are two ways to become public. First and better known is to make an initial public offerings (IPO); this is the approach taken by Comfort Systems and the predecessor to EMCOR. In today's world, a construction company would ideally have $1 billion of revenue or more to go public, though it might be done with less. Generally, IPOs are going to work best for larger diversified firms with strong "public friendly" management teams.

The key to going public is to have a growth story and a solid management team. Investors in public companies make money by increasing earnings or expanding the valuation multiple. Therefore, the investment bank underwriting the IPO and the investors buying the stock are looking for the growth plan. A good construction company with a record of accomplishment of making money, but not showing growth, may be a good moneymaker for its owners, but it is not a good candidate for going public.

The company will also need a CEO and CFO who can be the public face of the company to analysts and to investors. This may not be the same CEO and CFO who are successful in a private company. The public CEO is likely spending a lot of time at investor conferences and presenting to analysts. The CFO will have to deal with the nuances of Securities and Exchange Commission (SEC) regulations.

Another way to go public is to merge with a Special Purpose Acquisition Company (SPAC). A SPAC is a public company that is created by an investor group to acquire a business. Initially, the company will have cash on its balance sheet, but after being established will acquire or merge with a private business to make it public. The company may then grow organically or through acquisition. Primoris is an example of a company that has done this successfully in the industry.

Evolving Capital Structures in the Construction Industry

The success of numerous industry firms, along with changes in the capital markets, has created new capital structuring opportunities for owners. Traditionally, family and employee ownership has dominated the industry and ESOPs are used by many. However, alternative structures, including private equity, public company ownership via Blank Check and Special Purpose Acquisition Companies and Initial Public Offerings, are becoming more common.

Changes in the capital markets over the last 20 years have driven private equity interest and new public company alternatives. In the 1980s and 1990s, wealth soared internationally and in the U.S., driven in large part by extraordinary returns in the stock market. Around this time, the individuals, pension funds, endowments and other owners of this wealth sought to protect and expand their wealth by finding creative ways to diversify their investments. Investment strategy evolved from holding a portfolio of stocks, bonds and real estate to an asset allocation strategy where investors seek a greater variety of asset classes in which to invest. The purpose is twofold: first, to gain returns in an alternative investment and second, to reduce risk by owning a number of assets whose return is not correlated.

These new asset classes generally required more management and therefore worked better with larger investments. Universities such as Harvard and Yale and high-net-worth individuals were early to emphasize these alternatives. These early-market entrants encountered inefficient markets and generated substantial returns. As private equity funds have evolved however, they have attracted increased investment. Today, with more and smaller investors allocating a significant portion of their investments to these "alternative" classes of assets, there is significant money under management looking for something to do.

Private Equity Funds

Private equity funds, as their name implies, invest in private companies.

They gather funds from high net-worth individuals, endowments, pensions and others with money to manage and invest in private companies. They may buy all of a company or, more likely, part of a company, leaving a significant portion with key management. For diversification, private equity firms will invest in a number of companies. The general strategy is to help management improve the value of the company by increasing earnings. Eventually most will sell the companies they invest in to realize a gain, though some have more of a "buy-and-hold" philosophy.

When private equity started, fund managers were selective about the types of companies in which they invested and were relatively conservative in valuation. As private equity has matured as an investment class, the dollars allocated to it have increased, creating the need for more investment opportunities and more aggressive valuations.

Initially, private equity made few investments in the construction industry, preferring other industries instead. Over time though, private equity firms have recognized that construction services are a large portion of our economy, that there are many very profitable niche firms, and that the industry is not moving overseas. Therefore, opportunities for construction industry owners have expanded significantly.

Some fear a correction in the private equity market, and it is expected that some funds will struggle with bad investments. However, most established private equity firms have solid track records, and they are able to attract money for new funds. In many ways, they are like mutual funds except they invest in private companies instead of publicly traded companies. Private equity as an asset class in the last 15 to 20 years has generated average returns in the midteens. Over that same period, the stock market has averaged 9% to 12%, depending on which indices you choose. Private equity returns could be expected to moderate with higher valuations paid by funds for companies and a more efficient market for private companies. Nonetheless, private equity is an asset class that is expected to be around for a long time.

Our experience in acquisitions in the construction industry is that firms that are salable are generally valued at 3-6 times pretax earnings, implying returns of 17% to 33%. Clearly, although public company and private equity investment returns can be good, there is still nothing quite like the internal return a closely held contractor can generate.

Implications for the Business Owner in Construction

For the business owners, the evolution of private equity means there is capital available if you meet their investment criteria. You may still choose to go it alone or sell to family or employees, but for many, private equity can provide a better valuation, capital to grow and a renewed sense of vigor to the firm.

What Private Equity firms look for in an investment:

- Firms that are growing profitably
- Companies with the potential to sell to a strategic buyer, go public or sell to a larger private equity fund
- Management teams that want to stay and grow the company
- Companies with recurring revenues
- Businesses with high net margins

With the large numbers of funds out there of all sizes, if your firm loosely fits the above criteria, it is probably a candidate.

Private Equity firms do not like:

- Bonding: Although they will look at companies that require bonding, they will be more conservative on valuation
- Pure exit strategies where owners are simply looking to cash out and there is a lack of successor management
- Volatility of revenues and earnings
- Incomplete information — private equity firms are very thorough buyers

If the previous sounds appealing, you should also be aware that there are some negatives in having a private equity fund as a partner. Private equity firms are not operators and will generally leave you to operate your business. However, if the company does not perform, they have a fiduciary responsibility to their investors to take action. In addition, private equity funds try to leverage their investments with as much debt as possible, which may create major problems given the cyclicality and volatility of the construction industry. Private equity funds make their money by the company increasing its earnings and, ultimately, selling or recapitalizing the business. You may also prefer not to sell, recapitalize or go public when your financial partner desires.

Public Alternatives

We think going public could make a comeback in the construction industry. There are plenty of negatives of being public such as full disclosure, compliance cost, Sarbanes Oxley cost and scrutiny, and the short term focus of analysts.

However, there are also a few real advantages:

- Bonding: Whereas private equity typically utilizes a lot of debt that bonding companies do not like, public companies can utilize less debt and have alternate sources of capital via the issuance of new stock.
- Private equity firms need exit strategies, and if going public is possible, it can be very favorable to their returns.
- Valuation: There are a number of successful public construction industry firms that are trading at lofty price to earnings multiples, suggesting a healthier appetite in the market for industry-related firms.

FMI thinks the increase in the number of industry firms owned by private equity funds will inevitably lead to more firms going public. What could slow this trend is poor performance by public industry firms, a sudden drop in the economy or a soft public offering market.

Special Acquisition Companies and Blank Check Companies

Currently in the market there are public shell entities in the form of Special Acquisition Companies (SPACS) and Blank-Check Companies. These are vehicles that allow a company to go public much more quickly than they are able to through an Initial Public Offering (IPO).

With a SPAC or Blank-Check company, a group of investors without an operating company conducts a public offering to raise cash with the intent of acquiring an operating company after it raises the money. SEC rules require that the investors creating this type of entity not have a specific company in mind for acquisition while doing the public offering. After the public offering is completed, the new entity may pursue an acquisition. The advantage of this to the selling company is that it is quicker, easier and probably less expensive than doing its own IPO. The disadvantage is that the valuation is probably lower, and the original founders of the SPAC or Blank-Check Company will retain much of the stock in the new entity. There are many complexities to this type of transaction, but for some desiring to be a public company, it could be an interesting alternative. If a few construction firms succeed in going public in this manner and their stock price does well, you will see more go this path.

While there is an array of exit strategies today, it is still not always automatic for the industry. The keys to making the exit strategies work are profitability and people. Without profits, few buyers are interested. Without people, profits may be good, but buyers of all types will be reticent. If a sale is being contemplated, we recommend reviewing a variety of options, because what would not work or was not available five years ago may work today.

If you are successful in a sale, you will have your own problem of how to allocate your assets and will be in the position to decide which asset allocation is right for you.

Section 3

Strategies for a Sustainable Organization

Opportunism and Patience

In the construction industry, it makes sense every once in a while to look around you and see who is still standing. Every year it seems a few big names in the industry fall. Ours is a tough industry, and survival is no small accomplishment; prospering is to be taken note of. FMI has always admired the entrepreneurs that drive this industry and continue to stand in the face of change.

Having been in the industry for several decades, we have observed some common characteristics of those that survive and prosper. The obvious one is a fundamental grasp of the industry, with its inherent fragmentation, dependence on people and waves of activity. This grasp often causes them to react with silence when someone with a seemingly brilliant business idea from another more "sophisticated" industry is spoken. Alternatively, they view the seemingly brilliant idea as an opportune time for profit taking as we saw in the consolidation wave.

The less obvious characteristics of those still standing and prospering are being opportunistic and patient. Opportunism is key, because the construction market is forever changing and surprising us. What seems obvious to be built, for example our decaying infrastructure, is not always built. What seems like a good geographic market or construction specialty to participate in is not always the most profitable. Those that prosper seem to have a way of taking advantage of new opportunities to add to or replace their current pursuits. Failure to pursue new opportunities often leave companies empty-handed when the market moves on or in a market where competition drowns out margins. In other industries, there may be a grand strategy or new product that drives change. In construction, it is more often identifying a good opportunity and building on it.

Patience is also a virtue in construction, as speed can be dangerous in this industry. How many organizations have we seen grow dramatically in revenues only to outrun their people or their balance sheet? It is very hard to turn down a seemingly open-ended opportunity, but patience to pursue the right opportunity within one's capability is more likely to bring success. We have seen many a good contractor successfully pursue a new opportunity while patiently turning down another good opportunity that would stretch its resources. Patient contractors tend to do their due diligence and are as willing to walk away as they were open-minded to consider an opportunity.

Being patient and opportunistic does not require a complex strategic plan or business model, so business gurus do not write extensively on the topic. However, our observation is that opportunism and patience in execution are more important than the strategy itself.

Successful contractors develop these characteristics over time from their successes and failures. Having said that, it is common for a successful contractor to lose patience or fail to take advantage of an opportunity even late in a career, causing problems for his or her business.

The challenge we face at FMI as investment bankers and management consultants is to help newcomers to the industry and develop leaders to understand this simple notion. For the newcomers that came to the industry in the consolidation wave, we largely failed in enabling them to understand the difference from where they came. Some succeeded, but most failed. We did help numerous contractors succeed in taking financial advantage of the opportunity that the consolidation wave brought.

Leader development is a buzz in most industries today, and our task is to help develop great leaders in our industry. A primary focus of our practice is bringing leadership principles together with our knowledge of the industry to accelerate leader development for contractors. The value of opportunism and patience is something we hope our leaders develop in our industry emphasis.

HAVE YOU CREATED VALUE IN YOUR COMPANY THIS YEAR?

How do you measure success in your business? Most owners look at earnings or net worth, as they should; however an owner or CEO's job is more than maintenance of earnings or equity. It is to enhance or create value in the business.

This concept is usual for the public company CEO. The public company CEO will be measured by the increase in share price during his or her tenure. For the privately held company, the concept is abstract until reality hits, when you face a sale or ownership transfer. Ultimately, your company will be sold, gifted to heirs or liquidated. In the interim, you may draw income and other benefits, but without focusing on the creation of value, you may be in for a rude awakening when you seek to exit.

What is Value?

Value is negotiated between a buyer and seller. Value is not a single number because it varies in the eyes of the beholder. In the construction industry, we often say a construction company is worth most to its current owner. That is because the owner best understands the company's earnings capability, and therefore his or her perception of risk is usually lower that anybody else's. Value to a prospective buyer varies with the buyer's perspective of risk in the company's earnings. If outside the industry, ignorance of the nuances of the industry usually raises the perception of risk high enough to make a purchase at any price undesirable. Within the industry, a buyer's perception of risk will vary with the knowledge of the company's markets, organization and ability to work with them.

In this context, value is not a simple matter of calculating a multiple of earnings sales or net worth. Nor is it using a discounted cash flow methodology. It has more to do with creation of earnings capacity along with minimizing the risk associated with the earnings capacity. That is, you should not look at value as a number calculated by an accountant or advisor; you should look at it as a range of numbers looked at by a range of buyers with varying perceptions of risk.

Earnings are the driving force behind value and to create value, you must be focused on creating opportunity for earnings growth. However, you must also focus on the risk associated with those earnings. You must ask yourself questions like:

- To what degree is the owner involved in the creation of earnings? If the owner is the driving force, you have a problem with value. Buyers cannot buy owners. They want to buy the organization's ability to create earnings.
- To what degree are the earnings tied to one or two clients? If earnings are based on one or two clients, buyers will have to evaluate carefully their ability to retain those earnings.
- Is your organization vibrant and capable of sustaining itself well into the future? If your key players are in their 50s with no successors, you have a problem. The buyer is looking for a nucleus of motivated people that know how to make money. Also, sustaining your business in construction often means changing, or adapting to new markets over time. Does your organization have this flexibility?
- Does your business have opportunity for growing its earnings capacity? The construction industry is mature in aggregate, but sectors go up and down. Are you in a growth sector? Or are you in declining markets? Buyers are looking for a story as to how you will make them money in the future.

Value Creation Strategies

As owner or CEO, it is your job to figure out how you will make money in the future. Your organization should focus on today and next year. It does not often work that way, but if creating value is the goal, you must look forward and do those things necessary to enhance earnings and minimize risk. Here are a few strategies:

Delegate. The companies that grow the best have a CEO or owner that pushes day-to-day operations down to a competent organization. The company whose owner or CEO does everything himself is limited in growth potential by the owner or CEO's capacity to do. They often make a lot of money but are limited in their ability to create value.

Make Your Company Opportunistic. In aggregate, the construction industry grows slowly, but the industry is made up of growing and dying opportunities. A successful company is a group of people who know how to pursue opportunities and profit from them. This type of organization reduces the risk in the eyes of the buyer.

Develop Specialties. Dependence on jobs that have a large numbers of bidders portends risk to prospective buyers. Having specialties where bidders are few or where work is negotiated reduces risk and creates value.

Keep Your Financial Statement Clean. Nobody likes paying taxes, but owners who go to extremes often render their financial statements meaningless. Maintain a financial information system that can be understood by a buyer.

Stay Focused on the Future. Be wary of the satisfaction of making this year's budget. If you spend all your time doing this, you need to work on your organization. Your job is the future and searching for opportunity.

None of these strategies are earthshaking and perhaps none that you have not used from time to time. Together they define your role in the organization. Your job is creating value, because if you are not, who is?

ACQUISITION AND STRATEGY: THE FUNDAMENTALS FOR CONTRACTING FIRMS, 2012

Ten years ago, I published an article "Acquisition and Strategy–The Fundamentals for Contracting Firms." Since then, we have experienced a strong construction market in most sectors, followed by the Great Recession. There was a strong acquisition market, particularly with private equity capital investments, along with the customary strategic buyers, before the Great Recession, followed by a pause. As we have emerged from the recession, acquisitions activity has picked up, particularly driven by strategic buyers repositioning themselves in the marketplace.

Today, while the construction market is improving, there continues to be uncertainty about the future:

- Residential construction is showing signs of life, though at a much-reduced level. Will it continue its slow growth?
- Credit markets remain tight. What affect will this have on the acquisition market for contractors and the economy? Will credit ease and find growth?
- Public spending has been under pressure. What is the longer-term impact, given our tremendous need for infrastructure spending?

Let's review our observations of a decade ago.

Contracting is fragmented for a reason

We cited geography, lack of economies of scale, and propensity of the business of larger firms to unravel as reasons for fragmentation. Ten years later, the industry remains fragmented, and the reasons for fragmentation are still valid. This has not stopped attempts at consolidation. Utilities acquired and divested of numerous mechanical and electrical firms. Public specialty contractors, such as Comfort Systems, struggled with their numerous acquisitions but are persevering to be successful. Other firms, such as EMCOR and Quanta, have seen their stocks do reasonably well. Private equity firms have invested in acquisitions in the industry and are working to overcome fragmentation.

Our conclusion is that the reasons for fragmentation remain hard to overcome, but there is no shortage of investors interested in trying to overcome fragmentation for potential economic rewards.

Market opportunities come in waves.

The residential wave has subsided. Power looks like a tsunami. Schools are being renovated and built. Industrial, commercial and medical construction are having a long run. Many cities in the country are doing very well. Contractors are riding the waves, but markets are expected to change.

New waves in energy have been driven by fracking technology and the need to upgrade the electric utility infrastructure. Industrial markets will be busy. There is need and hope for infrastructure spending. Many sectors remain in a trough, but there is hope they will improve as the economy improves.

Contractors do not do very well in downturns.

Public residential builders are showing losses in their downturn. Nonresidential contractors have not seen a downturn in a while. The Great Recession has hurt many companies, but arguably the industry has adapted better than in previous downturns.

Acquiring a company often destroys some of its value.

The consolidators and utilities proved this. It is exhibited by the problems they had and the valuation of divestitures made. This remains true, making planning and integration key.

Cash flow is king, but the balance sheet matters in contracting.

The tightening of the bonding market bears this out.

A contracting business is usually worth more to the seller than to the buyer.

This is borne out by the deals that have not been done. We speak with contractors all the time about their money, their families and their companies. They often indicate a desire to sell until they understand valuation from a buyer's perspective. Ninety percent (not 100%) of the time, unless the seller is motivated by retirement or desire for change, economics tells him or her to keep going versus selling.

An acquisition in construction is more like a marriage than an investment.

Even private equity buyers eventually figure this out. A contracting business is people and relationships. Failure to take care of people issues will cause financial issues.

Our recommendations were:

1. Do not outrun your people, and do not assume the acquired troops will follow.
2. Formulate an operating strategy to build people.
3. Do not outrun your balance sheet.
4. Base forecasting beyond five years on your confidence in a changing market.
5. Analyze the waves.
6. Have a strategy to deal with the changes you will inflict on the company.
7. Look for companies with similar cultures.
8. Focus on culture and motivation early in the process, but don't procrastinate on value and structure.

Fundamentals for a Successful Acquisition

Do not outrun your people, and don't assume the acquired troops will follow.

It is easy to become enamored with marketing strategy, operational efficiencies and financial potential. Remember: The business is fundamentally the people's ability to procure, perform and get paid for construction services. Strategies without people to execute them will fail. Plan according to your organization's ability to get the troops aligned behind the strategy.

Formulate an operating strategy to build people.

This will support organic growth and provide leaders for acquired companies to bring them into your culture. It is important to remember to develop leaders, not just managers. There is a difference between management and leadership. Managers implement plans and direct people. Leaders drive the organization and set direction for the business. You need both, but leaders are often forgotten in development efforts. Leaders can be developed internally. Leaders are hard to hire without upsetting the organization. Make leadership development part of your long-term plan for growth and ultimately the continuity of the firm (whether sold to employees or to a third-party buyer).

Do not outrun your balance sheet.

Financial advisors often counsel aggressive growth or distribution of earnings. Construction is a cyclical business, and markets can turn quickly. Bad jobs happen even to the best of contractors. History tells us that banks and bonding companies are not very forgiving when times get tough. In the recessions of the early 1980s, 1990s, 2000s and the most recent Great Recession, it was the contractors with perseverance and a solid balance sheet that emerged stronger. We expect that will continue to hold true.

A bit of a "Depression mentality" helps in construction. Anyone who has spent time with a parent or grandparent who lived through the Great Depression should understand what I mean by this. There is a certain way of thinking that says, no matter how good things get, you should be prepared if things get really bad. Boomers and Generation Xers are less likely to think this way. In construction, markets can turn sharply, a job can be a disaster, people can be lost, and lawsuits can defy comprehension. If your fortunes turn, a strong balance sheet is a good thing to have when those you have counted on are less than supportive. Never make a bet you can't cover.

Base forecasting beyond five years on your confidence to deal with a changing market.

Be realistic when making projections beyond five years. By years four or five, the buyer will have far more impact on the success of the operations than the seller will. Cash flow and earnings are the basis of valuation, but the reality in construction is that after you make the acquisition, your culture will change the acquired company's culture; some people will be lost and markets will change. Thus, cash flow in the short term will be driven largely by what you buy; but over time, your responsibility for cash flow will increase for better or worse.

If you are going to forecast beyond five years, you are really basing it on what you do to the company to make it successful in five years. A lot of buyers five years into an acquisition wonder what they were thinking when they started, because their initial vision was so different from the world they now face.

Analyze the waves.

Study the trends in construction where the seller performs work. Look for the likely cycle in various sectors. Buyers often look at companies as financial machines that generate cash flows for which they pay fair value. Underpinning that assumption is another assumption, which is that the market that generates the cash flow will be there as long as the cash flow model projects. The reality in construction is that most market sectors go through peaks and valleys of activity and that good margins draw competition. Successful companies are able to move with the markets.

Have a strategy to deal with the change you will inflict on the company.

You will change the company you acquire, and some of the change will likely be destructive. Think this through realistically and develop action plans to make the best of it. You need to perform an organizational analysis before you close, and you should take it to some depth before you value the company. This organizational work will lead directly into your integration plan. The seller, and as much of the organization as the seller will let you work with, should be involved in developing the integration plan. This involvement should enable you to surface as many of the problems you will face in the acquisition as you can. As we discussed earlier, the very act of acquiring the company will often destroy value. Your goal is to minimize the destruction and set the stage for building future value.

Look for companies with similar cultures.

We sat at a meeting of a potential buyer and seller recently and noted that, after the buyer finished the presentation of the acquiring company, the potential seller said, "You sound like us describing our approach to the business." That type of cultural similarity is important in acquisitions. Changing culture is risky and hard to do.

Focus early on culture and motivation, but don't procrastinate on value and structure.

You can spend a lot of time getting to know an acquisition candidate, and that should be the focus initially. However, if the seller is not motivated or is unrealistic on value, cultural fit will not get a deal done. Do not rush to numerical analysis, but after basic fit is determined, begin a discussion of value and structure.

All of these recommendations remain valid. The recommendations I would add in today's market are:

Study the waves closely. Where is the target in the cycle? What will the trough look like? If you invest based on what is going on today, you could get in trouble. If you invest based on a quick bounce out of a trough, you could also get in trouble. Be realistic about the long-term view to avoid a problem but not to miss an opportunity. Some waves, such as energy and power, look like they will last for a while.

Make the time to think strategically and opportunistically. There is money to be made by those who find and take advantage of opportunities in our construction economy.

Remember the fundamentals. Some things do not change. Good luck with your strategy and acquisitions.

Planning the Lingering Ownership Transition

On October 15, 2008, Kathleen Casey-Kirschling, who was born after midnight on January 1, 1946, applied for Social Security benefits. She belongs to a generational group known as the baby boomers (born between 1946-1964), a group that had a significant influence on the economics, politics and leadership that we know today. Some 80 million boomers will join Kathleen in making the transition out of the full-time workforce in the next 18 years.

The baby boomer transition brings both opportunity and challenge to organizations. One of the greatest challenges in the engineering and construction industry will be the ownership transition and succession of closely held businesses.

Ownership transition planning for E&C firms has historically focused on a transaction with retiring owners selling to the next generation. The transaction typically took place over a period of years and had a defined end. FMI is seeing a shift in the way sellers think of "retiring." Sellers are taking a slower approach to the sale, and sometimes the process does not have a defined end date. We call this the "lingering ownership transition." Several factors are driving this change in thinking:

1. People are living longer – The prospect of living to 90 or 100 means that retirements are longer, which, in turn, implies that retirement income may potentially be needed for decades.
2. Traditional retirement investments have been underperforming for more than a decade – Since 1999, the stock market has been essentially flat, interest rates are nominal, and real estate has struggled. The strategy of living off the income from traditional retirement investments is not working very well. Trading stock in a profitable private business for traditional retirement investments is not very appealing economically.
3. Many business owners want to stay engaged in their businesses – Pure retirement does not appeal to all. The traditional model of

working until the magic number of 65 is no longer desirable to many owners who still want to contribute while reducing their time obligations.

4. Government's role in the economy undermines confidence in the future – In combination, budget deficits, trade deficits, the falling dollar, entitlement liabilities and expectations of rising taxes undermine the confidence of business owners. Will inflation and taxes eat away at personal net worth and the retirement nest eggs in coming decades?

The reaction of some business owners to this environment is to put off transition planning indefinitely. Others sincerely want to sell and move towards retirement, but are unsure how to proceed in the new environment. Some business owners feel the need to tie in the next generation with ownership, but are not sure they are ready to make the full transition. For those that want to begin the process, FMI is seeing what we call a "Lingering Ownership Transition Strategy." It works like this:

1. The selling owner(s) begins a process of selling a portion of the business to the next generation with the intent of retaining 10% to 51% of the company indefinitely.
2. Selling owner(s) continues to work, drawing salary and benefits while transitioning responsibilities of lesser interest to the next generation.
3. The selling owner(s) encourages leader development activities and programs for the next generation to drive the growth and profitability of the business.
4. Sellers maintain a flexible transaction structure that allows them to retain some ownership indefinitely, but also a structure that can be accelerated should full retirement be desired.

The advantages of this structure for the seller are that it maintains income for the indefinite future, holds exit options open and, hopefully, locks in the next generation. The owner's slow exit also provides stability for the organization, less financial strain on the company and, hopefully, a positive mentor for the next generation's leaders. The disadvantages of this structure include the retention of business risk and the possible under-motivation of the next generation.

This structure could be perceived positively or negatively by the next generation. A negative perception could result from the possible delay and uncertainty in gaining control of the business. The next generation also may not look favorably upon sharing income with a less active, or exiting, owner. If structured fairly, the positive should be in the opportunity for increased ownership and leadership.

The primary key to this strategy's success is developing and motivating the next generation. Prior to our long national recession, finding top, next-generation talent was already one of the greatest challenges facing leaders. This situation was likened to a "perfect storm" for the construction industry because of three factors that would transform the competitive landscape:

- Industry image
- Changing workforce demographics
- Ineffective or nonexistent recruiting, development and succession planning

Many construction leaders assume that the "perfect storm" has blown over since the recession. However, a close examination of the three factors above reveals a different story. The construction industry still faces an uphill climb in marketing itself as an appealing profession for young people, who often assume it is dirty, dangerous and low paying. It is unlikely that the talent that left the industry during the recession will return. Demographics are still a critical issue as the baby Boomer generation transitions out of senior roles in droves, leaving gaps that cannot be filled by the next generation. Finally, the recession has forced many companies to cut back on anything discretionary associated with talent development, which has had a major impact on recruiting, employee development and succession planning.

Companies that ready themselves for the new perfect storm affecting talent will be in a position to achieve considerable strategic advantage over less prepared companies and increase their odds of a successful ownership transition.

FMI expects more E&C business owners to adopt the lingering transition strategy. Our advice for this strategy is as follows:

1. Objectively plan the financial side of your retirement.
   a. Prepare a personal financial statement, and make projections for your retirement income needs and desired personal balance sheet.
   b. Evaluate the risk you retain in the business. How long will you sign bonds if are required to do so? What limits can you put on your indemnities? Open-ended personal signatures should be avoided.
2. Take care of your next generation of leaders. Without them, this strategy may not work.
   a. Make the deal good for the next generation.
   b. Empower the next generation to do their jobs, while monitoring your risk.
   c. Commit to leader development strategies, including educational opportunities, peer/association affiliations, management planning and personal time with them in running the business.
3. Have a sustainable transaction strategy
   a. The structure for your sale should be a template for the next-generation's future sale.
   b. Put in place a buyer/seller or stockholders agreement that is in the mutual best interest of selling and next-generation shareholders while being protective of the company as well.
4. Make your lingering a positive for the company
   a. Transition your responsibilities appropriately.
   b. Be supportive of the next-generation development.
   c. Earn your returns on personal contributions and capital invested.

As economic and political volatility continues to impact construction markets, the “lingering ownership transfer” will be a common occurrence. Leaders facing a talent gap and an uncertain environment should examine this option as one to transition their business successfully to the next generation.

About the Author

J. Stuart Phoenix

Chairman of the Board

Stuart Phoenix is chairman of the board with FMI Corporation and a managing director with FMI Capital Advisors, Inc., FMI Corporation's Investment Banking subsidiary. He has worked with general, specialty, and heavy contractors, residential builders, construction materials producers and engineering firms in the areas of mergers, acquisitions, and ownership transfer.

Stuart helps buyers find appropriate acquisition candidates, and he assists sellers in their search for buyers. He works with his clients to develop and implement strategies, select target criteria, locate and screen prospects, negotiate price and terms, and structure transactions. His clients include both public and private firms.

Prior to joining FMI, Stuart headed the international marketing effort for a major manufacturer of testing equipment used in heavy construction work. In that capacity, he visited job sites and worked with construction clients in more than 30 countries.

Stuart holds a bachelor of science in engineering science and mechanics from North Carolina State University and a master of business administration from the University of North Carolina at Chapel Hill. Stuart also holds a General Securities Representative license (Series 7) from the Securities and Exchange Commission and FINRA.

Raleigh
5171 Glenwood Ave.
Suite 200
Raleigh, NC 27612
T 919.787.8400
F 919.785.9320

Denver
210 University Blvd.
Suite 800
Denver, CO 80206
T 303.377.4740
F 303.398.7291

Tampa
308 South Boulevard
Tampa, FL 33606
T 813.636.1364
F 813.636.9601

Scottsdale
14500 N Northsight Blvd
Suite 313
Scottsdale, AZ 85260
T 602.381.8108
F 602.381.8228

FMI
MANAGEMENT CONSULTING • INVESTMENT BANKING
for the ENGINEERING and CONSTRUCTION INDUSTRY