Ownership Transition for Contractors: Current Thoughts and Methodologies
Ownership Transition for Contractors: 
Current Thoughts and Methodologies

Prepared for 
The Foundation of Wall and Ceiling Industry 

By 
FMI Corporation 

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Preface

Foundation of the Wall and Ceiling Industry

In the late 1970s, there was a clear recognition among industry leaders for the need to unite and expand the educational and research activities available to contractors, manufacturers, distributors and the public, in general. At the time, there were many issues facing the industry—from a national energy crisis to injuries in the workplace, to unsafe buildings occupied by the public. In response to these issues, the Foundation of the Wall and Ceiling Industry was formed in 1977 with the following mission statement as an IRS designated non-profit 501(c)3 corporation to pursue educational and research activities benefiting the industry and the public at-large:

The Foundation’s mission is to be an active, unbiased source of information and education to support the wall and ceiling industry.

To fulfill this mission, the Foundation owns and maintains the largest independent library serving the wall and ceiling industry, provides research support to industry inquiries and publishes research papers. In addition, the Foundation provides financial assistance through its AWCI Cares program to AWCI member company employees experiencing hardship.

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Executive Summary

In the following report prepared by FMI Corporation for the Association of the Wall and Ceiling Industry, we cover the major issues that executives of construction firms need to consider for ownership transition and management succession (OTMS). According to a research report published by FMI in 2013, only 44 percent of the owners of construction firms had a formal plan in place to transition themselves out of managing the business. For those executives who have not started planning their exit strategies, this report offers a detailed look at the reasons they should plan and the various options available to them to transition their companies. For both those who currently have plans for exiting the business and those who do not, we cover some areas that they might not have considered, including implementation issues and strategies for a profitable transition strategy.

The first thing the reader should take away from this report is that planning for ownership transfer is harder than most owners might expect and takes longer to implement. For instance, answering the question, “Who will the next owner(s) be?” is a first important step in the transition process. Hint: The new owners aren’t always who the current owners expect they will be. When internal transfers are contemplated, determining if the next generation of leaders is ready to take on the responsibilities, and whether they can afford to take ownership, may pose particular problems for many current owners. We will cover these issues and more in the beginning sections of the report:

- The Art and Science of Business Succession
- Exit Strategies for Wall and Ceiling Contractors
- The Internal Option Sale to Employees or Family – Why Plan?

Ultimately, there are a number of approaches to ownership transition. The primary goal for the current owner(s) is to preserve the equity he or she has built up in the firm while also providing a method for the next owner(s) to be profitable. How the owner meets this goal and others is the focus of the middle section of this paper where we cover the various techniques of transition, including the potential risks and rewards of each method:

- Equity Transfer Techniques for Sale to Employees or Family
- The Internal Transition Process
- The Mechanics of a Transition Plan
- Traditional Tools — Subchapter S Buyout
- Recapitalization
- Oldco/Newco Strategies
- Employee Stock Ownership Plans (ESOP)
- Sale to a Third Party
- Private Equity
- Valuation of Contractors

Finally, we look at the details that owners should consider to better preserve their personal wealth and to assure a smooth implementation of the transition plan. We also cover current trends in mergers and acquisitions for construction industry trade contractors:

- Personal Planning in Preparation for a Transition
- Implementing the Transition

This report is not a complete manual for ownership transition. It should, however, present enough information for owners to start planning and organizing their thoughts around their eventual ownership transition and, in most cases, give owners an idea of where they need help in creating and implementing the plan.
Introduction

Top executives in construction companies, or any company, wear a lot of hats. With the long list of responsibilities and skills needed for the top job, it is not surprising that companies can take a long time to find the right person when it is time to replace a current top executive. A list of the primary skills and characteristics required to carry out the responsibilities of a CEO include the following:

- Director: Set the direction for the company.
- Decision-maker: Make high-level, critical decisions about policy.
- Leader: Provide vision for the future of the organization.
- Motivator: Motivate employees and shareholders.
- Driver of change within the organization.
- Promoter and head salesperson for the company.
- Manager and facilitator of operations: Presides over the organization’s day-to-day, month-to-month and year-to-year operations.
- Advisor to the board of directors.
- Communicator: Within the company and with the rest of the outside world as needed.
- Visionary: Lead strategic planning efforts and oversee the plan’s execution.
- Listener: Surround him or herself with the best people for advice.
- Recruiter/mentor: Select and nurture his or her successor.
- Fiduciary: “A CEO’s legal responsibilities to his company’s shareholders are broken down into three distinct fiduciary duties: the duty of care, the duty of loyalty and the duty of disclosure.”
- Ethical leader for the organization.

Many owner/founders of construction firms didn’t start out with the idea of taking the CEO position described above. Given the size distribution of construction firms, most companies likely started out more like the proverbial “two men and a truck.” In time, the business flourished, made money and grew to the point where full-time accountants were hired along with a foreman, project manager, and marketing department. The owner(s) began to realize they needed to work more on the business than in the business. They hung up their drywall tools and spent more time with prospective customers and bankers. They made strategic plans. On the way to success, their roles changed to include taking on the responsibilities listed above except that they often overlooked their “recruiter/mentor” responsibility to select and nurture their successor.

Of course, not all current owners started from the bottom to build a company, but in the construction industry, many of their parents did. The results of an FMI survey published in 2013, “Ownership Transfer and Management Succession,” found that “62 percent of the respondents to our survey consider their businesses to be family businesses. While 43 percent are still in the first generation, 30 percent have made it to the third generation or longer. This is typical across the construction industry. Family businesses have all the challenges of other businesses when it comes to management transition and ownership transfer, and family relationships often compound the transition problems. It is notable that only 57 percent of the owners responding to the survey prefer that family members own the business, and a similar number (52 percent) prefer that family members run the business.”

Other owners may have purchased shares over the course of the many years they worked in the company. For the few, large publicly traded companies in the construction industry, the current top executive may have been recruited from outside the company. There are a number of routes one might take to become the owner of a construction company. There are also a number of approaches for the current owner to step down from that role and enter the next phase of his or her life or career. This report will cover the major challenges, concerns and approaches leaders might follow as they assume one of the most important roles and responsibilities of a top executive/owner, namely that of assuring a smooth transition of ownership and maximizing his or her return.

The Coming Succession Boom

Much has been made about the tremendous wealth transfer of the largest and wealthiest generation this country has ever seen, with trillions of dollars set to change hands as the Baby Boomers retire. Focusing on the construction industry alone and projecting estimates from our surveys of contractors, a little over 50 percent of firms will change ownership in the next 10 to 12 years.

While it is certain there will be a large transfer of ownership over the next decade, what is uncertain is when and how that transfer will take place. Only 47 percent of respondents to “FMI’s 2013 Ownership Transfer and Management Succession” survey believe they have capable, strong managers who could run the company in their absence. Furthermore, only 44 percent say they have a formal plan in place to transition themselves out of managing the business, and just 64 percent have a formal plan in place to ensure continuity of operations in the event of their death.

Meanwhile, owners continue to get older. The percentage of respondents over the age of 60 in the 2012 survey was 32 percent, versus 20 percent in FMI’s survey conducted in 2007. The economic downturn has further complicated ownership transfer trends because as the key indicator of ownership transfer funding, pretax return on equity declined for two-thirds of the businesses surveyed. Not only are owners getting older, they now need to work further into their retirement years to fund the transfer of their businesses.

Nonetheless, it does appear that since the 2007 survey, more owners are making plans to transfer ownership of their firms,
and most of those nearing retirement age that haven’t begun to plan are aware of the need to get the process under way. Their recognition of the immediate need to begin planning for ownership transfer is highlighted by several comments received from owners answering the FMI survey:

- “It takes a long time.”
- “I should have started earlier and done more training in the areas between project management and the ‘executive suite.’”
- “Two third-generation members are still in college, and their competence/ability to run the business has yet to be determined. Several nonfamily managers are interested in taking over, and the business needs to be transitioned in the very near future.”
- “We have had many discussions on the subject and have some of the pieces in place to structure a formal succession plan. We need to take the final step to decide on a specific course of action and implement it.”
- “I am 60 years old and would like to move out slowly; I have a young son, 22, who has potential. I’m not ready to retire, but I’m tired and frustrated with the economy and industry. There are several employees who have a lot of time in and who I would like to see benefit from their time here. They should start thinking about their replacements. It is difficult to keep young, smart employees unless they are part of something.”
- “We are in the five- to 10-year process of transferring ownership to selected family members and possibly a key manager or two.”

Current Mergers and Acquisition Trends for the Construction Industry

There are millions and billions of dollars at stake in potential wealth transfer for construction firm owners in the next five to 10 years, and for many, in the next one to two years. The recession has postponed some of these transactions, but not that business is coming back, the question, “Is this the right time to get out?” will be asked by more owners thinking it is time to turn over the reins. FMI Capital Advisors released the FMI 2014 Mergers and Acquisition Trends report that describes an improving environment for mergers and acquisitions in the construction industry. The following highlights from the report offer a look at the current climate for construction industry mergers and acquisitions:

An aging and retiring population of owners should contribute to additional M&A opportunities. The severe market downturn of the last five years curtailed the exit opportunities for aging baby boomers, which is now resulting in a continuous departure of executive leadership from the industry. Many engineering and construction firms lack the available capital or patience to complete an internal transition to the next generation. Consequently, many companies will turn to third-party sales as opposed to internal transfers of ownership in order to facilitate liquidity for retiring owners.” (FMI 2014 Mergers and Acquisition Trends)

- Both publicly traded and privately held acquirers have tremendous levels of cash and are looking to deploy capital through acquisitions in order to continue diversifying business lines and accessing countercyclical or diversified opportunities. However, caution abounds, given overall market conditions.
- Purchase price multiples remain at historic norms; however, historic and near-term earnings forecasts are erratic and, in many cases, speculative. Agreement on valuations between buyers and sellers therefore is challenging in the current environment. As a result, earnouts remain common in the general building transaction marketplace, as buyers are only willing to pay upfront for those earnings levels they confidently believe can be supported.
- Geographic expansion remains a perpetual key trend in construction firms’ growth strategies. As populations and economic activity shift within the United States, firms expand to new markets to pursue that work. Such growth is both organic and acquisitive and remains a major driver of transaction activity.
- Challenges surrounding multi-employer pension shortfalls have eased somewhat as equity market returns have increased in 2012 and 2013. However, firms affiliated with multi-employer plans are using acquisitions to diversify into nonunion geographies. For those selling firms saddled with withdrawal liabilities associated with pensions, transaction structuring hurdles are arising.
- Since there has been a scarcity of buyers in the building sector in recent years, many firms needing a succession option have moved forward to employee ownership programs, including ESOPs. The aging of the owners of firms does not stop for recessions, and exit plans continue to be implemented. The drawbacks, of course, are several years to affect a buyout and valuations that are conservative relative to historic third-party transactions.
- Overall, 2014 will be a transitional year for M&A activity involving general building firms. There are a tremendous number of private business owners who have not had a viable window for a liquidity event in nearly five years. This provides motivated sellers; however, buyers have yet to share that enthusiasm. As certainty increases regarding general economic conditions, optimism and speculative behavior will emerge, even if slowly. Transaction activity will follow this sentiment for the general building market in 2014 and beyond. (FMI 2014 Mergers and Acquisition Trends)

While the overall outlook for mergers and acquisitions in the construction industry is improving, it is notable that “a scarcity of buyers in the building sector in recent years,” has driven firms who expected to sell the firm to a third party to now look at “employee ownership programs”, including ESOPs. The aging of the owners of firms does not stop for recessions, and exit plans continue to be implemented. The drawbacks, of course, are first, that it takes several years to affect a buyout and second, that valuations are conservative relative to historic third-party transactions.” This trend bears repeating since the greater percentage of ownership transfers
will not be accomplished by selling the company to another contractor or outside investors. It is also worth repeating that, as one contractor told us: “It takes a long time.” It takes a long time to plan for a smooth transition because the owner has to start a number of things in motion with help from advisors and other key management. However, many contractors have reported to FMI that they don’t have key top management who are ready or willing to assume the position of owner. We will provide below more details about the various strategies and approaches available to owners for planning a smooth transition of the ownership of their firm. First, we will take a brief look at the art and science of succession, or how to put the “success” in succession.
The Art and Science of Business Succession

The Art of Succession
In FMI’s experience, business succession is both an art and a complicated science. Success and succession together define what business succession is at its essence. Success in business implies strong profitability coupled with client and employee satisfaction. Success 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.

Contractors have a way of being pragmatic in the face of decisions. Succession can be accomplished 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 needed to fund the owner’s vision of value, and therein lies the art of a well-planned succession.

The art of a successful succession is the ability to balance the pragmatic with solid business practices. It is important for entrepreneurs facing a transition to recognize that a smooth succession is different from other business challenges they have faced in the past. It is an issue of nuance and subtlety rather than black and white, and a smooth 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 position, company and profits that they are so accustomed to keeping. Furthermore, succession planning is not a project that can be delegated. Although experienced advisors are helpful, the owner must be involved in the process.

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

Thus, the art in the process is the business owner “painting” his or her succession by making the business successful and developing the organization that is able 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 Science of Succession
The science of succession can be divided into two categories:

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

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 continuing business success while leadership and ownership are transitioning.

Leadership 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 successful leader we try to emulate, there are many who have not been successful, whether they were trying to start a business or to 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.

The science of financial strategies for transferring and selling ownership pertains to how to transfer ownership from one set of owners to another, including determining the valuation of the business. Analyzing financial strategies is often where business owners begin when contemplating a succession, and it is often the easiest piece of the transition puzzle to solve. However, addressing financial concerns assumes that the two prerequisites for a transition have been met—namely, that the business is successful, meaning it has a good business strategy and profitable future, and that there are prospective leaders. If these are in place, a structure for transition can then be developed. There are numerous ways to structure a transition, including 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?
Ownership transfer and management succession (OTMS) may not seem exciting, but if you are an “artist,” you should be asking how it can help you. The primary message here is that succession in most cases is something that should not be delegated or executed alone. You may need help with the science of the process: 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. Owners also have to pull it all together “artfully,” balancing technical issues with people issues, as well as the owners’ personal objectives. Advisors can help with that, but the complete picture of succession is something the owner has to paint for him or herself.
There are three approaches generally used for valuing construction companies—market-based, earnings-based and asset-based. The market-based approach examines valuations for “comparable” companies. There are two sources generally available for valuations of comparable companies: trading values for public companies and published acquisition data. For public companies, valuations are published daily, and valuation metrics such as price-to-earnings ratios and price-to-book value can be determined. For acquisitions, metrics for transactions are sometimes published, though information is often incomplete, making it difficult to gain a full understanding of the valuation.

The asset-based approach begins with the balance sheet, particularly the accounting net worth shown at the bottom of the statement. Net worth may also be called book value or equity. This value is in fact used in many buy/sell or stockholders agreements as the value at which a selling shareholder will sell stock to other shareholders or back to the company on exit.

While book value may accurately represent the value of a company, there are several inherent problems with it. First, there may be assets, such as equipment or real estate that may be worth more or less than that shown on the balance sheet. Second, net worth does not indicate how liquid the assets are nor does it indicate the costs to liquidate the balance sheet. Third, book value does not indicate how profitable the business is, or even whether the company has made any money or not, or what the prospects are for the future of the company.

To compensate for some of these limitations, two other asset valuation methods are sometimes utilized. Adjusted book value adjusts the value of individual assets, such as equipment and real estate, to their “appraised” market value. Liquidation value adjusts the value to include the cost of selling all the assets, paying the liabilities and winding down business operations.

While market- and asset-based valuations are useful, earnings-based valuation is usually the preferred starting point for analysis. This is because a buyer is usually acquiring a business on the basis of the future earnings to be expected. There are two primary approaches used to determine an earnings-based value. The first is to capitalize historical earnings. This is accomplished by examining the earnings for the last year, three years or five years and determining an earnings capacity for that business. Some adjustments may be made to the earnings based on what conditions might change after the buyer owns the business. For example, the owner might take large or insufficient bonuses from the business, so a normalized market-based compensation needs to be determined for someone running the business. The owner might also have certain travel or other personal expenses that could be eliminated when the business is owned by a new party. The business might have had a large project where the earnings spiked up or down for a year, but that is expected to be a one-time occurrence. This procedure is called normalizing earnings, where the goal is to determine what the earnings capacity of the business was before the sale and get a realistic picture of what expected earnings will be if owned by someone new.

The problem with basing value on historical earnings is that what a buyer is really buying is not what was earned in the past, but what will be earned in the next three, five or 10 years depending on the buyer’s planning horizon. That brings us to the discounted cash flow (DCF) method. In a DCF evaluation, earnings and cash flow are projected for five or more years. A terminal value at the end of the projection period will be estimated; terminal value represents either the value at which the business could be sold at the end of the projection period or the DCF of all earnings after the projection period. The problem with the DCF method, particularly in construction, is that projecting next year is hard enough; projecting five or more years is next to impossible. Therefore, while capitalizing historical earnings has limitations, it is usually relied on more than DCF except for the more financially sophisticated buyers.

In Exhibit 1, the value of the business is represented by the formula using a capitalization multiple multiplied by the earnings or free cash flow. While this is a very simple formula, there are a number of nuances to it. The most common capitalization multiple for most industry transactions falls in the range of three to six times earnings. Three times earnings is the most likely multiple for smaller, more risky businesses that do not have a succession plan in place, and the six times earnings is more likely for service-oriented businesses with recurring revenue.

The capitalization multiple captures the risk and salability of the business. A very sought-after firm in a desirable niche with a strong

**Exhibit 1: What Drives Value Capitalization of Earnings?**

\[
\text{Value} = \text{CM} \times \text{E} \\
\text{(Capitalization Multiple)}
\]

- **Earnings** (free cash flow)
- **Risk and Salability**
- **Growth** (in earnings)
The earnings typically utilized are pretax earnings. Often EBIT (Earnings Before Interest and Tax) is used, which takes interest and how the firm is capitalized out of the analysis. Some analysts will use EBITDA (Earnings Before Interest, Tax, Depreciation and Amortization), which adds back depreciation and amortization to the earnings of the business.

The No. 1 factor driving value is earnings; the higher the earnings, the higher the value.

The second most important factor is growth in earnings. If the business is in a growing market and expects continued growth, a higher multiple and a higher value are likely to be assigned. The third factor is salability. In today’s market, there is limited consolidation activity, so selling opportunities are more limited and valuations are likely to be more conservative.

In conclusion, the value for most contractors is going to be in the range of three to five times EBIT. Service companies may command a higher multiple, and smaller firms will probably be in the three to four times EBIT range. Human nature being what it is, it is not surprising that owners’ expectations are at the high end of the range. From an asset perspective, the valuations are most likely to be one to two times book value adjusted to the market value of the assets. That does not mean adjusting equipment values to new values but to a realistic appraisal of value.

Private equity firms and consolidators may pay higher valuations than the multiple of book above if the earnings justify it. They focus more on earnings versus asset value. If there is a difference in opinion about value between buyer and seller, sometimes an earnout is used to bridge the gap. Transactions with earnouts are structured with a base price at closing and additional future payments based on the actual earnings over a period of years.

Protective assets are low-risk assets, such as your home, an insurance policy or cash in the bank. Market assets are investment assets that earn a return, such as pension plans like a 401(k), stocks and bonds, and investment real estate. These are investments that the business owner is not actively managing but that are held for a return. Aspirational assets are “get-rich” assets, ones that the business owner is actively managing to earn a higher return. While the goal of protective and market assets is the preservation of capital and income, the business owners’ wealth-creating opportunities are found in aspirational assets.

The liability side of the balance sheet may include debt that is related to the business, a home mortgage or other personal debt. It might also include personal guarantees for bonds or debts owed to the bank. A business owner’s personal net worth is equal to the difference between the owner’s assets and his or her liabilities.

Our recommendation for the business owner is to prepare a personal balance sheet and then to ask the following questions:

- How much in assets net of liabilities does the owner have excluding the business?
- Could he/she live at a desired standard of living off the income from the assets outside the business?
- Is the risk associated with selling the business to family or employees acceptable, given the likelihood of the purchase taking five to 10 years to complete?
- Are assets outside of the business appropriately diversified?
- How much income does he/she want after retirement, and how much net worth will it take to generate this income?
For many company owners, particularly younger ones, personal balance sheets will indicate most of the owner’s net worth is in the company, that is, in aspirational assets. The owners have not necessarily built up their protective assets; they may have a mortgage on their home and may not have a large retirement plan. That is because they have invested in the business, which is appropriate for the young owner. However, as an owner ages, it is prudent to increase the protective and market asset categories.

In today’s world where one may live to be 80, 90 or 100 years old, it is hard to predict how long retirement will need to be funded. The prospect of retiring at 50 and then living another 50 years is daunting, particularly given the inflation that some think may be on the horizon. Therefore, it is important when planning a transition that the owner’s personal balance sheet is in good shape. So we ask again, as an owner, are you appropriately diversified, and is your risk level appropriate?

It is also important to note that protective assets being lower-risk by nature will provide lower returns, perhaps in the 3 to 5 percent range on average over a long period. One may think his/her house may appreciate more than that, but for your home to appreciate 3 to 5 percent per year over a 20-year period is a good return given the periodic flat markets that tend to occur.

Market assets, such as stocks, bonds and investment real estate, where the business owner is not involved, might be expected to return 7 to 10 percent on average over a period of decades. As is apparent from the decade beginning in 2000, there are some decades where the return can be zero.

If an aspirational asset is worth three to five times its earnings, the implication in a slow-growth industry is that the annual return on the value of the business is between 20 and 33 percent. That is significantly higher than the 7 to 10 percent return from market assets. If this is the case, it begs the question, why would a business owner sell an aspirational asset yielding 20 to 33 percent to likely invest in a market asset or a protective asset expected to yield less than 10 percent? The answer is that the business owner wants to retire or reduce risk. Contractors often go one job too many or sail into the headwinds in a tough market and end up losing everything they have realized.

Aspirational assets are good for building wealth. However, later in a business owner’s career, it makes sense to take money out of the business to pay off a mortgage or other debt and invest it in market assets to provide income and diversification in retirement. By shifting aspirational assets to market or protective assets, when it is time to sell stock to employees, the business owner will already have a nest egg outside of the business and can be flexible as to how to structure a sale.

For a third-party sale or private equity recapitalization, once the decision is made to proceed, it could take six months to a year or two to choose a buyer and close a transaction. Therefore, having an internal transition option as a backup to the sale is a prudent strategy.

### Implementing the Transition

There are five steps to implement a successful transition:

#### 1. Defining Objectives

Exhibit 3 shows typical timelines for an internal transition. Note that most internal transitions occur over a several-year period. Longer timelines are usually driven by the need to allow the business to generate enough profits to fund a transition. The longer time period actually increases the odds of the transition working. This is because sudden change can be disruptive to an organization, while slow change provides the opportunity for successor managers/owners to develop their skills. It provides time to train and observe the next generation. Longer timelines also put less financial stress on the business, as the business is more likely to maintain a strong balance sheet.

For a third-party sale or private equity recapitalization, once the decision is made to proceed, it could take six months to a year or two to choose a buyer and close a transaction. Therefore, having an internal transition option as a backup to the sale is a prudent strategy.

#### 4. Implement

Making the decision to start a plan for your exit strategy is often the hardest step. It is so easy to put ownership decisions off another year, particularly when the business is busy or some uncertainty lingers. Hesitating in many cases can work against the owner as key employees may leave, the business may drift or acquisition markets may change.
Exit Strategies for Wall and Ceiling Contractors

Strategies for Equity and Ownership Strategy
Every generation of construction firm owners faces the succession issue of transitioning management and ownership to the next generation. Publicly traded firms have a market for their stock, but still face the management transition issue. This section will address the exit strategies for construction firms. “Exit” addresses only half of the problem, unless an owner is liquidating the business. Most owners expect their businesses to continue operating in a sale to a third party, employees or a transfer to family members. In this case, “transition strategy” is a better description. In this section, the following topics are addressed:

- The internal option sale to family or employees—why plan?
- Equity transfer techniques for sale to family and employees.
- Third-party sale, private equity and public options.
- The positives and negatives of transition options for construction firms.

The Internal Option Sale to Employees or Family—Why Plan?
Many contractors do not plan for succession. According to FMI’s 2013 report, only 39 percent of baby boomers and 60 percent of the BB+ generation have formal plans for transitioning their management responsibilities. Forty percent of the baby boomers still do not have a formal plan in place to ensure continuity of operations in the event of their death, and 29 percent of the BB+ generation is lacking any formal plan. This is understandable because most business owners didn’t start their businesses to transition – they started their businesses as a career to make money. Usually business owners enjoy running their businesses and doing the things it takes to make them successful. They do not necessarily enjoy doing the things it takes to implement a successful succession plan. In this section, we will explore why succession can be difficult and will discuss the benefits to developing and implementing a succession plan.

Why Don’t Business Owners Plan for Succession?
FMI’s experience is that, while business owners recognize the inevitability of a transition, they often do not plan for succession. We often find business owners have fantasies about what will happen with their businesses. Many assume they will live forever or that when they are ready to sell, they can raise their hand and someone will write them a check for the business. Some think they can continue to work indefinitely without negatively affecting the business. Some think they can work periodically or on an absentee basis, again without negatively affecting the business.

Business owners sometimes hesitate to plan for succession because they fear being less important in the community, or they may fear that retirement would result in a drop in income or uncertainty about what to do with themselves. There are those who like to spend weeks or months in Florida or Arizona to get away from the business and then come back to run the business when they want to. While all of these scenarios are possible, they may not work. Our observation is that it takes a strong incentivized management team to run a business in the owner’s absence. Construction businesses are generally hands-on and need to have constant attention.

Some owners believe that potential successors will clamor for ownership and all they have to do is say, “Who wants to be an owner?” and employees will step up and provide a plan to buy them out. Our experience is that, when employees are offered an opportunity to put together a plan, they often do not know where to start. Moreover, many times, potential successors are employees because they like being employees. If they wanted to own a business, they would have done that by now.

Business owners sometimes assume sons or daughters will step up to the opportunity. This happens in some cases, and sometimes the next generation may take the business farther than the parents could have ever expected. These parents should be very thankful. In other cases, family owners are ill-equipped to assume ownership and current owners are often blind to those limitations.

Some owners are reluctant to make decisions about key employees or family members. Some do not want to reveal the company’s financial position to their employees. Some are unaware or misinformed of equity transfer techniques and do not see an internal sale as a possibility.

While there are numerous reasons business owners do not plan for succession, there are also consequences for those who don’t have a succession plan. First, if there is no succession plan, key employees may leave, especially the most motivated ones. Secondly, if there is no plan in place and something happens to the business owner, the business may close. Business is difficult enough with active experienced ownership; the loss of a business owner often debilitates the business. Lack of planning may also result in insufficient working capital or bonding necessary to run the business. That is why it is important to have a plan for maintaining the balance sheet throughout the transition.

Consider what would happen if a business were to end up as part of a deceased owner’s estate. Unqualified heirs could end up owning the business, or a spouse who might prefer to sell or shut down the business could end up owning and operating it. Nonetheless, 44 percent of the owners answering our survey said that, in the event of their death, their stock passed to their heirs through their estate. Alternatively, the business might end up in the hands of employees who really do not have what it takes to run it. For instance, our
The Benefits of Planning for Succession

The first benefit of planning for succession is that the process provides an opportunity to reinvigorate the business' strategic direction. The goal of a successful internal transition is to turn employees into owners and teach them to run the business. This is a great opportunity to think through the business' strategy and plan how the next owners can take the business to new levels.

Second, it is an opportunity to develop successful leaders who will grow the business. The current owners probably bring in the customers, set pricing and generally make key operating decisions. This is an opportunity to get the next generation to take increasing responsibility for these decisions and watch them grow as leaders.

Third, it is an opportunity to build a sustainable corporate culture. Some business owners view the transition as a transaction when they sell their stock back to the company or the employees. In our experience, it is better to view it as a process where a sustainable transition model and corporate culture are established that will work when the successors and future generations decide to sell.

Finally, doing all of the above should make money for current and future business owners. The business owner should make money from the business' ongoing profitability and from sales of stock. For the employees, it is an opportunity to be owners and build wealth.

Reinvigorating the business, developing future leaders, building a sustainable culture and making money for the future business owners depend on having qualified successors ready to run the business. At this point, only 47 percent of those surveyed have qualified successors and 47 percent responded that they have potential successors who need further development. In order to develop their successors, owners will need to assure that the next generation will have skills in the following business areas: business development, internal leadership development programs, preparation of budgets and reviewing financial information. When more potential successors understand the business, the depth in management capabilities strengthens both the owner and the business.

Key Facts and Assumptions for the Internal Sale

There are three alternatives for exiting your business: liquidation, third-party sale and sale/transfer to employees and family. Liquidating the business includes finishing the projects, selling the assets and laying off employees. While about 30 percent of construction businesses are eventually liquidated, particularly the small ones, it is the least desirable choice for most owners. In the case of owners answering our survey, only about 5 percent expect to liquidate the business, while 17 percent expect to sell to a third party, 24 percent plan to sell/gift shares to family, 37 percent plan to sell to employees and 17 percent plan to sell shares to both employees and family members.

The second alternative is to sell the business to a third party. Many business owners assume that this is what they will do. In our survey, even though 17 percent expected to sell to a third party, in reality, only about 10 percent of transitions take place with a third-party sale. This is because there are few third-party buyers for contractors. The most likely potential buyer is another contractor. There have been more unsuccessful consolidations than successful consolidations. There are many private firms that might seem to be possible buyers, but they often have the same continuity problem that the seller has. Therefore, while there may be a buyer for a particular business, selling to a third party is not easy.

The third alternative is to sell the business to employees or family. The majority of business owners will use this alternative. Contrary to what most assume, an internal sale is often as lucrative as or more lucrative than a third-party sale. This is because the typical internal sale is accomplished over a period of time, typically a five- to 10-year period, so business owners can continue to participate in the earnings of the firm during the transition.

More risk is associated with an internal sale, because the proceeds paid out over time are dependent on the performance of the business. Owners often balk at an internal sale because they assume the next generation has little money to buy them out. In fact, the two major concerns from owners about transferring ownership are: 1) Employees cannot afford to purchase the company and 2) Owners are not ready to transfer ownership yet. While transitions are inevitable, many owners are hesitant. Therefore, owners tend to think that they are following a plan described by the acronym, BYOWYOS, or Buy Yourself Out With Your Own Money. After all, the employees have been working for the business owner for some time and may not have been paid large bonuses. The business owner, in order to make the internal sale work, assumes a portion of the business's profits will be given to the employees so they can buy stock. While it is true that an allocation of profits to employees is usually a necessary part of the structure for an internal transition, key employees should be helping to create those earnings through their activities working with key customers, running successful operations and generally helping the business. Indeed, if the owner is not allocating some earnings to employees in some form, potential employee successors are likely to leave, particularly the more entrepreneurial ones. Our experience is that if the owner plans properly, the internal sale can motivate employees to excel, and the owner can help keep his best and brightest around to grow.
the business and make the owner more money by the end of the transition. Planning for a transition not only makes sense, but it increases the probability that the business will survive and the business owner will have a more successful retirement. Family and employees are also likely to be appreciative of the business owner that has a plan.

**Equity Transfer Techniques for Sale to Employees or Family**

**The Internal Transition Process**

Exhibit 4 shows five steps in succession planning. First, objectives need to be defined for the business owners. The objectives for the business and potential successors should be defined as well. There is no fixed list of objectives, but objectives need to be practical. For instance, an owner may desire to sell to a third party, but the business may not be salable. Alternatively, the owner may want to transition the business to children, but the family may not have an interest in joining or owning the business. Having clearly defined objectives allows you to test your objectives against the reality of your situation.

Second, the owners need a realistic understanding of the value of their businesses. Often owners have in mind a certain amount they want for their businesses; however, that amount may not be realistic in the third-party market. That amount may not be feasible for an internal sale either, without putting financial stress on the business. Obtaining a realistic understanding of value makes the likelihood of success for the ownership transition plan much greater and will save time.

Third, the owner needs to explore and select appropriate ownership transfer techniques. There are certain keys to all techniques, such as business profitability and having management successors. There is no correct answer for all situations; selection of technique is driven by factors including the corporate structure, tax situation, time frame, existence of non-operating assets or businesses, and the objectives of owners, the business and next-generation potential buyers.

The fourth and most important step is for the owner to understand and address the management succession issues. None of the ownership transition techniques will be successful if the next generation of leaders is not properly developed. There must be someone to take the CEO’s chair, even though most owners expect to sell their stock to employees or family members. Those who expect to sell to a third party also benefit from having qualified successors and leaders in place. The importance of succession issues becomes even more urgent when we consider that the majority of owners plan to sell all of their stock within the next 10 years.

Finally, after developing a plan, seamless implementation and follow-through are required. Some owners develop a plan but never...
quite pull the trigger. Some are hesitant, and some just think they are too busy. Some get help in developing a plan but do not get help in implementing the plan. Our experience shows that plans optimally take five years or more to implement. In fact, all businesses should have an up-to-date, ongoing management succession plan even if the owner won’t retire anytime soon. This approach makes the management succession plan a part of the business plan and less of a special task that owners may not address.

The Mechanics of a Transition Plan
There are three categories of internal ownership transition techniques; 1) traditional tools, 2) partnership tools and 3) ESOP. Traditional tools include a direct sale of stock to employees and recapitalization. Both of these techniques utilize the existing corporate structure.

In the partnership tools category, instead of the owner selling his or her existing company, a second company is started that is owned by select employees—often dubbed Newco. The original company (Oldco) then helps Newco to be successful. This option is very popular in the construction industry because it works like a joint venture. A few variations of this concept will be reviewed in this section. While only a few owners of construction firms are currently using this option, FMI expects more to do so, especially since more companies are now utilizing LLCs rather than corporations and because of the flexibility this technique provides.

Finally, the third category of transition plans is the Employee Stock Ownership Plan. Many firms have been successfully using this popular technique. However, ESOPs tend to have limited application for companies desiring to maintain family ownership or for smaller companies in general.

Traditional Tools—Direct Sale
The direct sale is a sale of stock from the owner to the employees. One hurdle to implementing this approach is that the owner must first have employees who are interested in buying stock. Construction firm owners may be surprised to learn that their employees are not necessarily interested in purchasing stock in the company. While this may indicate lack of interest by employees, it may also be that employees hadn’t thought of ownership as a possibility.

To implement a direct sale, employees normally fund the purchase to the extent they can with their personal funds and to the extent they can with borrowed funds. Over time, they may supplement their funding of the purchase with a portion of their compensation and/or their share of profits. Business owners may 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 enough borrowing capacity to make an initial payment. In addition, business owners are understandably reluctant to give up their stock and control without being adequately paid.

There are also surety issues 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.

An owner using this technique is likely to have covenants on any notes that he or she accepts to provide protection should the employees not perform. The owner is also likely to remain involved in the business for a transition period to satisfy bonding and banking purposes and to help with management succession issues. The reality is that, when an owner sells the business for a note, he or she retains the risk of the failure of the business. Therefore, another of the techniques discussed below is often preferable.

Despite the potential problems with this technique, we find that more than 25 percent of contractors indicate that this is the technique they are utilizing.

Traditional Tools—Subchapter S Buyout
The premise of a Subchapter S buyout is that an S-Corporation pays no tax at the federal level because the corporation 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 the amount they paid for the stock plus their share of earnings that are retained in the company. By contrast, a shareholder’s basis in a C-Corporation is what the shareholder paid for the stock or originally invested in the business. Retained earnings are not added to the amount paid to form the basis in the stock of a C-Corporation.

Another advantage of an S-Corporation is that the company may distribute current income or the AAA account without affecting its taxation. (The AAA account is the Accumulated Adjustments Account representing a shareholder’s share of a Sub-S corporation’s retained Sub-S earnings.) In contrast to the S-Corporation, when a C-Corporation distributes earnings, the earnings are taxed as dividends. In the S-Corporation, retained earnings can be transferred in and out of the corporation freely without creating a taxable situation.

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

*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 may be distributed to the owners. Distributing retained earnings makes the company smaller, which makes it easier to sell it to the employees.

*The employees 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 the employees’ savings or from proceeds from a home equity loan.

Annually distribute all or most of the profits as compensation or Sub-S dividends. 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, a portion of the profits may be allocated to be retained. Annually, after paying taxes on their distributions and compensation, the employees may then buy additional stock from the current owners. The selling owners retain their share of distributions and compensation and then sell stock to employees. By doing this, most of the earnings have been distributed to the selling owners and employees have received their share by paying taxes and then buying stock from the owners.

Repeat the above procedure until the selling owners are bought out.

Exhibit 5 shows an example of this process.

As shown in Exhibit 5, in practice, if employees can achieve a 20 percent ownership, then by repeating the buyout, they can achieve a complete buyout within a reasonable period of years. Subchapter-S buyouts usually take a minimum of five years to complete; however, they can take 10 years or more, depending on profitability. The key to moving the transition along is a large enough return on equity and determining a fair valuation.

Subchapter-S buyouts work well because they better align 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 he or she 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 percent to the employees is typically the maximum that is feasible as a starting point; therefore, the owner typically still owns 80 to 95 percent of the company after the initial sale. Because control does not change hands for several years, this transition period becomes an excellent time to train employees, to give them more responsibility and to 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 Subchapter-S buyout include the following:

1. If control is an issue and selling owners want to maintain control beyond when their ownership drops below 50 percent, 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 Subchapter-S transaction is typically accomplished with little debt. In the construction 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.

Finally, the selection of a valuation method for the buyout is an important consideration for Subchapter S buyouts. The example shown above employed 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 useful. 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 be interested. The valuation should be such that the transition will take place within a reasonable time frame, such as five years.

Exhibit 5: Employee Purchase of Stock Using Subchapter-S Distributions

<table>
<thead>
<tr>
<th>An Example</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
<th>Year 5</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$</td>
<td>$</td>
<td>$</td>
<td>$</td>
<td>$</td>
</tr>
<tr>
<td>Pretax Corporate Income</td>
<td>500,000</td>
<td>500,000</td>
<td>500,000</td>
<td>500,000</td>
<td>500,000</td>
</tr>
<tr>
<td>Existing Shareholder’s Portion</td>
<td>475,000</td>
<td>467,000</td>
<td>456,440</td>
<td>442,501</td>
<td>424,101</td>
</tr>
<tr>
<td>Employee Shareholder’s Portion</td>
<td>25,000</td>
<td>33,000</td>
<td>43,560</td>
<td>57,499</td>
<td>75,899</td>
</tr>
<tr>
<td>Income Taxes (30%)</td>
<td>9,000</td>
<td>11,880</td>
<td>15,682</td>
<td>20,700</td>
<td>27,324</td>
</tr>
<tr>
<td>New Dividend Income to Employee</td>
<td>16,000</td>
<td>21,120</td>
<td>27,878</td>
<td>36,799</td>
<td>48,575</td>
</tr>
<tr>
<td>New Ownership Total</td>
<td>66,000</td>
<td>66,000</td>
<td>66,000</td>
<td>66,000</td>
<td>66,000</td>
</tr>
</tbody>
</table>

Notes:
1. Assume equity of $1,000,000 is held constant throughout the period.
2. Key employee owns 5% of stock in year one.
3. All earnings are distributed annually through dividends or cash bonuses.
to 10 years. Further, it should be sustainable so that when the next-generation of employees retire, the plan will be effective again, utilizing the same valuation methodology. Having a conservative valuation to begin with will increase the odds of the plan succeeding.

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

The Subchapter-S buyout is a very flexible technique and requires minimal legal agreements. A buy/sell or shareholders’ agreement may be all that is required. Most companies with multiple shareholders have these agreements already. Beyond that, legal agreements are generally not required. We recommend that there is a plan agreed to by the selling and buying shareholders defining objectives, procedures and models describing the buyout. The following examples explain why binding legal agreements are not recommended. First, assume 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 the company, they are not likely to be effective at running the business. Alternatively, assume two years after starting the transition that 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.

Recapitalizations are sometimes effective when used with C-Corporations. Unlike S-Corporations, C-Corporations pay taxes on their income at the corporate level, and dividends to shareholders are taxable. With C-Corporations, 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 where shareholders only receive their earnings after Class A shareholders receive their 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 increased earnings beyond the Class-A allocation, the common stock is allocated its amount of earnings. This system 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 out of favor in the last 28 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 6, the new owners will set up Newco and contribute what money they can, and again, as with the Sub-S buyout, the amount the new owners can contribute 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; working capital, such as receivables and payables; and equipment. Then all or most of the organization moves to Newco as well.

Newco is typically 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 toward the new owners in recognition of their “sweat equity” if desired. In practice, LLCs provide flexibility when determining how profits are divided between the parties.

Over time, as Newco makes money, the new owners in Newco will accumulate enough earnings to increase the company’s net worth. Generally, distributions are only made to the Newco shareholders in order to pay their taxes. Oldco will receive distributions of its share of the earnings and return of capital. After a period of years, Newco should accumulate sufficient capital so that Oldco’s support is no longer needed.

The advantage of this technique is that the selling shareholders can retain any non-operating 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 that 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, IRS rules require the price to be “fair market value,” or the stock may be deemed a gift. In the Oldco/Newco structure, shares are not being purchased by the new shareholders, so valuation risks are lessened.

Newco could also be set up as an S-Corporation, and a joint venture might be set up as shown in Exhibit 7.

Under this framework in Exhibit 7, 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 and without major investment by the employees. This technique is used frequently and works well in the construction industry. Because it has many similar characteristics to 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 loan 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 their stake in the profits, but they still retain the risk of Newco’s potentially poor performance and inability to generate sufficient profits to pay them for their services. While FMI finds that only about 5 percent of contractors use these partnership Oldco/Newco techniques, FMI expects more contractors to begin using them because of the flexibility of the technique, particularly in more complicated situations.

**Employee Stock Ownership Plans**

An ESOP is a qualified retirement plan for the selling company. It is regulated by ERISA (the Employee Retirement Income Security Act of 1974) as are other retirement plans like 401(k)s or profit sharing plans. ESOPs are generally set up for the benefit of all non-union employees; however, 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 pro rata to the employees’ compensation up to a maximum set by the IRS.

The company may contribute up to 25 percent of its eligible payroll to the ESOP annually. Usually contributions are not this high, as they would reduce the profitability of the business. Contributions are sometimes made in lieu of a 401(k) and sometimes in addition to a 401(k) or profit sharing plan.

Exhibit 8 (below) illustrates the ESOP structure. The company’s board appoints a managing trustee for the ESOP. The company can be a C-Corporation or an S-Corporation. The ESOP will often borrow money guaranteed by the corporation to purchase the selling owners’ stock or sometimes accumulate contributions in order to purchase stock later. The corporation will typically make annual contributions to the ESOP. The ESOP uses the contributions to pay down the ESOP debt or to purchase stock from selling shareholders. If the ESOP borrows money to purchase the stock, the debt is considered a liability on the company’s balance sheet which may affect the bonding capability of the company.

ESOP companies often start by purchasing 30 to 50 percent of the company and may then later become a 100 percent ESOP.
The advantage of starting at less than a 100 percent ESOP is that less debt is needed initially. This helps ensure the company’s 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 the retirement plan (ESOP), it does not pay taxes when the income is earned. Taxes will typically be paid many years later after the 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 percent 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 few percentages 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 that make sure their executive team is properly incentivized and compensated are the most likely to have a successful ESOP experience.

Exhibit 9 shows the vesting schedule minimum guidelines provided by ERISA. The vesting schedules will tend to work in favor of longer-term employees. In the first schedule illustrated, employees do not initially vest until after two years, then they continue to vest over the next five years, until they are fully vested in year seven.

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

Exhibit 10 lists advantages and disadvantage for construction industry ESOPs.

In summary, the ESOP is a technique that is commonly used in the industry. Although many companies seem pleased with their ESOPs, they often end up buying them out or selling them to a third party due to the disadvantages in Exhibit 10. The ESOP is usually the most tax-efficient way to sell stock from one generation to the next. However, if an owner is going to utilize an ESOP, he or she should understand the issues and complexities that surround it.

FMI expects that the percentage of companies using an ESOP will remain about the same or even increase as industry participants get larger. It is a very tax-efficient technique; however, the complexities make it less desirable for smaller companies. ESOPs also do not meet the objectives for owners who want their companies to remain owned by family members or by a limited number of high-performing employees.
Fundamentals of the construction industry. Before addressing what makes a business salable and how to position it in the market, we will review some of the fundamentals of the construction industry that affect the marketability of industry firms. First, the construction industry is fragmented; across the country and internationally, there are tens if not hundreds of thousands of construction businesses. And, despite numerous consolidation efforts, the industry has remained fragmented. One reason for fragmentation is that most construction markets are local. There are some consolidators, like the IREX Contracting Group, which have built national businesses. Another reason the industry remains fragmented is that there are limited economies of scale in the construction industry. However, we see signs of this changing as more megaprojects have been in the works. These megaprojects cause a squeeze on local players when the larger companies have the resources not available to local players.

The second construction fundamental is that market opportunities come in waves. Currently, there is a wave of construction going on in the energy space in alternatives and upgrades to the grid. There is also a boom in oil and gas mining in the shale-rich areas of the country. 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 with office buildings being built to support growth and incentivized by then liberal depreciation schedules. In the last 50 years, we have seen numerous waves in the economy that 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.

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 percent of companies are sold to a third party, while about 60 percent of companies are sold or transferred internally to employees or family, and 30 percent (especially small companies) are liquidated. Therefore, the first question a business owner that wants to sell should ask is whether a third-party sale feasible for his or her company? Alternatively, if the owners are not ready to sell, what will a third-party buyer eventually look for in their business, and how can they position their business for a third-party sale?

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 some in the industry down. Banks and sureties tighten their lending and bonding criteria during downturns. All these trends together exacerbate the cycle and put the weaker contractors in jeopardy.

These fundamentals, namely 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 there are many companies a buyer could buy; and many of them will have continuity problems or other reasons to be motivated sellers. Why should a buyer particularly want your company? Market waves signal to the well-informed 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 making and valuation of the firm. Construction is a slow-growth 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, 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 very 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. 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 a construction company and what do you have? Take the top three, four or five people who drive the business out of the business equation and 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 to drive the business for its new owners. Many businesses are very successful, but
if the main driver of the business is the owner that 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 to be successful 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. Owners understand their company better than anyone does; they understand the risks, and they live and breathe the company every day. In the case of our survey respondents, 48 percent expect to receive book value or net worth for their company when sold. Forty percent expect the value of their company to be a multiple of earnings/cash flow. When asked what multiple would be appropriate, 44 percent said four to five times pretax income. However, both buyers and sellers must realize that selling to a third party often inherently hurts the value of the company just because the ownership has changed hands. 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 to the transition and future prospects. In the end, these changes may be healthy, but in the short term, change can be distracting and unsettling.

The realities of buying and selling contractors. In the light of FMI’s industry experience, the fundamentals of the construction industry and the factors that drive business value, we will take a brief look at the realities of buying and selling construction firms. First, relatively few sales are completed each year. As stated, 10 percent or fewer of construction industry firms change hands through a merger or acquisition. Second, contractors tend to be bought out by other contractors; occasionally, private equity or investors will buy out 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 an exceptional price.

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 is often 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, they are likely to sell the business to a strategic buyer or another private equity firm or perhaps prepare it for an IPO (Initial Public Offering).

Most private equity firms focus on manufacturing and distribution businesses, but there has been some investment in the construction industry. Most private equity firms are looking for companies that have a minimum pretax profitability of $5 million per year, although there are some private equity firms that 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 about how to structure deals; however, maintaining the management team to run the business with some level of continued ownership is a requirement for most private equity investors.

The biggest hurdle to 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 only initiates 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.
Most business owners view liquidation as the least desirable option. It has the principal disadvantages of being time-consuming and can erode value with the costs of winding down projects, continued overhead costs and selling assets. Liquidation does have the advantage of not having to worry about succession issues or a sell process. It is most appropriate for smaller operations where one person principally drives the business.

A sale of the business has the great advantage of quicker liquidity. Usually, some of the purchase price will be held back in the form of an escrow account, but a seller will get his/her money sooner when selling to a third party. The seller also has less risk if the business performs poorly after the sale and does not have to be as concerned with management succession after the sale. The primary disadvantage of a sale is that it may be difficult to find a buyer.

Selling to a third party, such as a strategic buyer, is the cleanest exit strategy. There will typically be accomplished by a purchase agreement providing substantial payment at closing and defined warranties and representations from the seller to the buyer.

A private equity recapitalization is essentially a partial sale where some liquidity is realized; however, some interest in the business is retained. The advantage is getting some liquidity at closing; the disadvantage is having to wait for a second transaction to most likely meet the business owners’ full sale’s objective. There is also risk as to whether the selling business owner(s) will mesh with the private equity firm. Private equity firms can be great and understanding partners when the business is going well. They can be more difficult if the business is struggling. Private equity firms have a fiduciary responsibility to their investors, so they are expected to make decisions that are in the best financial interest of their investors regardless of other considerations.

The private equity alternative makes the most sense when the business owner wants to grow the business, but wants to grow it using somebody else’s capital. The seller should also be comfortable with the fact that the company will likely be sold or recapitalized again within seven years in a manner that maximizes the proceeds for the private equity firm. It is advisable for the seller to be happy with the proceeds from the first sale. The second sale should be viewed as icing on the cake and make the seller very happy.

The internal sale is the most likely exit alternative for wall and ceiling contractors. Deciding which of the internal structures will work best for an individual company is a function of the objectives of the selling and buying owners and the company, as well as other situational factors of the business.

The Sub-S buyout works very well for a business owner where the operation and assets to be sold are in one corporation without extraneous assets or businesses. Selling the existing company provides simplicity in that only one tax return needs to be submitted, and once the owners have sold all their stock, they can cut their ties with the business.

Oldco/Newco techniques work very well when there is a need for the selling shareholders to retain some assets or businesses or generally hold something out of the transaction. It does add a second entity that requires its own tax return to be submitted. The taxation procedures add complexity versus conventional techniques utilizing one entity. FMI’s recommendation is to use the simplest technique that is workable. Therefore, selling the business as a single entity should be considered before choosing the Oldco/Newco technique.

ESOPs provide a very tax-efficient method to purchase a seller’s stock, and, if the business is Sub-Chapter S, a very powerful approach for accumulating capital. Forming an ESOP does add a level of complexity that is not for most firms. Before utilizing an ESOP, simpler techniques should be considered. One should also consider how the ESOP would fit with the company’s culture. ESOPs are probably appropriate for select wall and ceiling contractors.

The technique that is best for a particular firm is very situation-specific. Determining what is best for the particular firm starts with understanding the owners’ objectives and the situation the business is in.

**Implementing a Transition Strategy and Pitfalls to Avoid**

There really is a light at the end of the tunnel. For the first time since the economic downturn, we are seeing an increase in buyers who are considering the acquisition of specialty

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**The Positives and Negatives of Transition Options for Firms**

We have presented several exit alternatives shown below in Exhibit 11.

**Exhibit 11: Exit Alternatives for the Construction Business Owner**

1) Liquidation
2) Sale
   - Sale to a third party.
   - Private equity recapitalization.
3) Sell to employees or family
   - Direct sale.
   - Sub-S buyout.
   - Oldco/Newco strategies.
   - Employee Stock Ownership Plan (ESOP).
trade contractors. It is not surprising that this has coincided with healthier backlogs and an overall increase in contractor confidence. Both financial and strategic buyers are showing interest in mechanical, electrical and other trade contractors, and while most prefer nonunion firms with a strong service component, there are a number of buyers interested in attractive union shops.

An abundance of low-cost natural gas is creating opportunities (as well as labor strains) for industrial specialty contractors. There is an old saying that every dog has his day in the sun, and that is certainly true of contractors involved in industrial construction. Throughout the nation, and for union and nonunion firms alike, backlogs are strong and margins are higher than they have been in recent memory. This has created intense pressure for labor at all levels and is driving M&A activity in this sector.

Management succession issues are threatening the continuity of many firms. Nowhere do we see the imbalance of baby boomers and Generation Xers more clearly than among specialty trade contractors. Quite simply, too many baby boomers want to exit senior management positions, and there are too few Generation Xers to replace them. Complicating this situation, many owners and senior managers have delayed their retirement because of the economic downturn. These owners are often unwilling or unable to execute the traditional succession and ownership transfer techniques, which can take up to 10 years. It is difficult, and sometimes impossible, to bring in external management, and the lack of internal talent is threatening the continuity of many firms.

Focus on recurring revenue. Many industry experts (including FMI) believe that margins for commercial construction work will remain relatively depressed. Too many trade contractors are chasing too few jobs.

Increasingly, sophisticated construction managers and owners employ legions of project managers and engineers, cost accountants, MEP coordinators and others whose function it is to scrutinize every billing to subcontractors. Some owners are buying equipment and materials directly for the job and bypassing the subcontractor. All of these factors and more are contributing to lower margins. In order to combat these trends, many trade contractors are rediscovering the advantages of dealing directly with the end user and building a stream of recurring revenue.

Mechanical contractors are building service groups. Fire protection contractors are focusing on inspections and service. Electrical contractors are diversifying into energy management services. Conversely, many firms are also remembering the reasons they did not build these groups in the past. It is a slow, expensive, time-consuming process and demands a completely different approach to the business.

To those who stay the course, the rewards can be significant. Project sophistication gives trade contractors leverage with GCs, CMs and owners. As building systems become more complex, the expertise of trade contractors has become increasingly essential to the outcome of sophisticated projects. While this has been a longtime trend in the heavy industrial market, biotech, health care and higher education building projects demand a high level of sophistication in building automation, controls, optimization and energy management that is beyond the comfort level of many general contractors. This critical expertise is giving knowledgeable contractors in these markets higher margins and allows more work directly with owners.”
Conclusion

The first step in solving a problem is recognizing that there is a problem. The next step is to understand how large or important the problem is in order to prioritize and devote the right amount of attention and resources to solve the problem. However, that is not the last step; the problem is not solved until there is a plan to attack it and that plan is fully implemented. In this report which analyzes the results of our survey below, we have shown that recognizing the need for and planning an exit strategy should be a high-priority concern for all owners of construction firms. For most owners, selling their stock and exiting the business is a once-in-a-lifetime occurrence, and there is a tendency for the owner to put those decisions off until later. Nonetheless, we have also tried to show that, even if the owner is not planning to retire this year, there are many benefits to having a working exit strategy and ownership transition plan. While some owners may think they have too many irons in the fire to worry about it now, preparing leaders and successors who will one day become majority owners of the company will help the owner to manage his or her day-to-day problems as well. Even if there is a plan to sell the business, the buyer will place a higher value on a company with a succession plan and depth of leadership.

FMI often recommends allowing five to 10 years for implementing a successful transfer of ownership, depending on the goals of the owner, the means of transfer and other factors. In reality, every company should have an ownership transfer plan in place even if the owners do not plan to retire for many years. For one thing, bonding companies and banks like to see an ownership transfer plan in place, but it should also be part of good business planning and strategy. Ultimately, a successful exit from the business will preserve the value of the business that the owner has built over the years. It will also help to retain the best talent—for one day they may be owners and continue to grow the business for generations to come. Building a legacy and building wealth for the owners and those who work for the company require a long-term view, and management succession and plans for ownership transfer are a key part of the continuing success for the company.

Ownership transfer is best viewed not as just a one-time event, but as a continuous growth strategy at the heart of the business. Whether ownership transfer is a sale of the business to a third party or the transfer to family and employees, for future success and continuity of the business, all companies need to prepare for the next generation. A formal coaching and mentoring process will help the current owners to prepare the next owners and leaders to keep the business going strong. Coaching provides insight and focus so that the new owners can more efficiently move forward to where they want to be. A mentor teaches skills based on the mentor’s personal experience to one who is usually less experienced and often in the same profession. The coaching process does not rely on the coach’s experience or being in the same profession. Instead, the coach guides the client on a unique path in order to help the client meet his or her goals and objectives. In preparing and executing an exit strategy, it becomes clear that the owners of the company are not just working in the company; they are working on the company to leave a body of work or an ongoing and healthy business to the new owners or the next generation, thereby realizing the fruits of all of their own hard work and preserving the wealth they have built up in their company over many years.
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