2024

OWNERSHIP TRANSFER & MANAGEMENT SUCCESSION

FMI AND CFMA INDUSTRY STUDY

CONSTRUCTION FINANCIAL MANAGEMENT ASSOCIATION

INTRODUCTION

The domestic engineering and construction (E&C) market has experienced meaningful expansion since 2020 — with a 9.7% compounded annual growth rate for total put-in-place construction, per FMI research. While this has created opportunities and value for many participants, it has likely decreased opportunities for long-term ownership transition planning. A deliberate ownership transfer and management succession (OTMS) strategy is a must-have for E&C company owners who want their enterprises to thrive into the future.

The reality is that a small percentage of E&C firms are saleable to a third-party and most desire to remain independent. Removing the sale option means firms must look more carefully at internal alternatives and key succession considerations — a prospect that's not always easy to tackle when owners assume their firms are worth more than the market will pay.

To learn more about what executives are thinking and doing about OTMS, FMI partnered with the Construction Financial Management Association (CFMA) in early 2024 to survey almost 300 construction executives. Our findings indicate that half of the 38% of owners who plan to exit in three to five years have no ownership transition plan, putting them and their enterprises at significant transition and financial risk.

The analysis that follows includes tactics for exploring and preparing for your transition and positioning yourself and your company for long-term success. Because whether your business is a young operation or a more mature one, the earlier you start exploring options for OTMS, the more manageable risk mitigation will be, ensuring business continuity and protecting your legacy.

58% of respondents reported they do not have an ownership transfer plan.

> "Many owners in the industry assume that there will be a buyer for their business based on historical performance or a strong backlog. But you can't sit idly by and hope a buyer will come along — you must plan for all potential scenarios."
>
> — **Matt Godwin**, Managing Director, FMI Financial Advisory Services

THE TIME TO PLAN FOR TOMORROW IS TODAY

We are experiencing a generational transition as baby boomers depart the workforce at accelerating levels. In this landscape, our survey indicates that OT planning is decreasing: 58% of respondents don't have formal plans in place, versus 50% in 2020.

Whether you're selling to an outside party, leveraging an internal transfer or establishing an employee stock ownership plan (ESOP), planning is essential to drive both value and organizational strength. It is the most effective way to safeguard your legacy and create an enduring enterprise, something 47% of our respondents say is important to them.

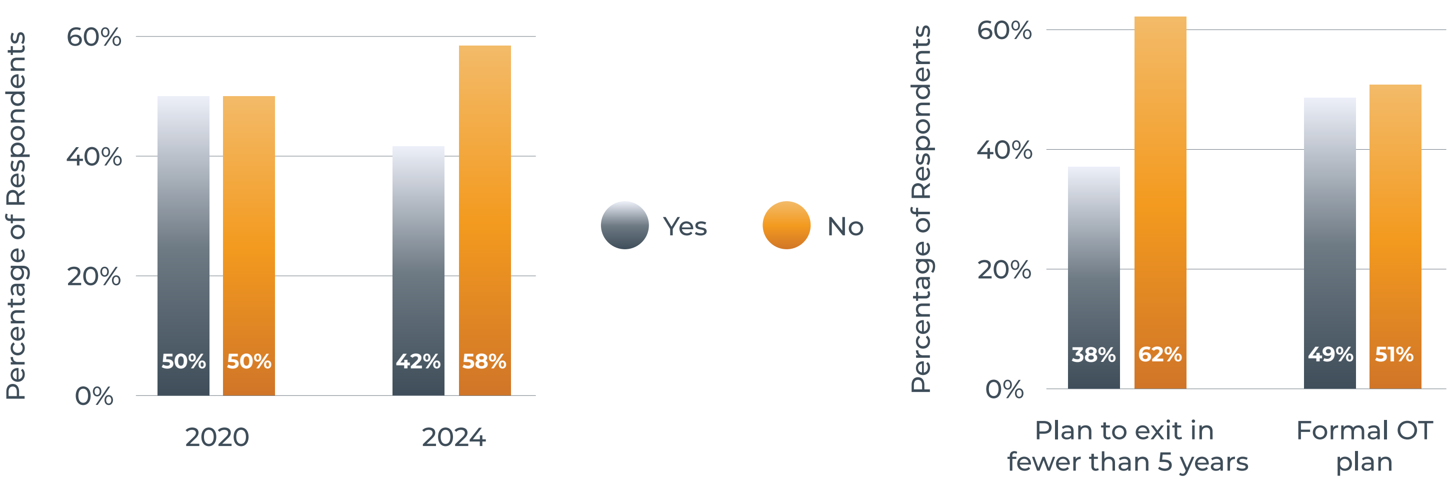
Planning early also supports future flexibility should certain business aspects shift.

"[Say] you've got the family name on the billboard out front or a multigenerational business," says Nathan Perkins, managing director, ESOPs, FMI Capital Advisors. "When you're thinking about the disposition of an asset like this that you've held, in some cases, for decades and with a lot of people who helped you get there, you feel very strongly about what you leave behind."

Again, planning must start early. In working with hundreds of clients over the years, we've found it takes several years to prepare for a smooth transition and roughly eight to 12 years for a full transition in ownership and leadership.

"Most people, most of the time, wait too long because OT and MS are important but not necessarily urgent until you decide you want to be out of the business in one to two years," explains senior consultant Ryan Quigley. "You can start then, but it decreases your options quite a bit. That's why it's never too early to start thinking about it, even if you feel you've got many years left in the business."

EXHIBIT 1: "Do you have a formal ownership transfer plan?"



*Of respondents wanting to exit in less than five years, 51% do not have a defined OT plan.

Source: 2024 FMI and CFMA OTMS Survey

OBJECTIVES DEFINE THE PATH FORWARD

Our experience tells us that building a sustainable organization is the most important aim a firm can adopt to enable a departing owner to access liquidity. Maintaining family ownership remains a key component in the E&C industry, which requires careful planning. When thinking about broader ownership, take into account the following factors:

- Requirement to enact stock transactions — the company has reached another level of scale and value
- Lack of available family successor, or family aims to de-risk
- Desire to align ownership with those responsible for managing business risk
- Use of ownership as a tool for recruiting and incentivizing talent

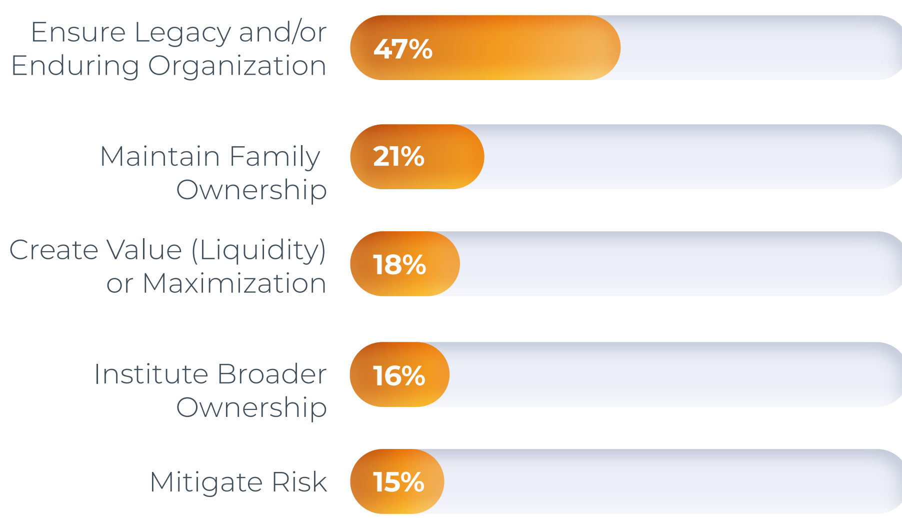
"It can be lonely at the top. As our firm has expanded, it no longer makes sense for one person to own 100% of the company and shoulder the burden of risk. We are now moving to a broader ownership structure (two to four key employees) to align with organizational needs."

— Midwest Specialty Contractor

Ultimately, the primary objectives of current and future owners inform initial transition options. An important consideration is where a company sits in its lifecycle. We have many clients who are expanding and developing significantly and have evolved beyond their existing ownership structure. In many such cases, establishing a broader ownership structure is necessary to facilitate required transitions or to use ownership as a tool. Bringing in additional owners can help transform the organizational culture and align key employees with the corporate mission.

IMPORTANT: *You must consider the number of shareholders and the number of shares allocated to new employees. As an example, if an owner will only be able to obtain 1-2% of stock, is it more meaningful and manageable for that employee to benefit from a quasi-stock or incentive compensation plan than to be an actual equity holder?*

EXHIBIT 2: "What are your objectives when thinking about the next steps for ownership?"



*Respondents were able to choose more than one objective.

Source: 2024 FMI and CFMA OTMS Survey

WINNING A DIFFICULT CHESS GAME

When asked about transition planning, Steve Lamp, secretary/treasurer of Lamp Incorporated, offered a question that many in the industry are trying to address: "How do you get your value out and still keep your legacy going? I think that's the biggest hurdle right now."

When we talk about ownership transfer, there's no clearcut answer to Steve's question.

Ownership transfer is like a chess game — it involves a lot of moving parts and very focused concentration to navigate successfully. The often-competing priorities of timeline, financial gain, control and risk can make selecting the optimal ownership transfer methodology a difficult decision.

Successful OTMS is not just estate planning or solving for the outcome of one individual. It's not simply a financial, organizational or family problem — or a bonding and banking problem. It's a combination of these elements and constituents, each one unique and with different challenges and objectives. Making all the pieces fit together requires due consideration and objective counsel, and is contingent upon your company's individual nuances, traits, successes and failures. That's why a longer-term strategic approach is crucial to correctly assessing your options and choosing a path that's right for your firm.

UNDERSTANDING INTERNAL OPTIONS

Most respondents (64% vs. 66% in 2020) intend to transition ownership internally, which aligns with the overall E&C industry landscape. While we note that less than 3% intend to liquidate, history tells us that number is closer to 5-10% due to a lack of capable successors.

The trend is also likely driven by a pervasive belief among industry owners, Perkins suggests. "A lot of people in our space feel like selling to a private equity firm or even a strategic buyer is less advantageous to the legacy they leave behind."

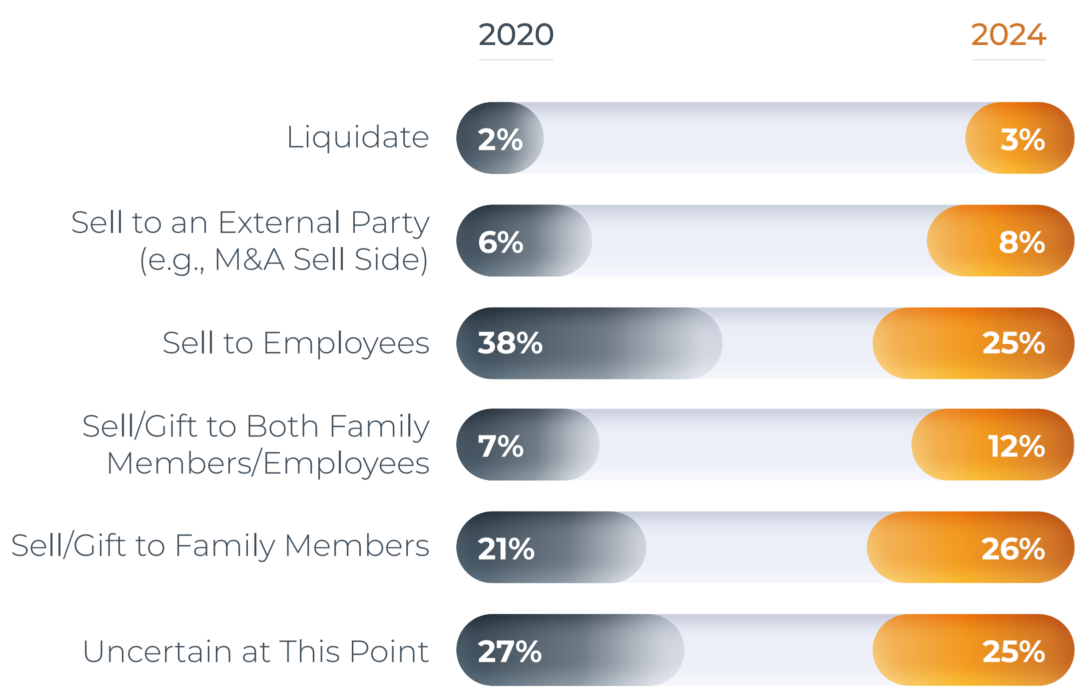
Ultimately, of course, a business owner must determine the best long-term ownership and governance model for their company.

Notably, this year's research revealed a change in internal tactics since the 2020 survey:

- 25% intend to sell to employees, down from 38%
- 20% plan to have family buy shares, up from 15%
- 8% aim to gift shares to family members, down from 14%

The decline in plans to sell to employees must be looked at in context, as the majority of respondents (66%) identify as family-owned businesses — and family businesses are the most common form of business in the world, accounting for 50-75% of GDP and workforce. We see a greater number of firms looking at internal transition options because in most cases, the most pertinent buyers are the next generation of family members. The increase in family members buying shares and the decrease in family members receiving shares as a gift may be a function of the need to generate certain levels of liquidity for transitioning owners.

EXHIBIT 3: "My ownership plan is as follows"



Source: 2024 FMI and CFMA OTMS Survey

KEY CONSIDERATIONS FOR THOSE PURSUING INTERNAL TRANSITIONS

ENTITY STRUCTURE: Sixty-four percent of respondents are S corporations and 17% identify as limited liability companies (LLCs). Typically these firms use pass-through entities to fund stock purchases through annual profit distributions.

IMPORTANT: *25% of respondents indicated they are unsure about their long-term OT plan. Though not surprising, this speaks to the amount of risk (transition, financial) held by E&C firms without a defined means to address their future.*

PURCHASE MECHANISMS: The two most prominent purchase mechanisms are a note at an agreed-upon value (20%) and a gradual sale of stock over time (49%). Both are highly utilized in the industry, and the selection of the appropriate mechanism is largely a function of the readiness of your people.

IMPORTANT: *The amount of upfront investment for new shareholders is crucial from a risk alignment perspective.*

INTERNAL SALE VALUATION: Most respondents intend to utilize a book (equity) value as the primary valuation mechanism, though some firms utilize a slight discount or premium. In many cases, this is used as selling shareholders obtain value via stock purchases and annual distributions.

IMPORTANT: *Valuation assessment is important because fair market value or an aggressive valuation can negatively impact the timeline and effectiveness of an OT plan.*

ESOPS: A MISSED OPPORTUNITY?

Despite their benefits, ESOPs are not widely known or understood, as indicated by the nearly two-thirds of our survey respondents who don't see them as a viable ownership transition option. Our research shows that non-family-owned businesses are far more likely than family-owned operations to choose an ESOP.

"ESOPs should be in the mix, especially in this industry, because merger and acquisition (M&A) activity is oftentimes limited by certain factors in the built environment — bonding and project-based work and unions limit the universe if you're looking for liquidity," Perkins notes.

Employee ownership makes the most sense for more mature enterprises with $3 to $5 million in earnings before interest, taxes, depreciation and amortization (EBITDA) and a bare minimum of 25 employees. This transaction option presents advantages for family-run or closely held construction companies.

First, Perkins notes, "Owners can often get more money from an ESOP sale due to the unique tax benefits. And it's usually a net win for the employees because they have a stake in the business. Plus, ESOPs are tax efficient for owners and employees and preserve company culture by keeping ownership 'local.'"

An ESOP offers a structured mechanism for transitioning ownership to employees over time, ensuring continuity in leadership and preserving the company's values, relationships and operational expertise. By facilitating an orderly ownership transfer, ESOPs mitigate the risks associated with sudden leadership changes, safeguarding long-term stability and operational effectiveness.

IMPORTANT: *How much of the company's stock is sold is an important part of the planning process. A minority sale of stock works great in a growth-oriented company where there's a desire to diversify a limited portion of company equity while preserving the option for a future sale, where in more mature companies a sale of 100% of the stock could be more efficient. It all comes down to goals, objectives and individual shareholder timelines.*

> **"This is your biggest asset. It's most of your life savings and often it's wealth that may span more than one generation. To be a good steward of that asset you need to make sure that if you're going to sell it or take some liquidity out you understand very clearly what your options are and the implications of that decision."**
>
> — **Nathan Perkins**,
> Managing Director, ESOPs,
> FMI Capital Advisors

TOP OTMS CONSIDERATIONS

- **Objectives and goals:** Start with what current ownership wants from the transition. Common outcomes are maximizing financial returns, preserving legacy, ensuring span of control and decreasing risk tied up in the enterprise.

  “The answer most of the time is ‘I want all of those,’” Quigley says. “Since some outcomes will come into conflict based on the methodology you choose, a good understanding of what’s most important to you is where to start.”

- **Organizational direction:** Next, look at plans for the business — products, services, growth, expansion — and determine capital allocation and balance sheet needs (two potentially competing priorities) that impact available liquidity.

  “Some strategic efforts draw from capital available to assist in a transition, which can delay the change in ownership,” Godwin notes. “Consider your operational strategy to define the feasibility of transition relative to defined objectives.”

- **Timing alignment:** Define your timeline and align with those of other stakeholders and leaders. For one, keep in mind that holding onto shares for too long makes it difficult to retain top performers and potential successors.

  “It’s important that next-generation owners have skin in the game, preferably earlier rather than later,” Quigley says. “If they’ve got ownership aspirations, giving an opportunity to buy shares earlier allows them to envision a pathway to ownership with your organization. Allowing them to purchase shares early also gives you more flexibility to influence the timing of your ownership transition.”

- **Contingency plans:** Consider macroeconomic factors, shifts in market dynamics, organizational changes and unexpected events that can interfere with your plans. Contingency planning is key to weathering these events. Having a defined, well-communicated plan in place gives you options and peace of mind when an impactful event occurs.

  “Certain ‘red truck’ scenarios — death, disability, unforeseen health events alongside retirement, employee poaching, failing to develop and assume greater responsibility in the organization — affect transition plans, too,” Godwin cautions.

PROTECTING KEY EMPLOYEES

According to data from the Insurance Information Institute (III), 71% of small businesses rely heavily on one or two employees but are ill-prepared if those key people are suddenly unable to work.

For example, in our research, almost a third of respondents expressed that they don't have a clear buy/sell or shareholders' agreement outlining what happens to company stock in the event of death or disability, heightening risk for the business and the owner's estate. Short-term contingency planning needs to address:

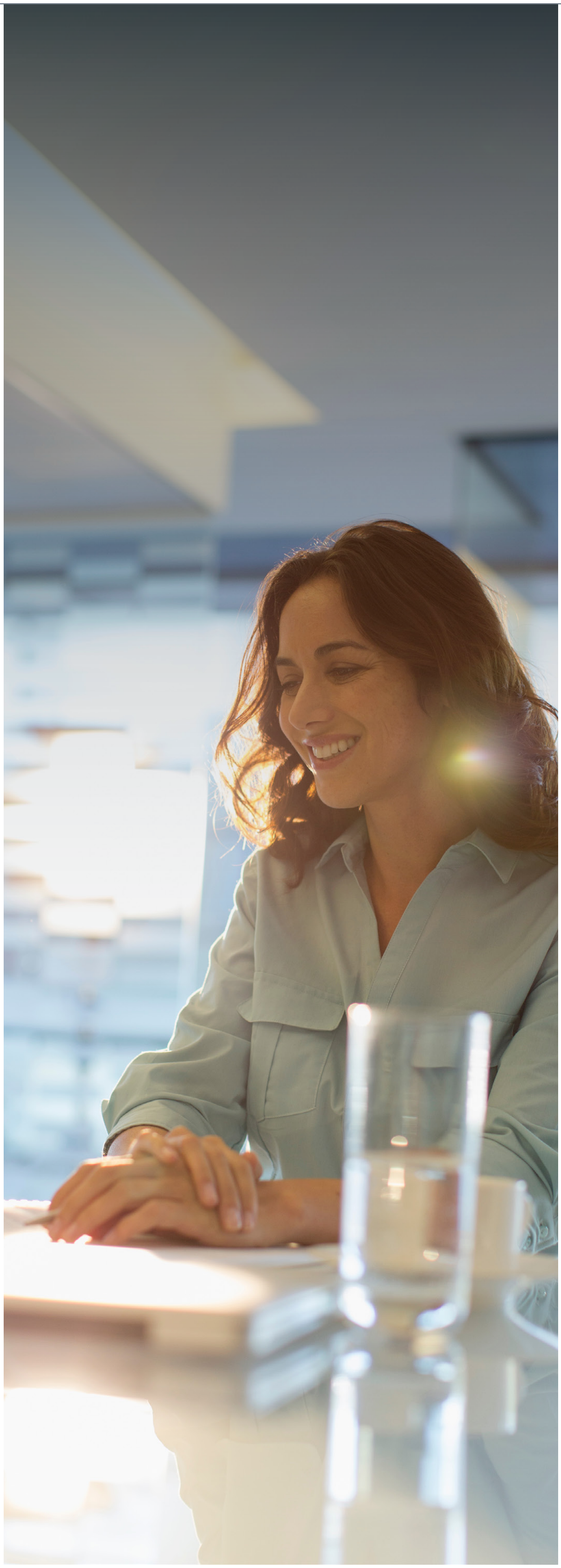
1. Leadership — how the company will be managed/led in the absence of a key leader.
2. How the departed owner's estate obtains share value. A clearly understood and articulated buy/sell or shareholders' agreement outlining valuation and funding mechanisms is the foundation of contingency planning. While always important, a defined buy/sell agreement is even more important given the 2024 U.S. Supreme Court ruling on corporate-owned life insurance.

ANOTHER ISSUE: Adequate life insurance for owners (either via the company or individual stockholders as beneficiaries). This coverage provides potential liquidity to an estate and increases business stability. Yet the III estimates that only 22% of small businesses carry key-person coverage.

"In 2022 we experienced the sudden and tragic loss of our longtime chairman and majority owner. As a testament to the exceptional leader he was, we had a succession plan in place that considered both ownership and leadership transition. While his passing was a huge emotional blow to us all, the effort and thoughtfulness he put into planning was a true gift, providing his family with a clear and smooth transition away from ownership while setting a path that allowed his company to survive both financially and operationally."

— **Samantha Hutchison, CCIFP, CPA**
CFO
Brookstone Construction

CHART YOUR PATH FORWARD WITH THE RIGHT PEOPLE



Remember, your strategy is only as good as the people who operationalize it. Our research shows that most in the industry (88%) feel they have a clear understanding of what's required for future leadership, although smaller general contractors (GCs) and specialty contractors are far less likely to have clearly defined criteria.

IMPORTANT: *Ownership criteria are not the same as leadership criteria. Not all top-performing employees have the mindset for ownership. Some may struggle with enterprise-level thinking, risk tolerance or cultural competency. "Our instinct is to promote the highest performers and keep promoting them, but leading a business unit requires a different skill set than being the owner of a company," Quigley notes. "For example, a business unit leader, depending on the structure of the business, may need to be somebody who goes out and chases work and is great at business development. That's not necessarily what you need in an enterprise-leader role."*

Without a codified point of view on leadership, you could be ill-prepared for a transition, have fewer options and prompt debate about who should be included.

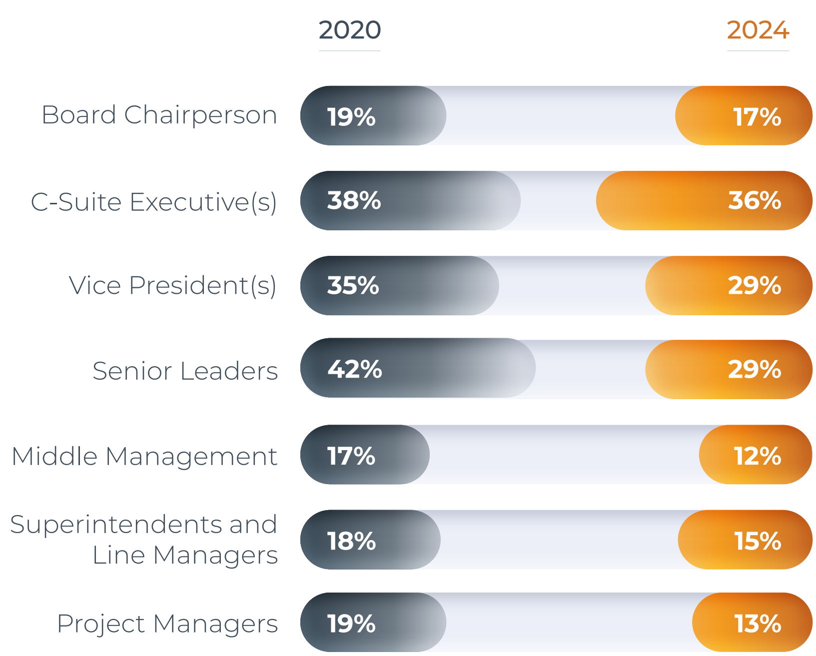
"People think, 'I've got a strong person ready to step in, and so I'll step out and everything will be fine,'" Quigley says. "But without the appropriate leadership depth up and down the organization, your successors often have a difficult time relinquishing the critical roles they currently occupy. These roles are often of paramount importance and without a strong leader ready to step in, the business could be exposed to risk. The successor ends up doing both roles with suboptimal performance compared to being able to focus on one or the other."

SUCCESSFUL TRANSITION DOESN'T JUST INVOLVE YOUR C-SUITE

Succession plans shouldn't be reserved solely for C-suite employees, as it's critical to develop talent at all levels of an organization. Think of succession as an organizational puzzle: If you remove one piece to fill a gap, then you need another piece to fill the void left in its wake.

Yet despite the importance, our study indicates that fewer companies are developing formal succession plans than four years ago (see exhibit 4).

EXHIBIT 4: "My organization has formal succession plans for"



Source: 2024 FMI and CFMA OTMS Survey

HOW TO DEVELOP LEADERSHIP CRITERIA

By enacting a clear talent development strategy, you can ensure you have a sufficient talent pipeline.

- **Get multiple perspectives.** Establishing and maintaining collaborative processes can help you understand the enterprise's future needs and align those with cultural values. It also encourages employee buy-in.

  Key questions: Who in the organization has a unique perspective on what "great" looks like in this role? Who understands what the business is likely to need from this role in the future? Who has a good grasp of our business culture and what makes this company special?

- **Define great leadership.** It's vital to quantify what effective leadership looks like at your company and how great leaders act. These should be actionable and observable behaviors, so that you have concrete examples and clear developmental opportunities for prospective candidates. This will help you weigh candidates' abilities to build a talent/ownership mindset and live the company's core values. It also makes it very clear to candidates what they need to be thinking about and working toward.

  Key questions: How do we define great leadership? What makes a superstar leader at this specific company?

- **Align with strategic priorities.** Based on your long-term strategy, determine what the business needs from its next leader to advance the company. For example, if you want to double the size of your business, this requires different leadership — from the CEO to project managers — than if you want to remain a local player and dominate the markets you're in currently. Consider what the business needs from its enterprise leaders, as well as the strategic positions they must surround themselves with to pursue their strategic vision.

  Key question: How do these skills and competencies align with our strategy and core values?

- **Assess leadership depth.** You'll want to have a clear idea of specifically how all positions within the organization add value and what skills/behaviors define success for the different roles. This allows you to assess current performance and gaps and how you can develop the next generation of leaders. Additional benefits include greater transparency and clarity around career paths for your employees, which can have positive impacts on engagement and retention. According to data from the Pew Research Center, most workers who quit jobs cite a lack of opportunities for advancement (63%) as a reason for quitting, and one-third say it was a major factor in their decision.

  Key question: How can we integrate these criteria into hiring practices and/or performance conversations?

THE VITAL ROLE OF TRUST

Research indicates that a company's good reputation and trustful relationships between management and employees deliver benefits like increased likelihood of achieving objectives, increased access to resources and improved employee and customer engagement — particularly for family-owned firms. It also contributes to transparency, a sense of ownership and stronger relationships.

Transition plans are living, breathing plans that require inherent flexibility and annual review. It's crucial to plan with intention and emphasize the importance of flexibility.

"We can define a 'perfect' plan on paper, but other factors — including business performance, leadership development, contingency scenarios, etc. — will have a continuous impact on how we define the path forward," says Godwin. "Everyone must understand this and have inherent trust that all parties have the other's best interest in mind."

Departing owners must trust that successors/new owners will step up and propel the company forward, ensuring their legacies. New and existing shareholders must trust that departing shareholders will position them for success and allow them to grow into controlling the organization.

"Upfront communication about control and how the plan will unfold is critical to ensuring that all parties are on the same page," Godwin says. "We recommend spending dedicated time to communicate openly with other stakeholders at a moment that feels right."

WHAT TO LOOK FOR IN AN OTMS ADVISOR

- Direct E&C industry experience
- Proven track record of navigating OT and MS transactions
- A network of professionals who can provide technical and transactional support
- Deep knowledge of business, tax, finance and other implications of various ownership transfer options

"Working with an industry expert is always better than not, especially in this industry," Perkins says. "There's so much uniqueness to it — you need someone who understands what makes this industry different, how companies like yours are valued and the common transaction structures."

WHY AND HOW TO WORK WITH A PROFESSIONAL

Most owners in our survey work with one or more partners on OTMS strategy, including lawyers, certified public accountants, investment bankers and business consultants. Only 6% choose to go it alone.

Successful ownership transition planning requires transactional expertise (buy/sell agreements, employment contracts, accounting and tax documents) and business acumen (financial capacity, capital needs, leadership needs, workforce planning). An experienced advisor brings objectivity to an emotional decision, representing the best interests of the company relative to the defined objectives of departing shareholders.

WHAT'S NEXT?

Transitioning out of your business is a huge decision that shouldn't be made in a rush or in a vacuum. You need time and support to determine:

1. **Your goals and priorities** (e.g., timing, value, control, business continuity). This is the foundation of a long-term ownership transition plan. "This aspect can be challenging as certain decisions and realities can be hard to face," Godwin notes. "But it's difficult to determine a comprehensive plan without honest communication on what we're solving for." Working this out helps provide all stakeholders with a clear understanding, informs evaluation of the current situation and illuminates the choice of potential paths forward.

   Key questions: What's our long-term strategy and how well is it communicated and understood? What's most vital to us in the process?

2. **Clarity around leadership and ownership criteria**. Thinking about the end of your tenure at the company can bring focus and specificity to your OTMS efforts. Every company is unique and requires different behaviors and skill sets from their leaders in order to be successful. Your leadership and ownership criteria should clearly communicate the qualities needed from future leaders, consistent with your core values.

   Key questions: What will our business need from our enterprise leaders in the future? How deep is our leadership bench up and down the organization?

3. **Your leadership team's readiness**. Ownership transition and leadership succession must go hand in hand. "Solving the leadership equation takes time, and is the starting point for any plan," Godwin says. "To fully evaluate the feasibility and likelihood of success in transition, we must understand the positioning of next-generation leaders."

   Key questions: What kind of criteria — both from future leaders and owners — are required to achieve our future strategy? How are talent practices and internal infrastructure aligned to support the long-term business strategy?

4. **Your options**. Not every ownership transfer option is a good fit for your goals and your business. Using the information above, you can evaluate and establish your ideal model.

   Key questions: What are our top priorities when considering ownership transition (money, timeline, control, legacy, etc.)? What options make the most sense given what's most important to us?

OTMS is difficult. It takes time and objective consideration of your business and is largely a function of the capability of your people. For E&C firms looking for the best possible OTMS solution for their individual situations, the best approach is to consider the pros and cons of all available options. Understand that it really depends on the individual circumstances, the preferences of current and future owners, and what approach "feels right." By taking the time to understand your company's current situation, assessing your options and planning well in advance, you'll be well-braced to handle the transition when the time comes to do so.

AUTHORS

MATT GODWIN leads FMI's Financial Advisory Services practice, which is focused on ownership transfer planning, business continuity and valuation work, primarily for engineering and construction firms. He brings more than 20 years of experience in the financial services and capital markets industry, with a breadth of transition and valuation experience. He can be reached at matt.godwin@fmicorp.com.

RYAN QUIGLEY is passionate about building strong leaders and developing high-performing teams through people and process improvement. He balances client work with internal research to support thought leadership team initiatives. Ryan has spent a significant portion of his time at FMI assisting clients with succession planning, talent development and building high-performing teams for large, complex projects. He can be reached at ryan.quigley@fmicorp.com.

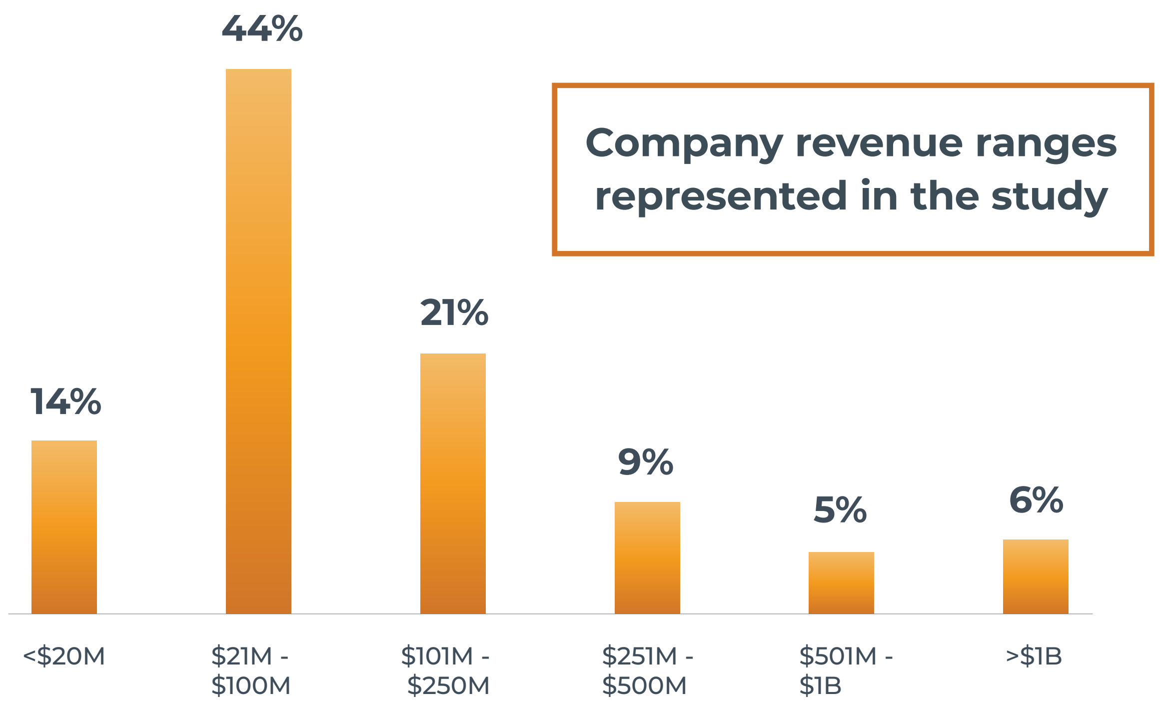
NATHAN PERKINS is an expert in employee stock ownership plans (ESOPs). He regularly speaks to industry groups about the value of these transactions for employees and as a liquidity strategy for business owners. He has advised on more than 300 ESOP M&A deals representing billions in value during his more than 20-year career. He can be reached at nathan.perkins@fmicorp.com.

ABOUT THE STUDY

FMI collected data about ownership transfer and management succession from almost 300 respondents and cross-referenced it with our 2020 survey findings.

EXHIBIT 5: Survey demographics at a glance

- 58% General Contractor/Construction Manager
- 42% Trade Contractor/Subcontractor



Source: 2024 FMI and CFMA OTMS Survey

CONTACT US

RALEIGH HEADQUARTERS
223 S. West Street
Suite 1200
Raleigh, NC 27603

919.787.8400

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OFFICES

Denver
44 Cook Street
Suite 900
Denver, CO 80206
303.377.4740

Houston
1301 McKinney Street
Suite 2000
Houston, TX 77010
713.936.5400

FMICORP.COM