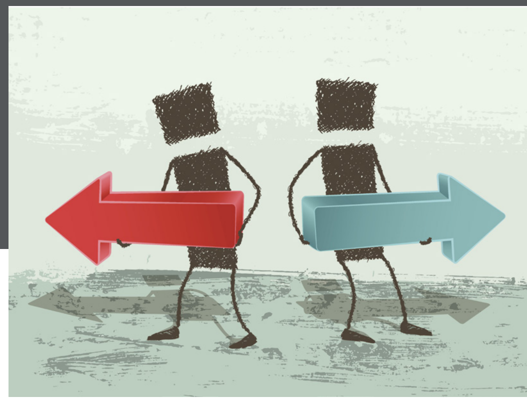
FMI
ISSUE ONE
2017
FMI Quarterly



Third-Party Sale or Internal Buyout?
How to Make the Best Choice for Your Firm

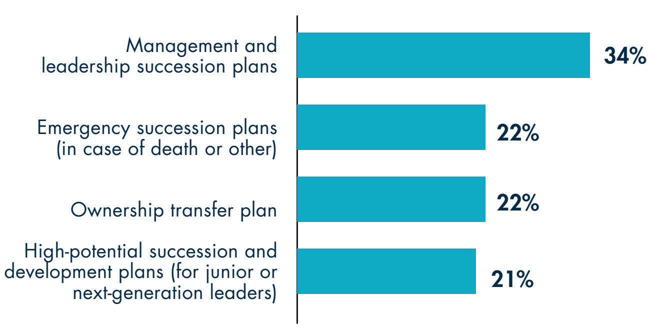
By Landon Funsten

Key considerations that come into play when pursuing a third-party sale versus an internal buyout.

There comes a time in every business owner's life when the tough questions about succession, ownership transfer and/or liquidation must be addressed. Many times, these topics aren't broached until the inevitable happens: A key retirement is eminent, someone wants to pursue other interests or business ventures, or, unfortunately, a company leader passes away.

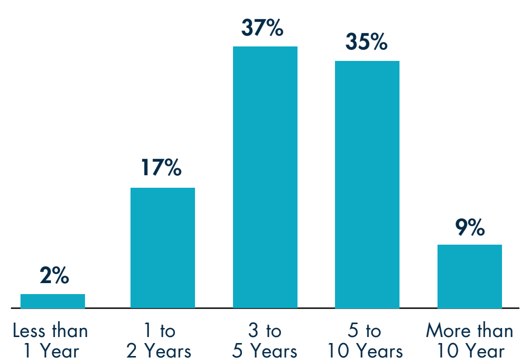
According to FMI's most recent industry research,[1] only 22% of the owners surveyed have a formal plan to transition themselves out of managing the business (Exhibit 1). These are staggering statistics, given the fact that more than 70% of survey respondents will need to replace most critical company positions in the next three to 10 years (Exhibit 2).

EXHIBIT 1 For continuity planning purposes, the following components are formally in place in my business.



Source: 2017 FMI NRCI and CIRT industry surveys, Q1.

EXHIBIT 2 My organization will need successors to replace most critical position in:



Source: 2017 FMI NRCI and CIRT industry surveys, Q1.

[1] Preliminary results of FMI's 2017 OTMS study. These are based on responses from FMI's NRCI and CIRT surveys for Q1. Final statistics will be published in the second quarter of 2017.

Most owners who are nearing retirement age—and who haven't begun to plan—acknowledge the fact that they need to get the process underway. This is a positive sign, but in many cases, the immediacy of the problem is reinforced by several comments FMI received from owners, such as:

> "It takes a long time."
>
> "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, which 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."

As E&C firms continue to distance themselves from the Great Recession, owners are increasingly grappling with an issue that they have put on the backburner, namely: Now that transitioning my business is financially viable, what's the best way to do it? And specifically, does it make more sense to sell to my key employees and/or family members, or should the company be sold to a third party? Further, what are the relative benefits and drawbacks of each alternative?

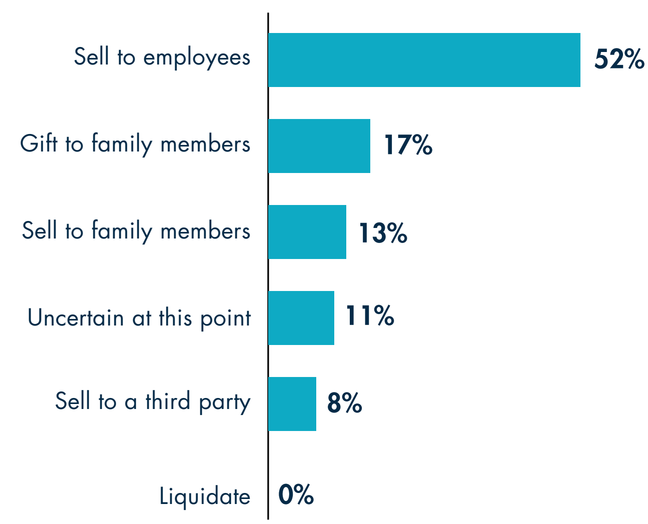
We explore these and other issues related to company sales and buyouts in this article, and help you make the best possible choice for your own firm.

Assessing Your Firm's Salability

For years, FMI has surveyed the industry to assess how contractors exit their businesses. By far, the most common methodology is an internal sale to key employees and/or family members. Our latest research shows that the majority (82%) of industry firms plan to initiate an internal transaction (sell to employees or family members or give to family members), only 8% of respondents plan to sell to a third party, and 11% are uncertain about their ownership transfer plans at this point (Exhibit 3). Moreover, many of these third-party sales are structured to simply allow the seller to complete its backlog and monetize its balance sheets, yielding no "goodwill."

For those companies that expect to sell to a third party, there are substantial risks involved with achieving this transition objective. In FMI's experience, for example, very few of the 8% expecting to sell to a third party will find buyers ready and willing to purchase the company at an attractive valuation when the current owner is ready to sell. And when this happens, the potential seller that doesn't have a backup plan can quickly find himself/herself forced to liquidate.

EXHIBIT 3 Ownership Transfer Plans



Source: 2017 FMI NRCI and CIRT industry surveys, Q1.

Attracting Third-Party Interest

An unfortunate truism of the E&C industry is that most firms simply aren't salable to a third party for much more than net asset value. Low barriers to entry, hypercyclicality, seemingly bottomless liabilities, thin margins, the local nature of the business and other issues conspire to chase away buyers. As a result, most contractors choose to pursue an internal transaction as a default decision.

But that doesn't mean finding a buyer is impossible. For example, your firm could attract third-party interest if it had several of the following attributes:

- ***A defensible market niche.*** By carving out a profitable niche, companies can make themselves more attractive in the eyes of a buyer who sees construction as a largely commoditized industry.
- ***Participation in an attractive industry sector,*** such as industrial, utility or health care. Pick an industry sector that's growing and find a way to service it better than anyone else can.
- ***Size*** (depending on the type of work– at least $20 million) ***and breadth*** (multiple offices or lines of business). The bigger, the better when it comes to company size and diversity of product and/or business lines.
- ***Top-quartile financial performance.*** In most cases, investors and buyers want companies that are at the top of their game and not financial laggards.
- ***A service/maintenance business.*** Companies that can build ongoing business (versus just "one-and-done" projects) with multiyear revenue streams will be much more attractive in the eyes of the buyer.
- ***Working directly with owners as opposed to having GCs and CMs as clients.*** The closer you can get to the decision-makers and the money, the better chances that your company will be hired for future work, be paid on time, control schedule and quality, and be able to negotiate profitable projects in the future.
- ***Deep management team.*** Buyers will be most attracted to companies that have well-rounded and deep management teams that go beyond just a single owner or family-dominated "inner circle."

It's important to point out that recent buyer demand for E&C firms has been considerable and that this demand is anticipated to continue to increase in 2017 (and beyond). While this makes more firms attractive targets, a third-party sale at a compelling value is likely to remain elusive for most industry firms.

The Legacy Component

Assuming that your firm is salable, the second most common reason that firms opt to sell internally is the whole issue of legacy. One of the biggest concerns potential sellers have relative to a third-party sale is a potential transformation of the culture and ethos that the company has developed during its existence. This concern is compounded by the fact that, according to years of FMI surveys, the majority of E&C firms consider themselves to be family-owned.

Examples abound of industry buyers falling prey to the "conquering army" syndrome subsequent to an acquisition and destroying the culture of companies that they acquire, whether those actions are intentional or not. If perpetuation of the company's legacy and culture is a paramount objective, selling to a third party is usually not the optimal outcome.

After-tax Proceeds

One of the most common and perpetual misperceptions of transitioning ownership in an E&C firm is that to optimize proceeds from a sale, a third-party sale is the only plausible alternative. This premise is demonstrably untrue for virtually all industry firms. In fact, FMI has found that industry firms that are sold typically sell for four to five times sustainable EBITDA. Certainly, there are many examples of firms that have been acquired for substantially higher (and lower) multiples, but this range has held up for the majority of firms for many years.

Contrast this metric with the structure of most internal buyouts, and you'll find myriad variations on the theme. However, most entail taking the profit stream that the current owner(s) stick in their pocket and, instead, funneling these profits to the next generation of leaders who, in turn, buy stock from the current owners. Increasingly large increments of stock are sold (generally at book value) until the transaction is consummated. For an industry firm that has normal profitability and a typical capital structure, this process could take anywhere from eight to 12 years to cycle out of 100% of ownership.

Now consider the difference between the internal transaction and a third-party sale. Under the former, the seller participates in the relative share of the company's income stream, sells its stock and continues to collect W-2 income and various other perks. Clearly, if a seller's objective is strictly financial, the after-tax proceeds an internal sale generates are the optimal solution.

The Clock Never Stops Ticking

The unexpected good news about an internal transaction is its financial outcome. The bad news is that it takes time. As mentioned earlier, it will take eight to 12 years to fully cycle out of your ownership (and that's assuming that you have a next generation of leaders that you can confidently sell the business to).

The fallacy and misconception that simply starting an internal sale and transition will somehow allow the owner to back away from the business, take more time off and ride off into the golden years of retirement are widespread in the industry. Unfortunately, this rarely happens in real life. In fact, E&C owners need to reconcile themselves to the fact that they will likely have to increase their time commitment to the business, often during nights and weekends.

And, assuming that there is a competent next generation of leaders in the business (a big if!), it will take considerable time, effort and energy to ensure that the new guard can competently run the business without the current management team. Transferring client relationships, providing financial training, developing leaders, fostering strategic thinking and so forth will consume vast amounts of time. And don't forget that we're not all cut out to be business owners, and that there is the considerable risk that the next generation of leaders is simply incapable of running the business.

What's Your Personal Risk?

When considering an internal sale versus one involving a third party, personal risk also comes into play. Clearly, a third-party sale monetizes your interest in your business and eliminates virtually all of your future personal risk. However, with an internal transaction, you will have the following ongoing personal exposures:

- Possibility that the next generation won't work out and is incapable of running the business. At best, you may have to find a new team; at worst, it could destroy your company. Keep this in mind as you make this very important decision.
- Exposure to another catastrophic downturn such as the Great Recession. Many potential sellers are still crawling out of this hole and definitely don't want to go back into it anytime soon.
- You will likely have to continue to indemnify the bank and bonding company for the short to intermediate term. If you're trying to make a clean break and head off into retirement, this could thwart your plans—at least for the short term.

Clearly, there are several critical considerations an owner needs to evaluate before choosing the appropriate avenue to pursue. A great place to start is to itemize and delineate your personal objectives for your transition and consider them relative to the key factors cited above. Using the advice outlined in this article, you can cull through your options, eliminate any that don't align well with you and/or your firm's future goals and plans, and come up with a workable solution to an age-old issue that a high percentage of E&C firms are dealing with right now.

Landon Funsten is a senior managing director with FMI Capital Advisors, Inc. He works extensively with contractors throughout the country, focusing on buyer and seller representation, business continuity and stock valuations. He can be reached at *lfunsten@fminet.com*.

FMI

Industry Focus. Powerful Results.™

About FMI

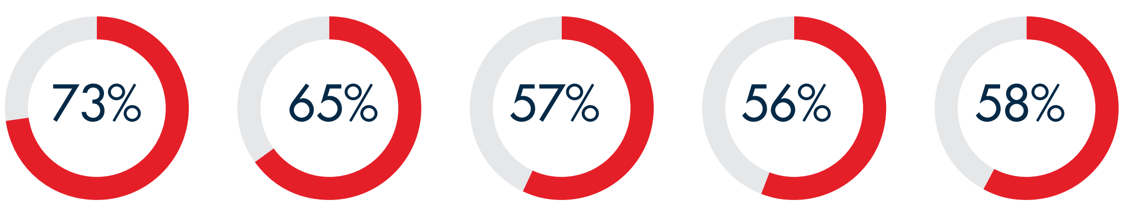
For over 60 years, FMI has been the leading **management consulting and investment banking** firm dedicated exclusively to **engineering and construction, infrastructure and the built environment**.

FMI serves all sectors of the industry as a trusted advisor. More than six decades of context, connections and insights lead to transformational outcomes for clients and the industry.

Sector Expertise

- A/E and Environmental
- General Contractors/CM
- Heavy Civil
- Industrial
- Specialty Trades
- Utility T&D
- Cleantech and Energy Services
- Construction Materials
- Building Products
- Oil and Gas
- Private Equity
- Owners

FMI Client Highlights



- 73% of the ENR Top 400 Contractors
- 65% of the ENR Top 200 Specialty Contractors
- 57% of the ENR Top 100 Design Firms
- 56% of the ENR Top 200 Environmental Firms
- 58% of the ENR Top 100 CM for Fee Firms

Industry Focus. Powerful Results.™

Denver
210 University Boulevard
Suite 800
Denver, CO 80206
303.377.4740

Houston
9303 New Trails Drive
Suite 350
The Woodlands, TX 77381
713.936.5400

Phoenix
7639 East Pinnacle Peak Road
Suite 100
Scottsdale, AZ 85255
602.381.8108

Raleigh (headquarters)
5171 Glenwood Avenue
Suite 200
Raleigh, NC 27612
919.787.8400

Tampa
308 South Boulevard
Tampa, FL 33606
813.636.1364

FMI

www.fminet.com

† FMI Capital Advisors, Inc., is the investment banking subsidiary of FMI Corporation, which has been exclusively serving the E&C industry for over 60 years.