2021 FMI and CFMA Ownership Transfer and Management Succession Industry Survey

CONSTRUCTION FINANCIAL MANAGEMENT ASSOCIATION

EXECUTIVE SUMMARY

In the COVID-19 pandemic, 2020 gave us a global shock capable of wiping entire business sectors off the map. Within the engineering and construction (E&C) industry, the pandemic acted as a stress test for company planning, and we were able to gauge the impact in real time. In mid-2020, FMI partnered with the Construction Financial Management Association (CFMA) to survey construction executives on their ownership transfer and management succession (OTMS) plans. The results presented in this article are based on almost 250 responses.

We found the economic slowdown had a direct impact on firms with plans to transfer ownership in the short term, delaying the start or extending the duration of equity transfer by several years. Of those that reported an impact to earnings from COVID-19, **30% said it would affect their ownership transfer plan**. There will also be a smaller effect stemming from the period of 2020 in which firms paused or dampened long-term planning to focus on survival. How this plays out will depend on companies' timelines for leadership and ownership turnover.

The decade ahead was already slated to see a generational shift as the last of the baby boomers reach retirement age in 2031. The effects of this transition are arguably more pronounced in an industry of closely held and family-run businesses, which is why one key finding sounded the alarms: There has been a decline in OTMS planning across the industry against the pool of firms surveyed in 2017, with **50% of respondents reporting that they do not have an ownership transfer plan**, up from 39%.

We delve deeper into the data in this report, but the key signposts in the years ahead are succession timelines that often exceed the off-ramp for retiring leadership and internal sales of owner stock that stretch even further into the future. The majority of people we interviewed want to exit their businesses in the next five years or so. If that is the case, we're going to need to accelerate the succession of the next generation of leaders: **More than two-thirds of identified successors won't be ready for another three to five years**.

30%

said economic slowdown would affect their ownership transfer plans.

50%

reported they DO NOT have an ownership transfer plan.

66%

identified successors won't be ready for another three to five years.

Owners also need to be realistic about sale options. The ability to transition ownership is dependent on a company's ability to create the next-generation leadership team who is either going to be the buyer or take on the role of successor. Looking at ownership transfer plans, we see risks: **27% of respondents are uncertain to whom they will sell**, and 2% expect to liquidate, while experience tells us that around 10% in fact will dissolve.

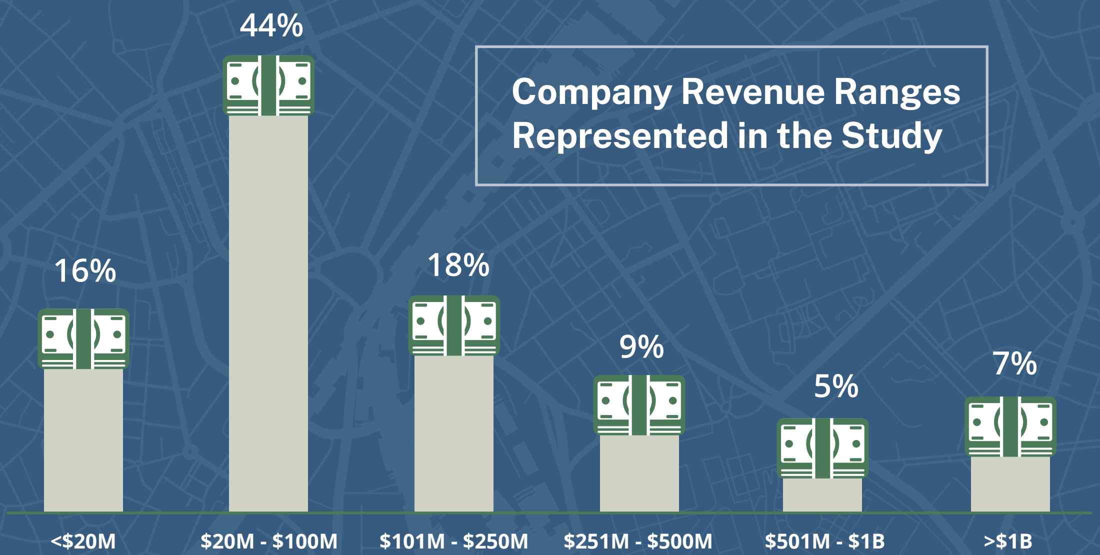
We do see some bright spots; a key trend is a continued shift toward employee stock ownership plans (ESOPs) and healthy M&A activity, as owners shift focus to third-party sales. To take advantage, firms will need to have a bulletproof plan in place that addresses both ownership transfer and management succession. Our data shows that the firms best positioned to grow in the years ahead have identified future leaders and put in place plans for transfer of ownership.

27%
are uncertain to whom they will sell.

Survey Demographics at a Glance

- 55% are family-owned
- 21% LLC; 65% S Corp; 14% C Corp
- 52% General Contractor/Construction Manager; 48% Trade Contractor/Subcontractor

Company Revenue Ranges Represented in the Study



MAPPING THE GREAT TRANSITION: Ownership Dynamics Over the Next Decade

2021

COVID-19 slowdown and looming time crunch for leadershp transitions.

Half of E&C firms are vulnerable. Only 50% of respondents have a formal ownership transfer plan, compared to 61% in 2017. Effects tempered by rapid uptick in key markets, Paycheck Protection Program (PPP) funding and coming stimulus.

2026

Shifting methodologies for ownership transfer.

Desire to transition equity and get liquidity faster is shifting focus to third-party sales (amid a strong M&A market) and ESOPs. The majority of firms will still transfer internally, which requires time and investment in the next generation of leaders.

2028

Higher share of firms with formal succession plans have an ownership transition plan than those who don't (66% vs. 50%).

2030

Next generation of leadership is not ready.

Pipeline has gaps. Only 51% of respondents have formally identified successors for most critical positions. Preparedness has dropped since 2017. Skilled talent shortage persists.

2031 Last of baby boomers reach retirement age.

2032

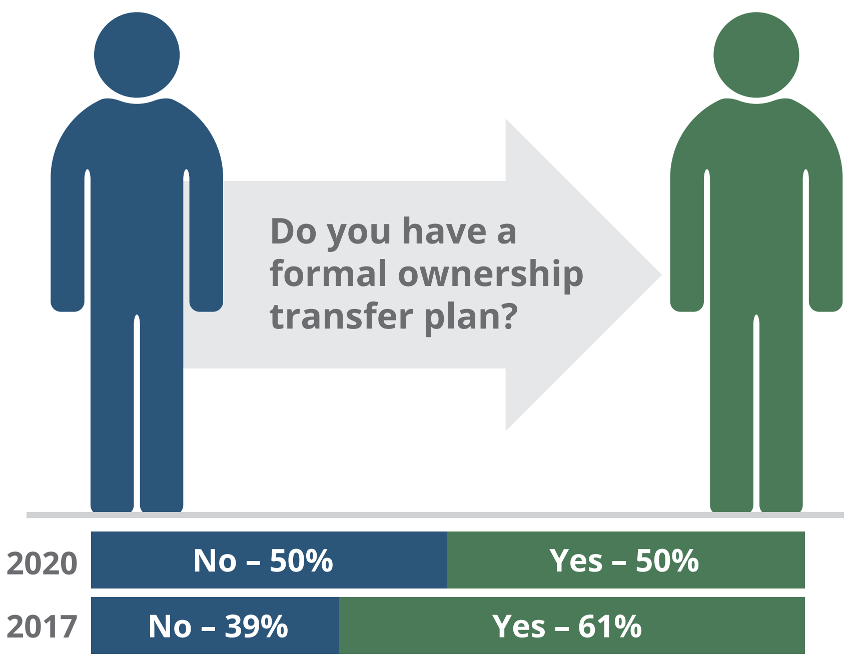
Future growth will be detemined by depth of bench and availability of capital.

Stalled transitions will drag on expansion. Succession planning will ensure valuation growth.

Half of Surveyed Firms Are Vulnerable Due to a Lack of Planning

There has been a significant decline from 2017 to 2020 in planning for ownership transitions (50%, down from 61%), right as the industry faces a once in 30-year generational change. **Of owners with less than five years to exit the business, 49% do not have an ownership transfer plan**.

EXHIBIT 1: Fewer firms have formal ownership transfer plans today



Source: FMI/CFMA

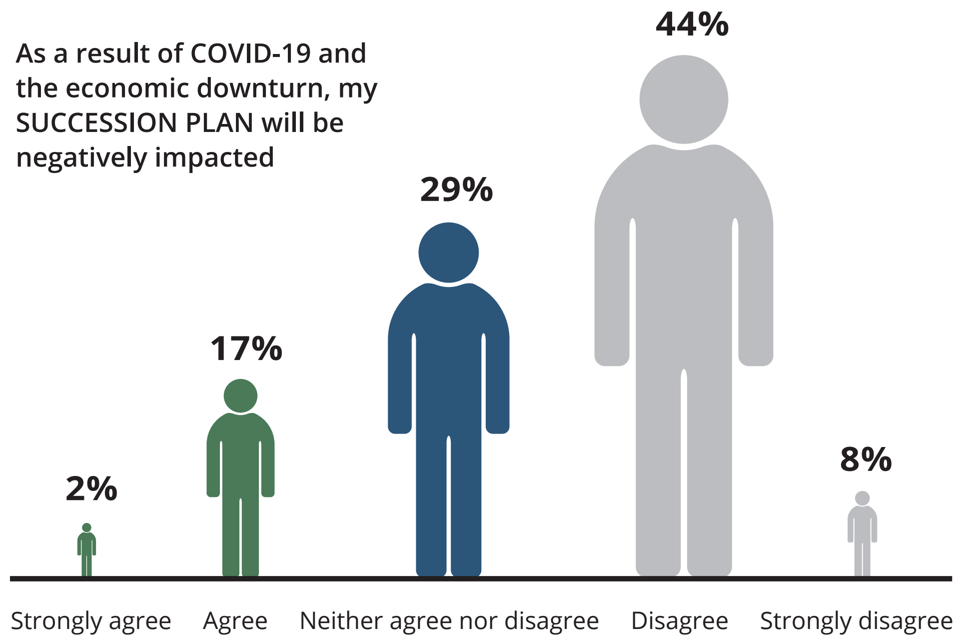
The economic slowdown has primarily impacted those looking to sell in the next five years, pushing out the start and duration of transition. Three-quarters of respondents indicated that COVID-19 would negatively impact their company's earnings; however, less than 30% of those with impacted earnings stated that it would have an effect on their ownership transfer plan. Given the financial impact of COVID-19 on the industry, owners expect it will take longer for the company to generate sufficient earnings to complete an internal buyout.

For many companies, COVID represented a lost year in terms of identifying and training the next flight of leaders. However, some firms used the crisis wisely to continue their efforts around developing leaders and successors, despite the uncertainty. Nineteen percent of respondents said COVID-19 had impacted succession planning.

EXHIBIT 2:

COVID-19 pushed timelines for succession and ownership transfer planning

As a result of COVID-19 and the economic downturn, my SUCCESSION PLAN will be negatively impacted



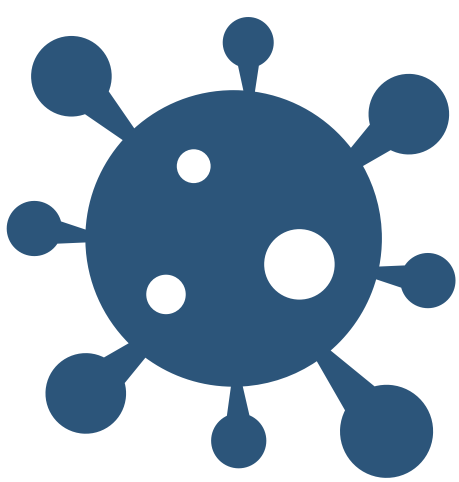
Source: FMI/CFMA

EXHIBIT 3:

Interrupted Plans

Prior to COVID-19, were you in the middle of an ownership transfer plan (external or internal), or did you expect to begin an ownership transfer plan in the next two years?

YES 51% | **NO 49%**



If "Yes," how will COVID-19 (and the economic implications) impact your ownership transfer plans?

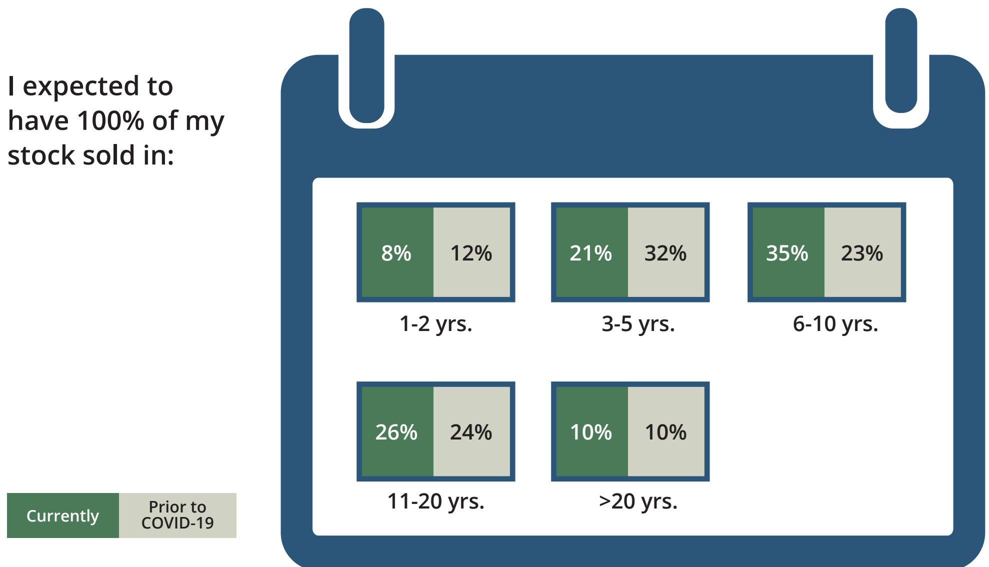
17%	Delay the beginning of an ownership transfer
35%	Extend the duration of an ownership transfer
2%	Change the method of ownership transfer (e.g., M&A, ESOP, gift)
10%	Reduce total proceeds from ownership transfer
36%	Other

Source: FMI/CFMA

While 32% of respondents in 2017 expected to have sold 100% of their stock within three to five years, this number dropped to 21% among 2020 respondents. Likewise, those expecting to have been clear of their stock within one to two years dropped from 12% to 8% from 2017 to 2020, reflecting a longer timeline.

Thirty-five percent of respondents now expect to have sold their ownership stake in the next six to 10 years, with respondents favoring internal sales by a huge margin (91% versus 9% for external).

EXHIBIT 4: Time crunch emerges for those looking to sell in next five years



Source: FMI/CFMA

Survey responses indicate a profound time crunch as owners look to exit in the short-to-medium term, many of them without solid succession or ownership transfer plans in place. It could take a decade to prepare the next CEO or CFO, while an internal sale of equity often takes seven to 12 years.

Sales are, however, also about opportunity. While COVID-19 resulted in a lost quarter of growth in the second quarter 2020, the upside of short-term cash through the Paycheck Protection Program (PPP) gave owners some breathing room. Additionally, companies operating in hot geographic sectors fared much better than others, and M&A activity picked up in the second half of 2020.

Sales ultimately depend on how profitable the business is and on where a company is in the business cycle. Strategy going forward will depend on when an owner wants to exit and may necessitate accelerated succession planning and/or a change in sales methodology.

2

Shifting Sales Methodologies as Owners Feel Time Crunch

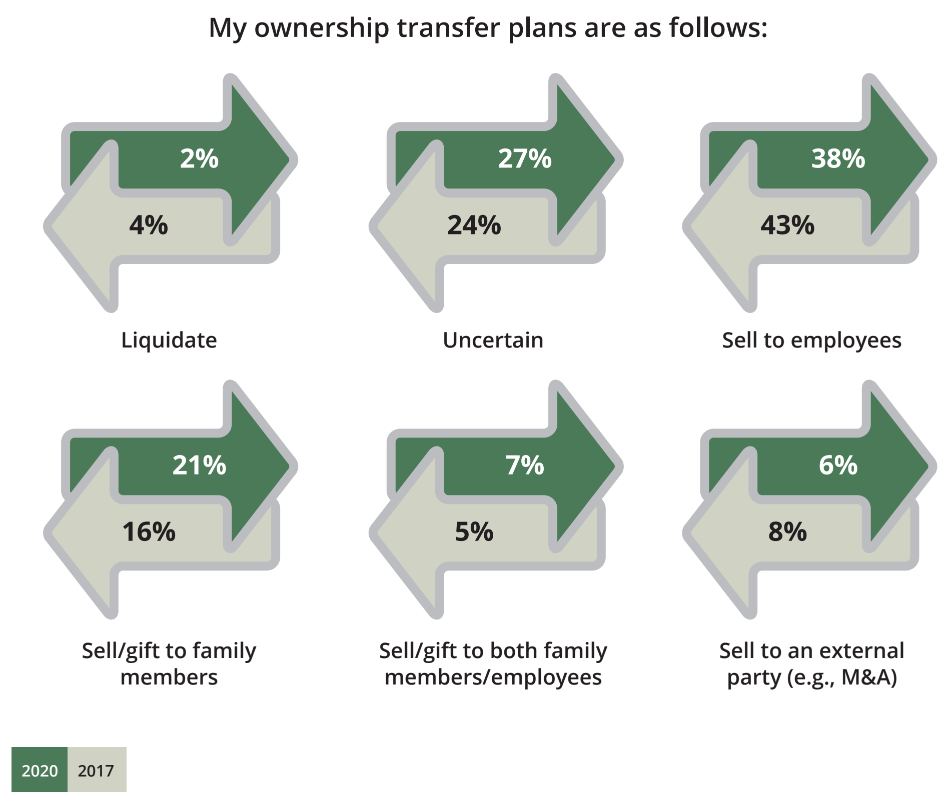
While the next 10 years will see a generation of leadership exit, those looking to leave in the next five years are under the most pressure. Two-thirds of all companies surveyed intend to sell their ownership internally – either to family members, employees or a combination of both – a number consistent with our 2017 survey.

That number is even higher when you consider that 27% of respondents are currently uncertain of their ownership transfer plan. Of those with an ownership transfer plan in place, 91% intend to sell internally.

However, internal sales take longer due to the need for the company to fund the sale. Given current headwinds, we expect it could take longer than usual to complete a transfer.

EXHIBIT 5:

High uncertainty over ownership transfer plans

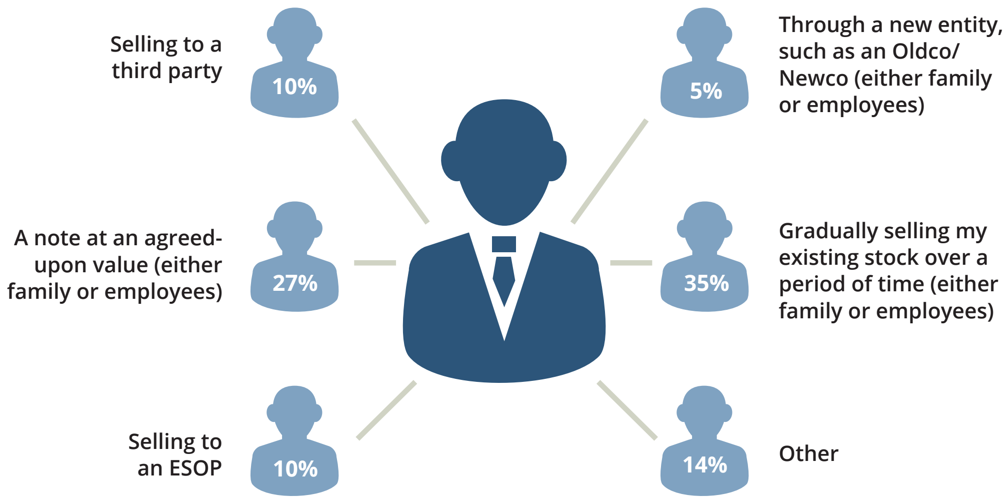


Source: FMI/CFMA

When the timeline for an internal buyout exceeds an owner's personal timeline, he/she may seek an external exit. Should that prove difficult, the only other option is to liquidate the balance sheet in order to unlock remaining shareholder value. While 2% of respondents anticipate liquidating their stake, industry data suggests that around 10% of firms will actually do so. In our experience, some percentage of firms with an uncertain or undefined ownership transfer plan (coupled with a lack of succession planning in next-generation leaders) will be forced to consider this alternative.

EXHIBIT 6: While a gradual internal sale remains most popular, ESOPs are growing in popularity

If you have a plan in place, is your ownership plan to sell externally *(e.g., M&A)* **or internally** *(e.g., family or employees)***?**



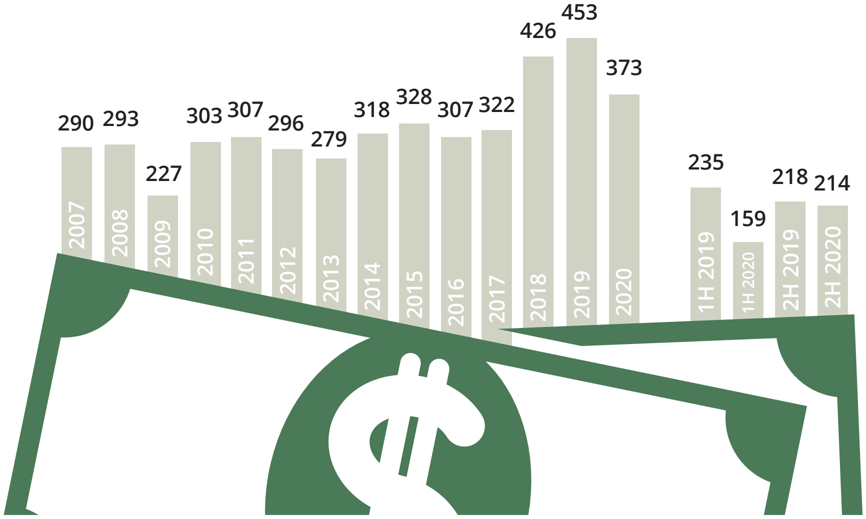
Source: FMI/CFMA

We see the industry adapting to time pressures and demands on company earnings with a shift in sales methodologies. Many large general contractors are shifting to employee ownership (10% of those surveyed), enticed by its value as a talent retention and recruitment tool as well as its benefits to the company's bottom line. S corporations that are 100% ESOP-owned are exempt from federal tax, while C corporation stockholders who sell to an ESOP can potentially avoid capital gains tax. Absent the drag on company equity, transitions can occur on a shorter timeline than internal sales.

Year ahead in M&A predicted to be strong

EXHIBIT 7:

M&A, OTMS and Other Trends *(January 26, 2021)*
Number of E&C M&A deals



Source: CapIQ

Of those considering selling to a third party, FMI expects that 2021 will be a strong year for M&A, given the pipeline of sellers who delayed a sales process in 2020, many of which are looking to transition equity and get liquidity faster. Nearly 40% of all respondents expect to exit the business in less than five years; those who do not have an ownership transfer plan in place may seek an external exit, given strong market conditions. However, they would need a robust sales strategy — only around 10% of all sales are to a third party per responses.

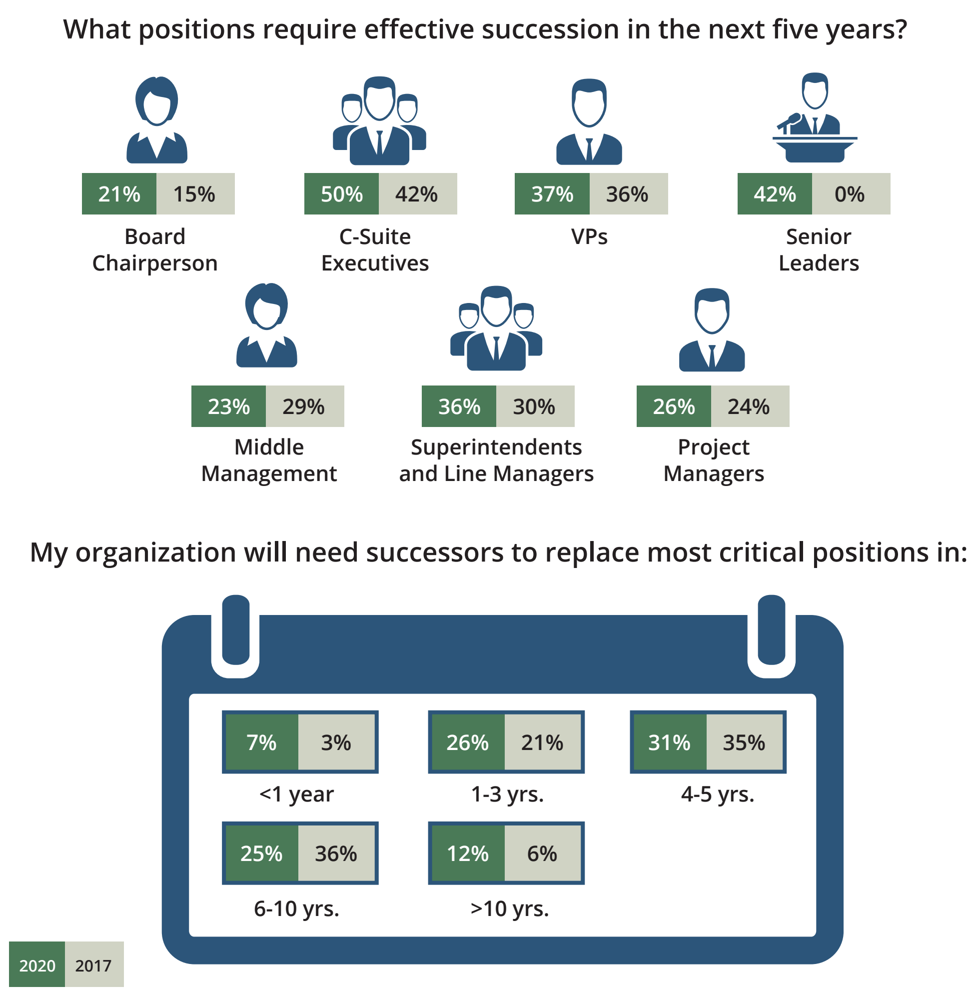
The majority of firms will ultimately transfer internally, either by choice or due to a lack of alternatives. This requires time and investment in the next generation of leaders. Firms with a two- to five-year time frame in place should have already identified the method of ownership transfer and started moving equity. They should also have identified leaders to move into key places, as well as replacements for those leaders, and so on down the line.

3

The Next Generation of Leadership Is Not Ready

Pandemics don't change demographics. The ownership base in the E&C industry is aging, pushing many companies to a once in 25- to 30-year ownership transition.

EXHIBIT 8: **Fewer firms have formal ownership transfer plans today**

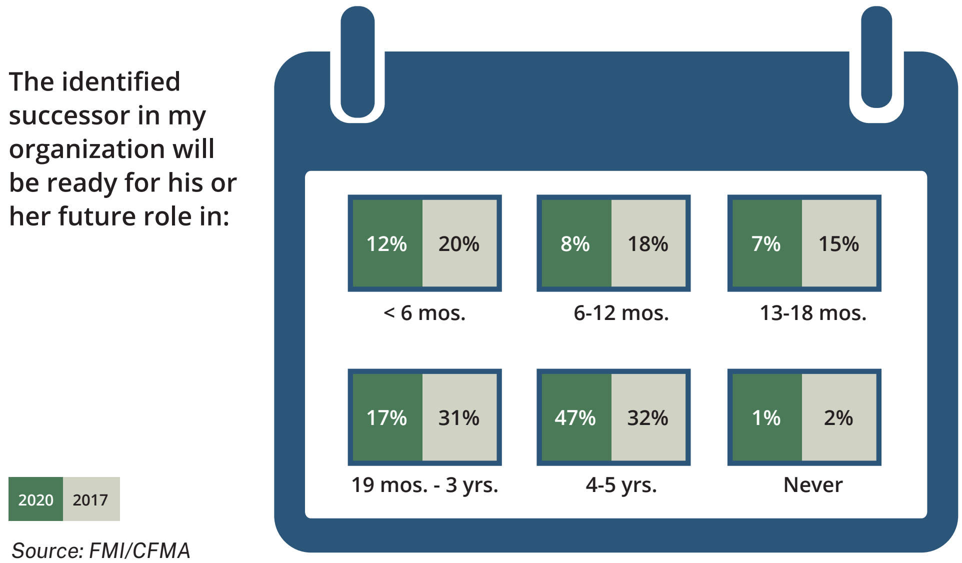


Source: FMI/CFMA

However, only 51% of respondents stated they have formally identified successors for the company's most critical positions. Of those who have, more than two-thirds of identified successors won't be ready for leadership roles for another three to five years.

The next generation just isn't ready. It may take seven to 10 years to develop your next president. It may take eight to 10 years to develop your next vice president of business development or your next chief estimator. In the E&C industry, it is quite rare to fill an executive-level position with an outside hire, primarily due to the importance of cultural fit; so the talent pipeline becomes even more important.

EXHIBIT 9: 32% of successors won't be ready for another 4-5 years



Source: FMI/CFMA

Even among firms that have succession plans in place, the survey showed that midlevel and field leadership are often left out of the picture. Just 17% of middle management positions had formal succession plans, 18% for superintendents, and 19% for project managers. We believe these are critical pipelines for talent that are commonly missed, particularly in light of the increasing number and size of megaprojects (see FMI's recent research: "Megaprojects: Changing the Conversation").

A formal leadership plan is important not only for client confidence but also for retention of the next generation of leaders. If there isn't a clear plan for their professional development and advancement, they may well leave the company.

EXHIBIT 10: Gap in succession planning for midlevel and field leadership

Source: FMI/CFMA

These concerns point to the larger cultural shift taking place as boomer leadership — often founders who perform multiple key roles in an organization — hand off to the next generation. A successor may not be a strict replacement for the outgoing president, who also served as COO or managed its high-risk clients; more likely, the role may be split across multiple key people in the new structure.

We recommend that firms ask themselves which leadership roles they will need in the future rather than which high performers they should bump up the ladder. Someone with a solid operational performance may not find his/her skill set translates well to management or leadership. As companies grow and expand into new geographic or vertical markets, they need to develop a leadership team suited to the new demands.

The outgoing flight of leaders likely learned on the job through trial by fire, but their successors will need formalized development plans. FMI recommends that firms establish benchmarks to track readiness and outline the specific experiences and areas of expertise that a future leader will need to have.

EXHIBIT 11: Cultural shift over the next 10 years

Culture today...

- First-gen founders/baby boomer
- Leadership cohort
- Family-owned business
- C-leader performing multiple key roles and ensuring cultural fit
- Informal talent development

Culture in 10 years...

- Gen X and millennial leadership
- Increase in ESOPs
- Change in leadership structure
- Codified cultural values
- Talent development process that trains toward and tests readiness

Source: FMI

For owners looking to exit in the next five years, successors should already have been identified and be on track to be trained and ready for a handoff.

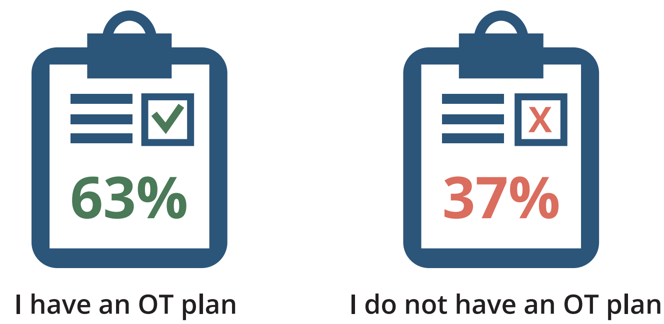
4

The Future Is Double or Nothing

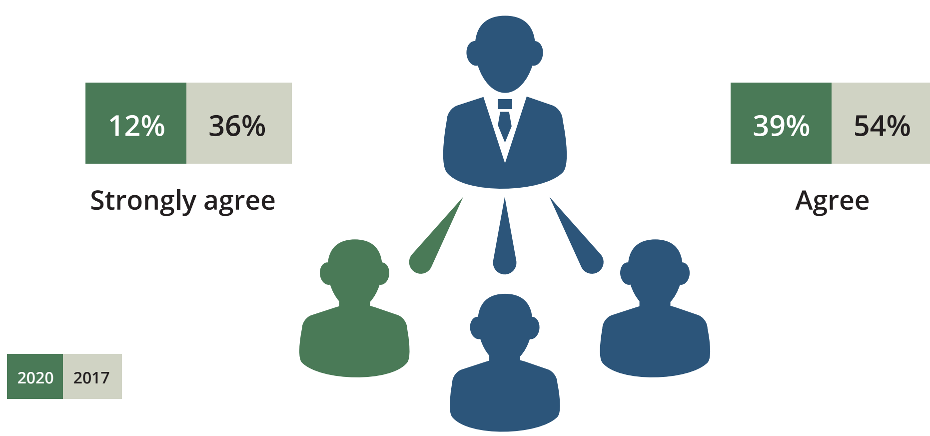
The time crunch is real, but this moment provides an opening for firms to adopt a continuity mindset. Government stimulus will take us through about 2029, and the industry is trending away from its COVID-19 ditch. It is time to plan for growth.

EXHIBIT 12:

Firms with successors are more likely to have an ownership transfer (OT) plan



Successors have been formally identified for the most critical positions of my business:



Source: FMI/CFMA

Interestingly, of the 52% of firms that have identified successors, 63% have a formal ownership transfer plan in place, much higher than the average (50%). Identifying and developing successors is directly correlated to creating and implementing successful ownership transfer plans.

This is intuitive. As companies evolve and expand, the next generation of leaders will be key to growth and may well also be the next generation of buyers. With 2020 in the rearview, 2031 is taking shape on the horizon: The time to foster tomorrow's leaders is now.

Alex Miller, Managing Director

Alex Miller is a managing director with FMI Capital Advisors, FMI Corporation's registered investment banking subsidiary. Alex works with engineering and construction industry firms across the country and internationally, focusing on merger and acquisitions (seller and buyer representation), growth strategy, ownership transfers and valuations.

Jake Appelman, Principal

Jake Appelman leads FMI's management succession practice. Jake has extensive experience guiding the succession process across a range of company sizes and structures, from closely held family firms to large, employee-owned firms.

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Rob Pulley is a consultant with FMI's Leadership & Organizational Development practice and partners with clients to build visionary and strategic leaders who drive growth, profitability, performance and engagement throughout their respective organizations. Rob also co-leads FMI's succession management practice with Jake Appelman.

ABOUT FMI

FMI is the leading provider of consulting and investment banking to the built environment. We provide services in the areas of strategy, leadership and organizational development, performance, technology and innovation, mergers and acquisitions, financial advisory and private equity financing.

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