INDUSTRY TRENDS SHAPING E&C OWNERSHIP TRANSITIONS

By Matt Godwin, Rob Pulley and Jake Appelman

Engineering and construction (E&C) organizations that invest in developing future leaders and building their businesses with multiple paths to owner liquidity are positioning themselves for long-term success.

Handing over an organization's reins to the next generation and transitioning ownership are never easy processes. For optimal results, the ownership transfer and management succession (OTMS) approach starts with identifying, selecting and developing key associates; ensuring that leadership roles are occupied by skilled, engaged individuals; and then cultivating them for success in their new roles.

This all takes place within the broader context of preparing the organization for future, ongoing success, with the understanding that it takes time, attention and resources. For an industry sector that faced severe headwinds and significant talent loss during the 2008 Great Recession, the path to OTMS success has become somewhat rocky and unpredictable.

Following the Great Recession, the E&C industry experienced a sustained period of growth that boosted industry financial performance and improved shareholder value. Then the pandemic hit, slowing the pace of construction volumes, disrupting the market and impacting the financial performance of many E&C firms. The pandemic had several immediate impacts on OTMS. These included:

- Owners, managers and firms were focused on keeping their businesses afloat, or they took a wait-and-see mindset through the uncertainty.
- Constrained financial performance delayed existing ownership transfer efforts.
- Talent acquisition and development slowed, and there was a loss of employees due to the Great Resignation, the downsizing of organizations and changing work environments.

For many E&C companies, OTMS took a backseat to managing the day-to-day demands of the COVID-19 outbreak, the labor shortage and growing demand for new construction. The pandemic also heightened the divide between E&C firms prepared for transition versus those not ready, as follows:

- E&C companies with solid foundational fundamentals in strong markets fared relatively well financially and are in a good position to handle OTMS going forward.
- Conversely, companies that did not have a plan, talent base or foundational business principles are now further behind or, in some cases, left with few, if any options.

In 2020 FMI and CFMA completed a national industry survey focused on the pandemic's impact on OTMS efforts and current trends, learning that 50% of companies had no ownership transfer plan in place.

FMI and CFMA also found that:

- 66% of companies had identified successors who wouldn't be ready to take over for another three to five years.
- 27% of respondents were uncertain about when they were going to sell their companies.
- Of the E&C owners with less than five years to transition, 49% had no plan in place for doing so.

With 41% of the current U.S. construction workforce expected to retire by 2031, the unresolved gap between hiring needs and labor availability could significantly impact companies' OTMS plans over the next few years. Concurrently, the return of economic stability and post-pandemic operational levels creates the need to reinvigorate transition plans to best prepare companies for sustainability and continued success.

Navigating the Perfect Storm

It takes time to successfully transition management and ownership – typically eight to 12 years to divest 100% of the company. Thus, it is never too early to begin planning.

However, the industry is now confronted with a perfect storm that may further delay OTMS planning. This is due to:

- The continuing resignation of the workforce and employees having more choices and leverage when it comes to their careers.
- Inflation and global supply shortages impacting the availability of construction materials, negatively impacting project delivery and/or financial performance.
- Speculation about a possible domestic and/or global recession.

Key OTMS Market Trends

For those considering the future of their companies, it's important to understand the current market conditions around OTMS. The following are a few of the predominant trends FMI is seeing in OTMS for E&C companies:

There's a clear migration to broader ownership underway. Historically tied to concentrated ownership and control, the E&C industry continues to move toward a broader level of employee ownership, enticed by its value as a talent retention and recruitment tool and as an effective means to expedite ownership transition.

To that end, FMI believes the trend toward broader ownership will not only continue but may also accelerate due to tightened transition timelines caused by COVID-19 and current economic sentiment. Companies will also need to compete for talent and face cultural and leadership changes during these generational transitions.

The E&C mergers and acquisitions market is extremely active right now. After pausing in 2020 due to the pandemic, 2021 was a record year for E&C mergers and acquisitions as construction spending improved alongside access to capital. There were 610 global E&C deals in 2021 (versus an average of 408 from 2017 to 2020). Deal flow improved as companies that paused transfer during the last year returned to the market, interest rates remained historically low, buyer interest increased and companies took advantage of current tax structures.

2022 will likely be another solid year for E&C mergers and acquisitions since balance sheets remain strong. That said, challenges remain for companies, including the state of the global economy, continued labor shortages, rising interest rates and the likelihood of a recession in the U.S.

FMI will be publishing its latest M&A trends report in the coming weeks, outlining key drivers impacting E&C mergers and acquisitions.

While the market remains active, many E&C firms are not saleable due to low barriers to entry, bonding requirements, cyclicality, the project-based nature of E&C companies and the high dependence on people.

Business owners must be realistic about their ultimate salability with the knowledge that internal transition of ownership is the primary vehicle for owners to access liquidity tied up in their business.

Rising interest in utilizing employee stock ownership plans (ESOPs) as a tool for ownership transition. The utilization of ESOPs as a mechanism for the transition of ownership continues to gain momentum in the E&C industry. Given the numerous advantages to this structure, E&C firms represent a sizable portion of domestic ESOPs. Read more about ESOPs and their growing popularity here.

A war for talent expanded the utilization of long-term incentive compensation plans. The intense competition for talent has heightened the use of long-term incentive compensation plans as a way to recruit, retain, develop and evaluate talent. These plans can feature equity (restricted stock, incentive stock, stock options) and quasi-equity components (phantom stock, stock appreciation rights).

More importantly, these plans help tie employees to the company and can be utilized to start the transition process, provide a bridge from one group of owners to the next, and compensate worthy individuals who may not participate in ownership due to certain factors.

The following are ways long-term incentives can assist with OTMS:

- Keeping potential successors engaged and motivated.
- Preserving management succession while vetting ownership transition options.
- Creating a funding mechanism for future equity purchases.
- Rewarding top contributors.

Overcoming OTMS Challenges

It doesn't take a pandemic or recession to derail an E&C company's OTMS plans. In many cases, a lack of corporate vision and direction can create uncertainty for employees and often leads to talent retention issues, thus compromising an OTMS plan.

In other cases, the company's primary owner is simply not willing to let go of the business, or the company as a whole lacks an ownership or executive transition plan. This root cause may be personal, role-based or centered on the fact that the actual business value rests with the owner or current executive team.

The other risks associated with OTMS include, but aren't limited to:

- **A lack of suitable talent.** This occurs when a company hasn't recruited or retained a strong talent base, or when the existing base is impacted by outside factors.
- **No one is ready to lead.** In many cases, the next generation of leaders is simply not ready to lead the business. Someone may be an excellent project manager or operations leader but may not be equipped to lead the broader enterprise.
- **The focus is on staying afloat.** Some companies must put all of their effort into maintaining profitability and investing in business growth versus planning for an ownership transition.
- **The company is trapped in the fallacy of salability.** Many E&C owners incorrectly assume that their businesses will be sold at the point in time when they're ready to exit. This can lead to an unwillingness to develop the next generation and often produces undesirable outcomes.
- **No viable buyer group is in place.** In many cases, owners don't create a viable buyer group in terms of readiness (e.g., a strong management team) or interest/alignment (vision, healthy business from a culture, profitability or market standpoint). In other situations, the owner passes away while still in charge or winds up liquidating the business, neither of which is a good option.

With advanced planning and a focus on business continuity, E&C companies can either overcome or completely avoid these and other OTMS-related risks. A good starting point for any leader who is shying away from this conversation is to ask what's holding you back (e.g., Is it fear of losing your life's work? Relinquishing control to others? Or not having a next step for your life or career?).

As you work through these questions, you might also address your company's strategic plan and the resources required to support it. All of these considerations should factor into your overall OTMS plan.

Next, define your objectives and OTMS parameters, both of which will serve as your guides on the OTMS path. Here are the key aspects to address:

- **Corporate legacy:** How important is your legacy? Will that legacy continue as an independent entity? Will it continue under the direction of the next generation of leaders? Is it OK to sell the firm and risk losing that identity?
- **Value:** Is the expectation of value over time being driven by the owner's estate or personal need?
- **Timeline:** How long do you intend to work? When is optimal retirement and availability post-retirement?
- **Future owners:** Do you have the next generation in place? If so, what are their expectations? How are you preparing them to lead and manage the business?
- **Governance and control:** How important is control throughout the process? Can the new generation work together? Can multiple people be in control, versus having just one leader in place?
- **Engage trusted partners:** Most E&C firms have an extensive network of trusted advisors. Engage these partners and get all of them at the table to communicate seamlessly. Your team should include accountants, corporate and estate planning attorneys, insurance partners (corporate and bonding), and others.

It's Time to Get Moving

Succession is not a single event. It's a continued focus on leadership development, strategy and financial acumen. When they work, succession plans help companies develop and keep talented employees, increase engagement with workers, prepare for unplanned circumstances and infuse diversity into their potential leadership pools.

Knowing that most E&C firms will ultimately transfer internally—either by choice or due to a lack of alternatives—the time to put energy and resources into an OTMS plan is now. For example, any company with a two- to five-year time frame should have already identified the method of ownership transfer and started moving equity.

The rising inflation rates and risk of recession make OTMS more important than ever. E&C companies that invest in developing future leaders and building their businesses with multiple paths to owner liquidity will be successful in the years to come.

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