Ownership Transfer and Management Succession:
Positioning Your Organization for Long-Term Success

By Jake Appelman and Alex Miller

Here are 10 questions all E&C firms should be asking themselves as they either reinvent existing ownership transfer and management succession plans or develop brand-new ones.

Transferring ownership of an engineering and construction (E&C) firm to a new owner, another entity or a group of employees is a complicated process that requires thoughtful planning, preset goals and an exit strategy that’s focused on a win-win outcome for everyone involved. And while every transition may not go as smoothly as planned, having these pieces of the puzzle in place before making this monumental move can position the company and its new owners for long-term success.

Current owners and managers who ignore this advice could put their organizations in peril: About 75% of all businesses fail to survive past the first generation of owners. Those failure rates increase to 85% by the third generation and over 95% for the fourth generation (and beyond). Avoiding this fate requires dedication, attention to detail, some forward thinking (read: don’t wait until the last minute to develop a succession plan), and commitment on the part of key stakeholders.

Ownership transfer and management succession (OTMS) focuses on the primary steps that E&C companies should take when transitioning to new ownership. Always important, OTMS is taking center stage as industry leaders shake off the negative impacts of the COVID-19 pandemic and plan for brighter futures. For some, that will mean passing the torch to a new generation of leadership and/or ownership.

Survey Says

With the post-pandemic recovery already underway in the U.S., a period of uncertainty has altered the playing field for contractors, particularly those poised for a change in ownership before the pandemic, according to our latest research published in the “2021 FMI/CFMA Ownership Transfer and Management Succession Survey.”

In collecting data from CFMA members and FMI clients around ownership transfer and succession management trends, the two groups learned that pre-COVID, nearly 50% of all companies were either in the middle of an ownership transfer plan or expecting to launch one within the next two years.

Those plans changed when COVID-19 emerged, forcing more than half (52%) of companies to consider either delaying or protracting their intended ownership transfers (Exhibit 1). This wasn’t surprising in light of the economic and operational impact of the pandemic; but it will have major ramifications for the key factors required to successfully exit a business: cash flow and profitability, talent development and management succession, and visibility into future performance.

Exhibit 1. 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% |
|--------------------------|
| Delay the beginning of an ownership transfer |
| Extend the duration of an ownership transfer |
| Change the method of ownership transfer (e.g., M&A, ESOP, gift) |
| Reduce total proceeds from ownership transfer |
| Other |

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

Source: FMI/CFMA
How COVID-19 Impacted Succession Planning

In mid-2020 FMI and CFMA worked together to gather data and assess the financial risks in the new economy and learn about the biggest impacts of the pandemic on OTMS. Our researchers also looked at how COVID-19 impacted business valuations and the broader mergers and acquisitions (M&A) market, the increased interest in employee stock ownership plans (ESOPs), and the biggest gaps in E&C succession planning.

According to the survey, internal ownership transfers remain the predominant methodology in the construction industry, with over two-thirds of respondents saying that they intend to transfer equity to employees, family or both. Properly structured internal transfers can be a great source of liquidity for owners and continuity for the business, but they require up to 10 years longer to execute than an external sale. This is because internal sales often require new owners to buy equity over time; and if earnings are reduced or capital is needed to fund operations, the process can take even longer.

For the survey, 75% of all respondents indicated that COVID-19 had a negative impact on their company’s earnings. This economic impact primarily affects those hoping to sell in the next five years. Prior to the pandemic, 43% of all respondents intended to have sold 100% of their equity within the next five years. Now, just 29% expect they will have sold 100% of their equity within five years.

Now that the recent boom years are in the rearview mirror, owners who put off succession plans or didn’t take advantage of a stronger market to develop their talent pipeline are experiencing more of a crunch than those who anticipated transitions in the years ahead.

For example, a significant share of respondents (35%) plan to exit their businesses in less than five years while 52% plan to exit their businesses in less than seven years. Given the squeeze on earnings, conventional wisdom would suggest putting off plans longer and focusing on the business; however, there are other strategic options to consider.

Internal sales can progress in the current market, provided that the planning accounts for volatility over the next five to 10 years. Alternatively, owners can consider an employee stock ownership plan (ESOP) or an external sale, given a robust merger and acquisition (M&A) market in the construction industry (as discussed in the next section). However, these alternatives do not create a substitute for leadership development and management succession.

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2 Often there is a finite pool of earnings to use for internal ownership transfer that may compete with demands for balance sheets needed to satisfy sureties or to support continued growth, owner distributions, incentive compensation and so forth.
For all companies, whether the owner is looking at an ownership transition in the near future or not, it’s never too late to invest heavily in developing the next generation of leadership.

Measuring the Impacts

Though M&A activity in 2020 did not stack up to the deals seen in 2018 and 2019, this was mostly due to the lost second quarter, when the economy was shut down and buyers and sellers focused on their own businesses. In the second half of 2020, M&A activity rebounded and was equal to that of the first half of 2019; this is proof of a strong recovery carrying through to 2021.

M&A activity in the construction industry is being driven by both increased supply of opportunities—given the large percentage of owners looking to exit their businesses—and increased buyer demand. Crucially, this buyer demand has resulted in valuations remaining very strong for quality assets, with strategic buyers looking to expand operations. Demand is also being driven by a substantial increase in private equity interest in the construction industry. Consequently, valuations for quality firms and buyer interest in the construction industry are causing many contractors to accelerate their personal timelines for an exit.

In assessing the increased interest in ESOPs as an exit alternative for E&C firms, FMI and CMFA found that while ESOPs still represent a small slice of ownership transfers, interest in them as an ownership transfer methodology has increased significantly over the past eight years. In 2013, 4% of companies were interested in ESOPs. By 2020, that number had risen to 10%.

The reasons for using an ESOP to position long-term success are compelling. Where an external sale may not be an option, for instance, ESOPs provide a lot of the same benefits. They also offer additional potential tax savings; the ability to leverage employee ownership as a tool for recruiting and retention; greater flexibility in deal structure and timing; and the ability to maintain autonomy of the business.

Also, companies with employee ownership structures have proven to be better for their employees and the bottom line, with 2.5 times the retirement savings and 5-12% higher incomes for employees by a factor of 2.5 against non-ESOP-owned peers. Other advantages include increased productivity, sales growth and resiliency during recessions for the company as a whole, according to the National Center for Employee Ownership.

These effects extend to periods of contraction, with ESOP companies 25% more likely to stay in business in the last recession and four times less likely to lay off employee-owners. Finally, ESOPs are also a tax-friendly option for corporations and shareholders. Congress has incentivized the practice with an exemption from all federal taxes, and some state taxes, for 100% ESOP S corporations, and potential deferred or nullified capital gains taxes for shareholders on a company’s sale to an ESOP.
Forged in Fire
Leadership bench depth was a defining factor in organizations’ ability to pivot during the pandemic, with next-generation leaders being “forged in fire” as five-year plans were overhauled and implemented on the fly. In the midst of the volatility, a shortfall of qualified talent continued to impede the smooth transitioning of company ownership.

Unsurprisingly, the importance of leadership development was reflected in the midyear survey, which found that 82% of owners saw a direct impact of their successors’ readiness to their businesses’ future growth and profitability. In addition, 47% of companies believed that leadership development was more important than they did pre-pandemic—a finding similar to that of the post-2008 Global Financial Crisis.

Fast-forward to 2021, and we’re again looking at a long recovery and uncertainty stretching over the horizon; but the stress test of 2020 is behind us. Companies with solid balance sheets and a steady pipeline of talent will be well resourced to pursue ownership transitions that position them for the post-pandemic landscape. Those unprepared for the events of 2020 can likewise take a fresh look at the projected value of their company and at the opportunities and risks in selling.

10 Questions to Ask Yourself Right Now
Now is an ideal time to reevaluate transition plans, starting with a rigorous look at what will change forever, which market principles still hold, and how owners can adjust their plans. Start by asking yourself these 10 questions:

1. How have my transition goals shifted in the current market?
2. Who will lead the business moving forward?
3. Is our succession plan aligned with our vision as well as our strategic and operational goals?
4. How aligned are the current and next-generation owners and leaders in terms of ownership, growth and vision for the company?
5. What is most important to current owners—legacy and business continuity, control of the business and/or maximizing financial return?
6. Where are points of risk/overreliance on key leaders?
7. How are we preparing successors for future leadership roles?
8. How will the current disruptions (e.g., economic recession, COVID-19, etc.) impact our ownership transfer plan?
9. Do we have effective buy-sell agreements in place to protect the organization and all shareholders?
10. Have we built the business to provide multiple options for ownership transfer to ensure a path to liquidity for shareholders?
From the answers to these questions, you’ll be able to 1) determine your current status on the OTMS spectrum, 2) identify the gaps that need to be filled, and 3) develop an OTMS plan that truly meets your company’s needs while concurrently preparing it for long-term success.

**Buyers Are on the Prowl**

The good news for E&C companies that are dusting off the OTMS plans that may have been back-burnered in 2020 is that buyers are on the prowl, looking for opportunities to diversify, add specialization, and/or take advantage of gaps in market supply after a seismic shakeup.

For E&C firms, successfully transferring ownership has always been coupled with the need to effectively manage succession planning. More so now than in the past, companies that invest in developing future leaders and building their businesses with multiple paths to owner liquidity will be successful in the years ahead.

This article was adapted from “Ownership Transfer and Succession Management in Construction: Top Four Questions,” originally published in the March/April issue of CFMA Building Profits.
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