



# Build Your Construction Company Exit Strategy



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## **Build Your Construction Company Exit Strategy**

There are certain truths in the construction business, and one of them is that it's often easier to get into construction than to get out. Many companies start with one individual and some tools. Twenty-five years later, that same person is running a complicated business with many employees, big loans, enormous responsibilities and a lot at stake.

Even if the company is well established and several generations old, the owners are often so busy running the business, the last thing they can think about is an exit plan. But big or small, every privately held company must transition ownership at some point.

In this paper, we'll present some of the important considerations when preparing your company for transition to new ownership. This is often a difficult subject, for both financial and emotional reasons, but the reality is, by planning early, you have much greater control of your future.

### **What's Next?**

One of the reasons construction company owners are often uninterested in broaching the subject of "what's next" for the business is that they are accustomed to living with a great deal of uncertainty. They have become comfortable with the inevitable economic downturns, political changes and other challenges that have affected their fortunes over the years. These uncertainties are just a way of life, so trying to create a concrete plan for the future often seems counterintuitive, even a bit futile.

According to a survey of construction company owners by construction management consulting firm FMI:

- 24 percent of all contractors plan to sell their stock in their company and no longer be active in the business in less than five years.
- Nearly 30 percent of those responding to the survey say they are not ready to transfer ownership.
- Another 20 percent are unsure of or unaware of techniques for transferring ownership.

So that's about half of all contractors who are unprepared to get out of the company, which is, in most cases, their largest and most income-producing asset. No wonder they're not taking action!

The best way to address this huge issue is to approach it as you would any construction project: Create a blueprint. Make a schedule. Give specific tasks to qualified workers, and assign completion dates. Of course, you can count on some change orders and lots of troubleshooting along the way.

### **Make A Plan. Now.**

What's the right time to start planning your exit? There are many different opinions on precisely the best time to begin the process, but all would agree that sooner is better than later. In fact, some would say that you should start planning how to get out of your company the day you open its doors.

At a minimum, you'll want at least two or three years. You need to give yourself enough time to get the business in shape for sale or transition, identify a new owner and get the

deal done. The length of time needed to accomplish all of this will depend on your company, the economy and your level of motivation.

Know that there is much to be gained by planning early, and much to lose if you start too late. Putting off the planning of an exit strategy means:

- You may not have enough time to complete a successful transition to your successor. If you die or become disabled, your traumatized survivors may not be the best candidates to run the business.
- You could leave your survivors with unnecessary financial and legal complications.
- Your business could lose value or fail, particularly if unprepared, risk-averse family members or employees have stepped in to “help.”
- Your business might have to be sold quickly at a reduced price. A rule of thumb is that the typical return on a construction company liquidated under duress is about 40 cents on a dollar.
- Employees who have been loyal to you for years could be left with no job or financial security.

Lawyer, exit planning expert and author of a new book, *Cash Out Move On*, John Brown has created a framework to help owners design their own exit strategies, with a step-by-step process that allows them to leave their companies on their terms and on their schedules.

According to Brown, the first step is to define your objectives in leaving the business. For example, when do you want to leave? Do you have someone in mind to succeed you as owner? How much income do you need after you leave?

The answer to the last question may dictate the answer to the other two. Leaving your company with enough money to sustain your lifestyle and attain your goals may mean making different decisions about how and when you exit.

To help think through the answers to these big questions, it's important to assemble a team of trustworthy advisors, including your CPA [CA], attorney, insurance agent, retirement and estate planning experts. Working with you, this team can make your exit smooth and effective.

### **What's It Worth?**

In most cases, the business is your most important asset. Do you know how much it's worth? Although you may have some idea of its value, it is imperative that you get an objective, independent business valuation before going any further with your exit strategy. Your exit plan will depend on how much the company is worth now and how much you want it to be worth when you want to leave.

If you've never had a business valuation before, you might be surprised at how much you will find out about your company through the valuation process, including information about your place in the market, opportunities, risks, and industry trends. Be sure to hire a professional, accredited valuation analyst with experience in construction company valuations.

The valuation professional will give you his or her professional assessment of the business' fair market value, which is defined as an estimate of the amount a willing buyer would pay to a willing seller if both were free of compulsion and in possession of all pertinent facts. Armed with the fair market value of your company, you can begin to make decisions about your next steps and design the transition of the company in a way that maximizes value and minimizes taxes.

Of course value is a relative thing, and fair market value should not be construed as the selling price of the company, but rather a benchmark from which to work. If you plan on selling to a third party, it is in your best interest to get the highest price possible.

On the other hand, if you're transitioning to a family member or insider group of employees, as is the case with many construction businesses, your strategy will likely involve transferring part of the business at the lowest possible value in order to save taxes. In this case, the value of a minority interest in your company would be substantially discounted, often by as much as 25 to 50 percent, due to lack of marketability. The idea behind a marketability discount is that shares in a privately held company are less liquid — or marketable — than shares in a publicly traded company, and therefore their value is discounted. It is part of the business valuation expert's job to determine the amount of discount.

Discuss these issues with your financial advisors as your exit strategy is fine-tuned.

### **Who's the Buyer?**

Construction is a tough business. Third-party buyers are often scared off by the risks involved, especially the thin margins and cyclical ups and downs dictated by the whims of the economy. Sometimes a construction company's success hinges on the relationships the owner establishes. Banks and surety companies often rely on the owner's personal guarantee, and once the owner leaves, loans and bonds may be more difficult to obtain.

### **Balance Exit Planning With Capital Needs**

The construction industry has unique capital needs. Crucial relationships with banks and surety companies require that you maintain a healthy amount of cash in the business. However, retaining extra capital in the company doesn't usually mesh with transition planning goals as you try to fund your exit. So what's an owner to do?

Recognize that bonding companies and banks rely on the financial ratios in the business. Work with your advisors to figure out the amount of cash you must retain in the business to supply the necessary working capital and keep the bank and bonding company comfortable, then plan to draw off the excess.

Share your plans with your bank and bonding company, explaining your transition and exit planning goals and strategies. Remind them they already have your personal guarantees, and explain that by taking this money out of the business, there is less at risk in a lawsuit or creditor claim.

Getting "approval" from your bank and bonding company means they are more likely to stick by the company after you leave. This improves the likelihood of the business surviving and providing an income stream to fund your future.

For these reasons, it can be difficult to interest a third-party buyer in the purchase of a construction company unless there is substantial equipment involved, a specific market niche, or another valuable resource, such as a quarry, that can be purchased along with the company.

Most construction company owners will transition ownership within the company, either to employees or family members, rather than selling to an outside buyer.

### **Setting Yourself Up for Success**

Transitioning the company internally is a long-term project with several key steps along the way, each of which enhances the value of the company and helps ensure a successful transition.

**Groom successors.** Who's the right person to take over when you leave? Is the next owner prepared to lead? Are you transferring to the right key employee or family member for the right reasons?

Leadership requires a special set of competencies, and whether you transition to a family member or an executive team, you'll need to begin grooming your successor in plenty of time. This process will involve training, goal-setting, financial planning and some soul-searching on your part. You'll want to feel confident that the business is being left in good hands, not only for the sake of your customers and your reputation, but also for the sake of your future income.

One of the best steps you can take is to develop a mentoring program. Although some degree of informal mentoring inevitably occurs among family members, it is important that the next leader also have non-family mentors inside and outside the business. An external mentor might be an admired executive in another industry, a consultant, accountant, lawyer or executive coach.

Another step you can take is to offer your successor opportunities to prove himself or herself. Assign leadership of an appropriate project or key account, and provide mentoring to support success. Allow your company's future leader to make independent decisions and find a personal leadership style.

### **Buy-Sell Agreements: The Key to Continuity**

Whether you are the sole owner or a partner in your business, you must have a continuity plan or buy-sell agreement in place — *now* — in case of your death or disability. In fact, your bank or surety company may require one. Banks and surety companies assume a business will be run by its owners — not by a deceased owner's spouse.

The agreement should cover the following subjects:

**Triggering Events.** A buy-sell agreement should define the events — death, disability or retirement, for example — that would trigger the agreement to go into effect.

**Valuation.** The agreement should outline a way of valuing the assets of the business. Discuss with your financial advisor the various valuation formulas that would make sense for your company.

**Funding.** While installment payments and a bank loan can be used as funding, a life insurance policy on the owner is a common way to create necessary cash to fund an owner buyout or keep the company going. When an insurance payout results from death, some or all of the proceeds are used to pay the estate in full.

*Because companies change over time, buy-sell agreements should be reviewed periodically. Contact Vito Loisi at (630) 545-4500 to make sure your buy-sell agreements are up-to-date.*

**Get the business in shape.** In most cases, owners count on their business interests to be the funding source for the next stage of their lives, whether that involves retirement, semi-retirement, or buying or starting another business. This means you can't leave your current business unless it is productive enough to give you the cash flow you need for the future.

What can you do to get your business running like a lean, mean machine capable of funding your exit? Perhaps there are problem areas of the business you've overlooked because they were unpleasant to address or beyond your area of expertise.

For example, what can you do to improve your project bidding and estimating process? Are there ways you can shore up long-term contracts? What personnel issues should be taken care of? What can you do to motivate and keep key employees who might be tempted to leave? How can you help your successor create and maintain good relationships with your lenders, vendors and clients?

If your goal is to leave the company in the best condition, now's the time to tackle these difficult issues.

**Motivate your team.** Keeping your key employees inspired and in place takes effort. Without your best project managers, estimators and foremen on the job, your business may fail. It's in your best interest to make sure that your business can run effectively without you.

Consider incentive programs designed to motivate key employees. Pay special attention to deferred compensation plans, which give specific employees substantial financial incentives for staying with the company for a period of time.

For example, a phantom stock plan is one way to give key employees a vested interest in the company's success without diluting ownership. Phantom stock involves a contractual agreement between the company and the key employee, designed to mimic actual stock ownership. A typical plan creates deferred compensation "units" at a set value equal to the company's stock. As the stock appreciates or splits, or dividends are paid, the employee's phantom stock account is "credited" equally.

Employee Stock Ownership Plans (ESOPs) are another option. An ESOP is a tax-qualified retirement plan that invests primarily in the stock of the employer. Employees have individual ESOP accounts invested in the employer's stock.

In the right circumstances, an ESOP can be an excellent exit strategy. The ESOP simply buys company stock from the owner. This gives the owner the opportunity to sell the stock to a ready market, diversify holdings outside the business and gradually step out of the company with his or her wealth preserved. However, ESOPs carry heavy administrative burdens and can also present the contractor with additional liabilities at a time when he or she least needs it, so you will want to carefully investigate how an ESOP would work in your company.

**Fund your exit.** There are special considerations when transitioning your company to employees or family members. Remember, this is a substantial transaction, involving substantial tax consequences.

It's unlikely that family members or a group of employees will have cash available to buy you out, which means they must turn to a bank or rely on owner financing. Banks are sometimes unenthusiastic about construction company buyout loans because the additional debt can make bonding difficult, which in turn can impact the future earnings of the company.

Owner financing — a structured buyout over a period of years — affects the company less because it is a personal loan arrangement. However, owner financing means that you'll probably be tied to the company for at least five and up to 15 years.

Alternatively, simply transferring the company ownership to the next generation of family members has its own set of issues. Among the most pressing is implementing strategies to minimize taxes to both you and the next generation. One of the most tax-effective strategies is to transfer by gift minority interests in the company. Your CPA [CA] can tell you exactly how to accomplish this in the most tax-advantageous manner.

### **Leave Feeling Good**

Leaving the company you built from the ground up may be exciting, but it won't be easy. You may feel frustrated by the new owner's choices or your ego may be bruised now that you're not the decision-maker. Working with an executive coach or mentor to figure out the emotional side of the transaction is time well spent.

In many cases, it's helpful to create a plan for the next phase of life, be it another venture, travel, retirement or a combination of new activities, endeavors and hobbies. Your company's new owners — even if they are family members — will probably benefit from your focusing on something other than the business. The new team needs a chance to make its own decisions and implement changes.

Preparing for such a big transition takes time and the willingness to embrace change. Working with a team of people you can trust to advise you through this process can give you an important advantage. Their expertise and guidance can mean the difference between an exit plan that helps you attain your goals, and one that leaves you disappointed and frustrated.

Preparing to leave your business may feel like a risky endeavor, but as the owner of a construction company, you have already demonstrated a fair amount of risk tolerance. By putting just a fraction as much time and effort into leaving your company as you did in building it, you'll be well equipped for whatever comes next.

## **Your Action Checklist for Leaving Your Business in Style**

Exit Planning uses an owner's unique personal objectives to convert his or her current reality into the desired outcome. The Exit Planning Process helps maximize financial return, minimize tax liability, plan for contingencies and increase the likelihood of a successful transfer of the business.

### **Step 1 - Owner Objectives**

Each business owner's unique objectives drive the creation of his or her Exit Plan. Step One articulates and tests owner objectives so that the comprehensive Exit Plan focuses on achieving those goals. Key exit objectives that will be identified as part of the Exit Planning Process include: (1) the owner's desired departure date, (2) the value that the owner wants or needs from the business, and (3) the individuals or entities to whom the owner wants to sell/transfer the business.

### **Step 2 - Business and Professional Financial Resources**

Step Two determines what owners have — how much the business is worth and how much cash flow the business can generate for Exit Planning. The current value and projected cash flow, along with other non-business assets and income, are used to determine the paths and planning tools available to reach the owner's objectives.

### **Step 3 - Maximizing and Protecting Business Value**

The elements that build the value of a business or protect the value the owner has worked so hard to create are called Value Drivers. In Step Three, owners and their advisors identify which Value Drivers are important to meeting the owner's overall exit objectives and devise specific steps to maximize the impact of the Value Drivers.

### **Step 4 - Ownership Transfers to Third Parties**

During Step Four, owners who want to sell their business to a third party will work with their advisors to identify ways to do so in the manner that results in the most beneficial sale price and terms. Not all business owners go through Step Four — those who don't, either retain their ownership long term or skip to Step Five.

### **Step 5 - Ownership Transfers to Insiders**

Step Five includes a detailed plan to transfer the business to insiders (children, key employees or co-owners). Careful planning in Step Five allows the owner both to receive the desired value from the business and minimize risk, while using the resources of the business should the purchaser have little or no personal capital.

### **Step 6 - Business Continuity**

Step Six prepares the owner for the contingencies that affect the business and its owners. A complete Exit Plan incorporates potential changes, such as death or permanent disability of an owner so that the owner's objectives can still be achieved if circumstances change.

### **Step 7 - Personal Wealth and Estate Planning**

The sale of a business generates cash for owners, their families and the IRS. During Step Seven, owners and their advisors create a plan that not only preserves wealth, but minimizes taxes using both lifetime and estate planning tools.

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For more information, visit [www.exitplanning.com](http://www.exitplanning.com).

## Exit Planning Resources

### Wolf Financial Group

[www.wolffinancialgroup.com](http://www.wolffinancialgroup.com)

The member companies of the Wolf Financial Group serve the varied and specialized needs of closely held businesses and their owners. Our 120 plus professionals offer an extensive range of accounting, tax, consulting and financial advisory services. Headquartered in the Chicago metropolitan area, we are able to satisfy our clients' global needs through our affiliations with PKF North American Network and PKF International Limited, associations of legally independent firms. Member companies, their services, and contact information are listed below.

**Wolf & Company LLP**, certified public accountants, provides accounting, tax, and financial and management consulting services; including a full range of succession planning and business valuation services. Wolf & Company has helped numerous construction companies meet their goals in exiting their businesses. Wolf also is a member of *ProfitCrew™*, an association of independent accountants and business advisors in North America dedicated to helping construction companies build profitable businesses. Contact Vito Loisi at 630-545-4500.

**Wolf Capital LLC**, provides investment banking and due diligence services to medium sized privately owned businesses; including assistance with finding buyers of businesses and developing succession strategies. Contact Greg Lafin at 630-545-4577.

**Wolf Financial Management LLC** provides wealth management, investment and retirement plan administration services. Contact Peter F. Bauer at 630-545-4777.

### Business Enterprise Institute

[www.exitplanning.com](http://www.exitplanning.com)  
888-206-3009

This provider of education and information to successful business owners is the creator of The Seven Step Exit Planning Process™ (See *Your Action Checklist for Leaving Your Business in Style.*)

### SCORE

[www.score.org](http://www.score.org)  
800-6343-0245

This nonprofit association is dedicated to the formation, growth and success of small businesses nationwide.

### Small Business Administration

[www.sba.gov](http://www.sba.gov)  
800-827-5722

This independent agency of the federal government protects the interests of small businesses.

## APPENDIX

### Case Study: Preparing the Understudies to Take Over the Show

Andy Beck is a rarity: an entrepreneur who's been actively planning his own exit from his homebuilding business for the past five years. He started taking preliminary steps almost 20 years ago by setting up an incentive plan for key project managers.

"It was hard to find and keep these guys," says Beck, CEO of Beck Building Company. "I was concerned they would be hired away." The incentive plan gave the project managers a portion of the company's profit, in part through an immediate cash bonus and in part through a vesting schedule. The plan worked: Of the five employees who ultimately participated in the plan, two are still with the company, one retired after 27 years with the company and one moved to another state but remained active in the company as an estimating consultant and subcontractor.

Taking good care of your employees is an essential foundation to a successful exit strategy; but turning your retirement from wishful thinking into actuality requires some very specific steps. (See *"Your Action Checklist for Leaving Your Business in Style."*)

The first step — acknowledging that you will have to leave your business at some point — is usually the hardest. "For an entrepreneurial person, it's not easy to let go," Beck says. "First, you have to make up your mind to do it. Then you can roll up your sleeves and get to the business of making it happen."

About five years ago, Beck decided he was ready to get the wheels turning. Answering the next important question — who would take over — was easy. "I had a loyal cadre of people and felt it was right to give them the opportunity to own the company," Beck says.

But preparing the next generation of owners and managers isn't as simple as handing over the keys to the building. To help ensure their success, Beck set up a plan that included gradually transferring:

**Financial and business management knowledge.** "If you're going to hand financial management to people, they have to understand what it means," Beck says. "So before we offered stock options, we shared financial management information." The managers needed some education on financial management concepts, so he sent them to local seminars. **[Note to Reader: Wolf & Company offers clients continuing seminars on financial management issues in conjunction with our affiliate, Wolf Financial Management LLC.]** "We wanted them to understand the concept of retained earnings — in other words, you shouldn't be handing out all the money. A fundamental step that was difficult for my crew to understand was that you can grow yourself out of business," Beck says. He found that such knowledge created a different mindset among the owners-in-training. "The conversation with senior staff becomes different," he says. "They start asking, 'Do we need to spend the money on that?'"

**Shares of ownership.** Five executives ultimately bought into a stock purchase plan, funded in part through employees' deferred compensation plans and in part through a loan from Beck.

**Responsibilities.** Beck and his team created a matrix that spelled out all of Beck's responsibilities and established a time frame for transferring them. Beck recently handed off the last piece in that matrix — calculating incentive bonuses — to the president of the company. "You can't just prepare the business financially to be transitioned. You have to, over time, shift responsibilities and performance of management tasks to all these other people and see who can thrive and accept that responsibility."

**Relationships.** Banks, sureties, architects and engineers are all vital partners in a construction company's success. "If you're going to make the buyer of your business successful, make the transfer of those relationships part of the process," Beck says.

**Strategic vision.** Beck and his team spent about a year-and-a-half establishing a strategic plan, which involved establishing core competencies, a vision statement and guiding principles. "We started taking our loose, entrepreneurial way of doing things and making it fundamentally more quantitative." This process was important for two reasons: "You plant the seed of your successors' continued success, and you get to shake out early in the process who wants to participate and find out if they are ready for management."

**Leadership.** Not everyone will be able to fill the role they want. "Everyone has to be prepared for the result that might come out of this process that they may not be the person in the organization they wanted to be."

Once the right players are in the right positions and have the knowledge and training to execute their new responsibilities, it's time to "take the training wheels off," Beck says.

Letting go of active management is a difficult transition. "If you're entrepreneurial, and you're used to being a big shot, it's tough to stand down," Beck says. "It's like having an understudy and they take over the show."

But mentoring and seeing others succeed is its own reward, Beck says. "You can take pride in putting this great team together," he says. "It's fun to watch people who do good work. You've just got to be prepared to be in the back seat."

*Our firm can help you exit gracefully from your current business – whether you're considering doing so in two years or in 20. Call Vito Loisi today at 630-545-4500 to find out how to establish long-term strategies for meeting your personal and business financial goals.*