

SUCCESSION PLANNING AND THE 7 HABITS OF HIGHLY EFFECTIVE PEOPLE

IL CPA SOCIETY CONSTRUCTION INDUSTRY
CONFERENCE

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2



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3 WHAT IS SUCCESSION PLANNING?

- Planning for the orderly transfer of the management/ownership
- Avoid liquidation
- Avoid unnecessary taxes
- Carry out the family's nontax objectives
- Assist in structuring the future of the company

4

HOW DOES THIS RELATE TO BUSINESS SUCCESSION?

The **7** HABITS Of Highly Effective People

- 1 Be Proactive
- 2 Begin With The End In Mind
- 3 Put First Things First
- 4 Think Win-Win
- 5 Seek First To Understand,
Then To Be Understood
- 6 Synergize
- 7 Sharpen The Saw

5 NOT AS SIMPLE AS IT SOUNDS

- Competing interests: Owner/next owner
 - Treat each with great care
 - Uncover Steven's desires for family/business
 - Thinking about business issues (tax, legal, finance) AND psychological issues
- Barriers: Discounting future events

6 HYPOTHETICAL

- Steven Covey has two children, Steven Jr, and Stephanie. Steven is divorced and is remarried to Sally. Sally gets along well with Junior and Stephanie, but also has her own children. Junior is married with two children and has managed and operated the family business for three years.
- Stephanie is married with two children and plays a small role in the family business. Her husband is an officer in the business. None of the grandchildren have the talent or desire to run the family business.

7 HYPOTHETICAL

- The business is a commercial construction company. The business is worth about \$20 million. Steven owns 81%, Junior owns 10% and Stephanie owns 9%.
- Steven is willing to give or sell all of his interest in the business to Junior and Stephanie. Steven has \$4 million of nonbusiness assets and a \$3 million life insurance policy. He intends to leave the business equally to his children. Steven also plans to leave one-half of his nonbusiness assets to his children with the remainder of his nonbusiness assets to Sally. Sally does not have substantial assets of her own.

8 HABIT I – BE PROACTIVE

- Advisers
 - Help owner avoid inaction and reactive mode
- Understand fear and irrational beliefs of owner
- Plan for potential problems which can be numerous
 - estate tax/liquidity
 - gap in management operations if unexpected death
 - drive down value
- Start the process!
 - Set goals for plan and exit – could take many years
 - Incremental gains

9 TRIGGERS TO OPEN DISCUSSION

- Aging owners/leaders or pending retirement
- Next generation involvement at management level
- Sudden events
- Rapid growth
 - Hiring or loss of key management team

10 INITIAL STEPS

- Conduct crucial conversations
 - Align goals for succession with company core values and strategic goals
- Assess current state of readiness for succession
 - Identify friction and competing interests
- Consult with business and/or estate planning attorney with relevant background

|| EXAMPLE

- Goals:
 - Steven Jr. to control
 - Equalization among children
 - Funding for second spouse
 - Gifting considerations



12 CONSIDERATIONS:

- Steven's balance sheet
 - Gift or sale?
- Control of company – Steven Jr.
 - Voting and Nonvoting Stock
 - Other impact on company
- Trusts or outright
- Grandchildren?

13 HABIT 2: BEGIN WITH THE END IN MIND

- Envision future in order to work and plan towards it
 - How will business operate going forward
 - Consider family dynamics
 - Steven's retirement
 - Charitable endeavors
- Applicable to Individual and Company:
 - How do I want to be remembered?
- No perfect solution and interests will compete

14 WHAT'S NEXT FOR STEVEN?

- Key question in the process
 - Life after running the business?
- Applicable to Individual and Company:
 - How do I want to be remembered?



15 IDENTIFY CHOICES FACING STEVEN:

Planning to transfer the business involves many issues.

- Should business continue after the owner's death?
- Who will own the business after the owner's death?
 - Separate ownership from control?
- Treat children equally in the distribution of estate?

16 FIND STEVEN'S WHY

- Most important financial transaction of Steven's lifetime
- Financial security
 - depends upon exiting properly
 - maximize value by planning
 - Others depending on business owner (other owners, employees, kids, lenders, suppliers, customers and the community)



17 FIVE VOLUNTARY EXIT OPTIONS

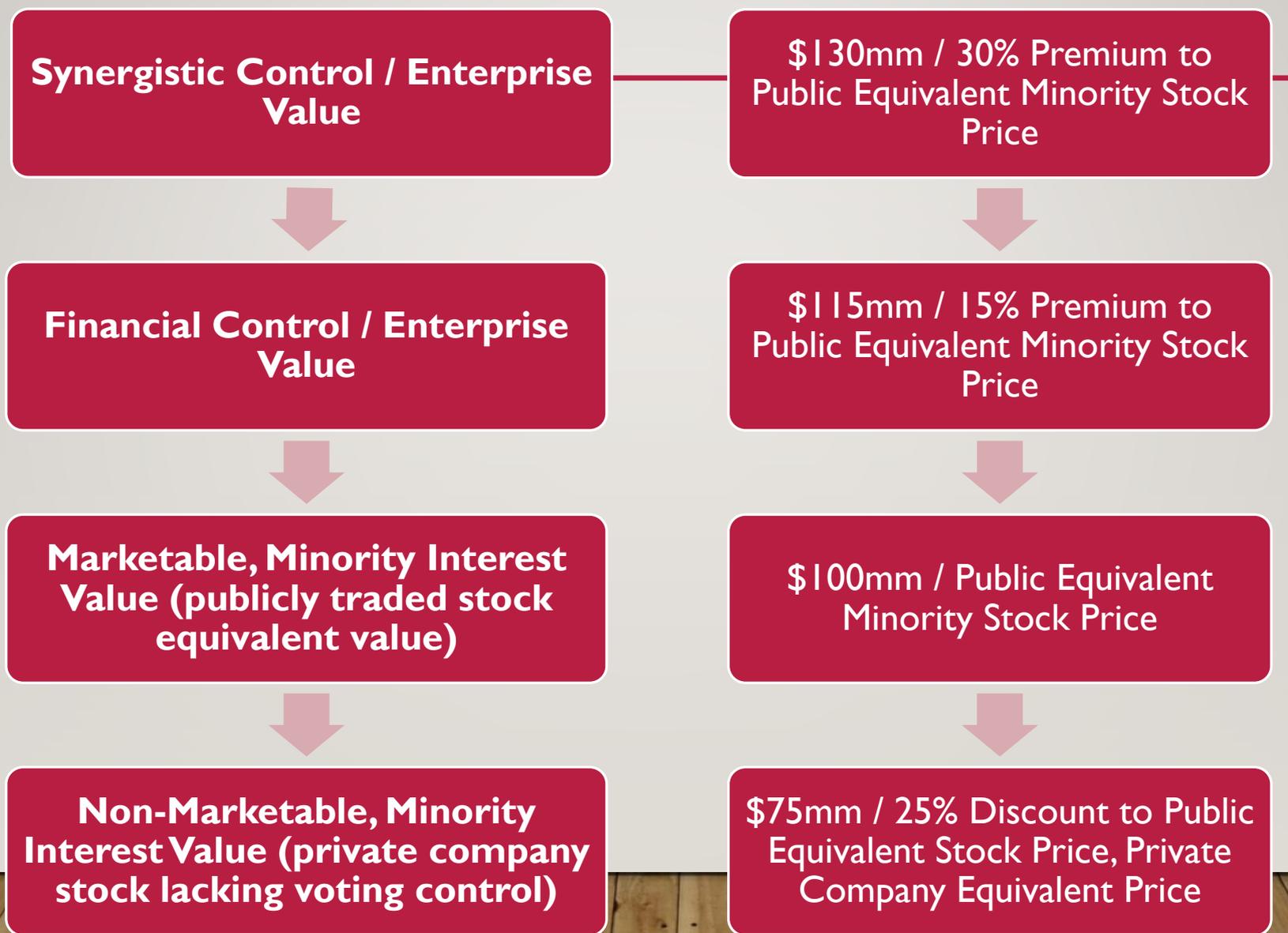
1. Transfer the business to next generation
2. Transfer the business to the key managers
3. Sell to a third party strategic buyer
4. Sell to an employee stock ownership plan (ESOP)
5. Liquidate

18 INDICATIONS OF A SUCCESSFUL BUSINESSES:

- Strong management
- Quality of earnings
- Performance in line with projections
- Good customer and supplier relationships
- Diversity of customers
- Competitive advantages
- Well-designed strategy and action consistent with strategy
- Technological or intellectual property advantages

LEVELS OF VALUE

(THESE ARE WIDELY RECOGNIZED CONCEPTS IN THE VALUATION INDUSTRY. THE CHART BELOW WAS PREPARED FOR ILLUSTRATIVE PURPOSES ONLY. DISCOUNTS AND PREMIUMS SHOWN ARE NOT APPROPRIATE IN ALL CASES.)



20 BUY-SELL AGREEMENTS

- Logical time to revisit Buy-Sell Agreements.
- Do clients understand the ramifications of tax rate changes on value?
- Have pricing formulas become stale?
- Make sure business owners understand how business appraisers will incorporate tax law changes and related changes in company management policies in valuation models.
- Have business owners in the construction industry considered how the buy-sell will “perform” in different market environments?

2 | CONSTRUCTION INDUSTRY NEWS

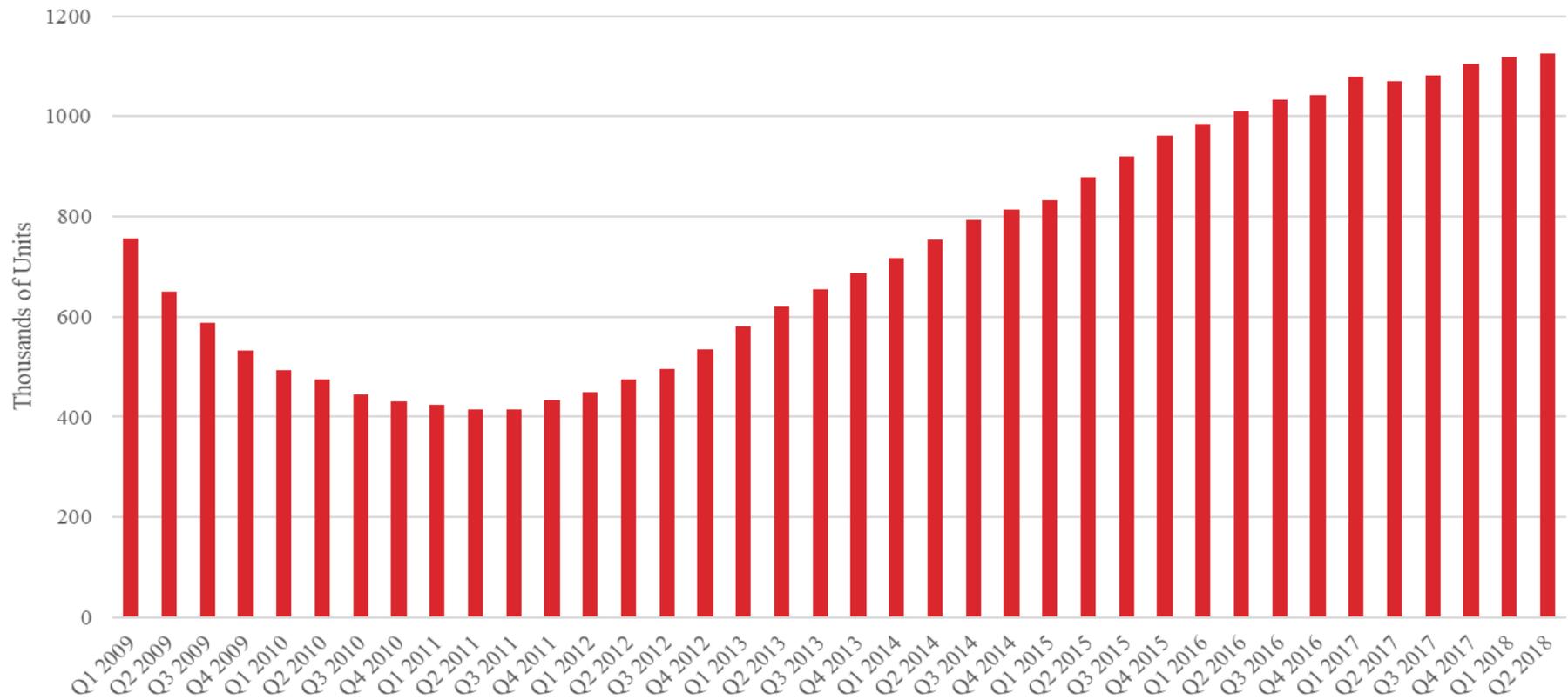
- **Spending** year-to-date through the first eight months of 2018 was 7.0% higher than in January through August 2017 for public construction and 4.8% for private construction.
 - Within private construction, spending for residential projects increased 6.5% and 2.7% for nonresidential projects.
 - The largest public categories recorded year-to-date gains of 6.4% for highway construction, 1.0% for educational construction and 15.9% for transportation construction.
 - Single-family homebuilding rose 7.9% year-to-date, multifamily slipped by 0.7% and improvements to existing buildings climbed 6.9%.
 - Among private nonresidential spending niches, the largest—power construction (including oil and gas field and pipeline structures)—edged up 1.1%, commercial (retail, warehouse and farm) construction rose 4.6%, office construction increased 6.5% and manufacturing construction declined 5.5%.

22 CONSTRUCTION INDUSTRY NEWS

- First Half 2018 **nonresidential** construction **starts** are down 5.5% year-over-year; June 2018 starts down 6.3% year-over-year.
 - Higher education down 29%; hotel/motel up 22%; private office down 34%; transportation terminal up 61%;
- Data is consistent with forecast of decelerating growth for total construction in 2018: 3% in 2018 vs. 5% in 2017.

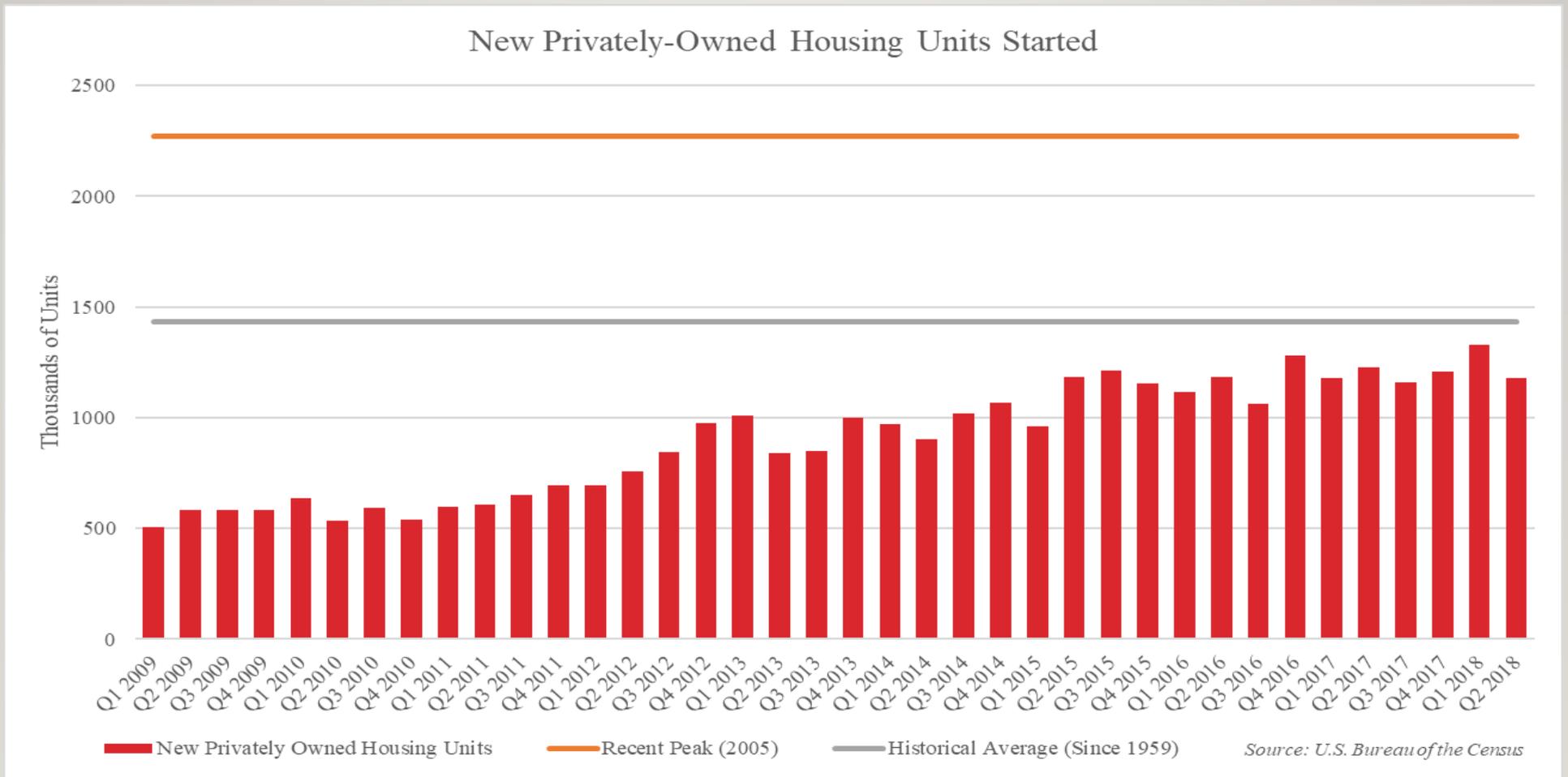
23 HOUSING UNITS UNDER CONSTRUCTION

New Privately-Owned Housing Units Under Construction



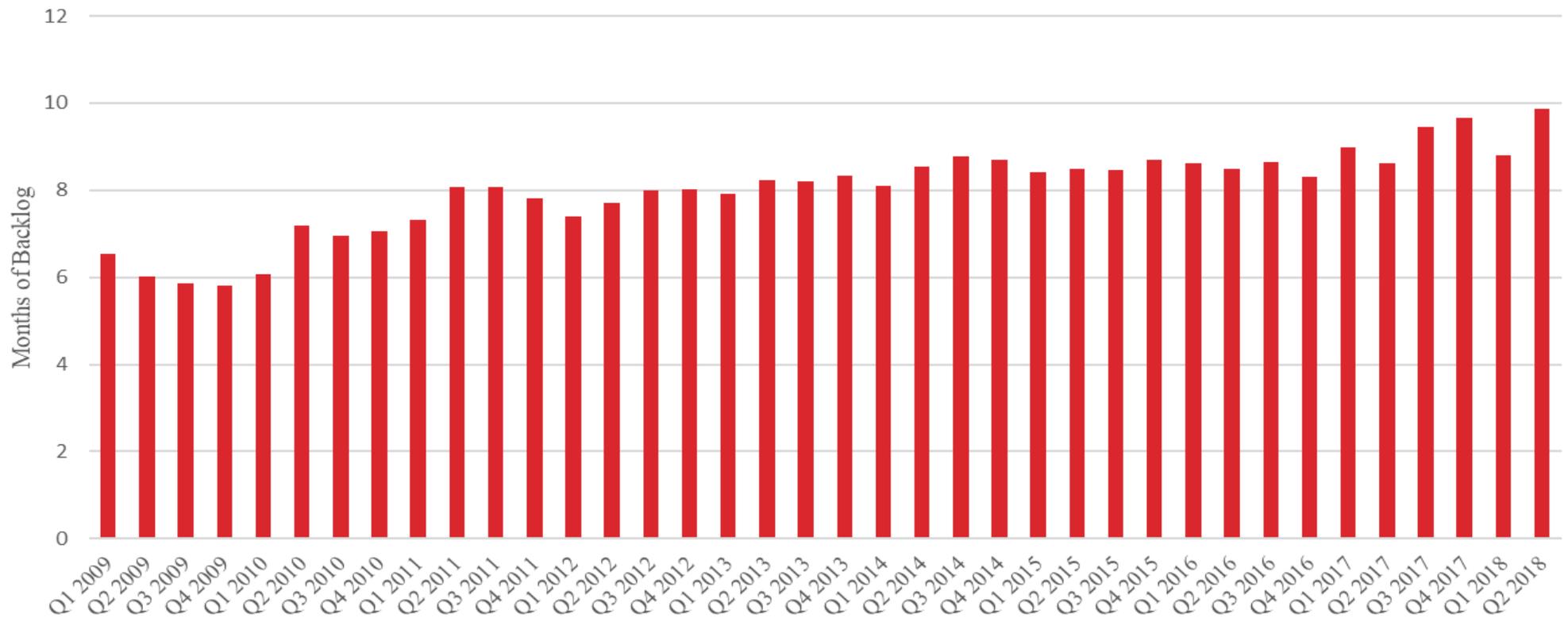
Source: S&P Capital IQ

24 HOUSING STARTS



25 NON-RESIDENTIAL BACKLOG

Construction Backlog Indicator for Commercial and Industrial Contractors



Source: S&P Capital IQ

CONSTRUCTION INDUSTRY NEWS

(SOURCES: AUTODESK AND THE ASSOCIATED GENERAL CONTRACTORS OF AMERICA (AGC);
WWW.ECMWEB.COM; WWW.CONSTRUCTIONDIVE.COM)

- In a survey of more than 2,500 firms, respondents overwhelmingly say they **plan to add employees** in the next 12 months – a strong indicator of ongoing demand for construction...
 - 80% of construction firms report they are having a **hard time filling hourly craft positions** that represent the bulk of the construction workforce.
 - The September 2018 IHS Markit PEG Engineering and Construction Cost Index report revealed that **construction costs** rose at an accelerated pace month-over-month to an index reading of 62.1 — up 3.2 points from August. This marks the 23rd straight month of cost increases.
 - The cost of many products used in construction climbed 7.4% over the past year due to double digit increases in commonly-used construction materials.
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27 LOOKING AHEAD TO 2019 & BEYOND...

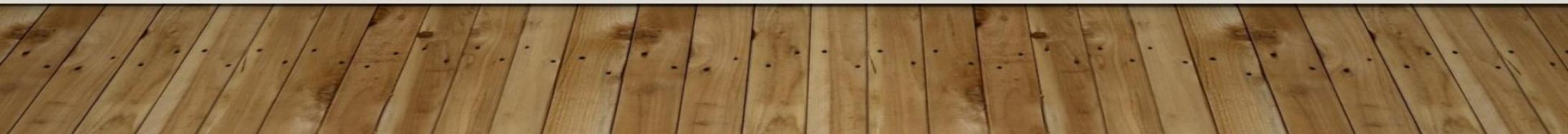
(SOURCE:WWW.ENR.COM)

- Executives of large construction and design firms believe market growth will continue at least until mid-2019.
- Beyond that, less optimistic. About 15% think the market will be in decline in 12 to 18 months, while 29% say it still will be in growth mode. But those percentages will reverse in three years, with 35% expecting a market decline and 16% still forecasting growth.
- Concerns include rising interest rates and increasing prices for steel and aluminum.

28 LOOKING AHEAD TO 2019 & BEYOND...

(SOURCE: DODGE DATA & ANALYTICS)

- The forecast, presented by Dodge Chief Economist Robert Murray, also offers critical data for members of the media covering economic and sector-based trends.
- "The expansion for the U.S. construction industry has been underway for some time now, with **deceleration in the rate of growth taking place recently**," stated Murray. "The current year has seen the headwinds of rising **interest rates** and higher **material prices**, but also the tailwinds of a strong economy, still favorable market fundamentals for commercial real estate, and greater federal and state funding for public works and institutional building projects. For 2018, U.S. construction activity remains on track to post a modest gain, but the **supportive factors affecting construction become less certain moving into 2019.**"



29 TRENDS IN PUBLIC COMPANY MULTIPLES

Guideline Public Company Analysis - Changes in Prices & Multiples from 9/30/16 to 9/30/18

Company	Stock Price 9/30/2018	Two-Year % Change	MVIC/Latest Year Net Sales/Revenues 9/30/2018	Two-Year % Change	MVIC/Latest Year EBITDA 9/30/2018	Two-Year % Change
<i>Stuart Olson Inc.</i>	\$5.70	-5.3%	27%	-4.4%	7.2 x	-2.4%
<i>MYR Group Inc.</i>	\$32.64	8.4%	42%	-13.9%	7.3 x	2.2%
<i>Tutor Perini Corporation</i>	\$18.80	-12.4%	39%	3.4%	8.0 x	3.7%
<i>Quanta Services, Inc.</i>	\$33.38	19.3%	57%	-9.3%	8.8 x	-10.6%
<i>MasTec, Inc.</i>	\$44.65	50.1%	78%	10.4%	8.9 x	-4.6%
<i>EMCOR Group, Inc.</i>	\$75.11	26.0%	60%	7.2%	9.7 x	-5.4%
<i>Granite Construction Incorporated</i>	\$45.70	-8.1%	82%	-8.3%	12.7 x	-10.4%
<i>Dycom Industries, Inc.</i>	\$84.60	3.4%	122%	-0.8%	13.4 x	59.6%
<i>Fluor Corporation</i>	\$58.10	13.2%	50%	4.1%	13.9 x	20.5%
<i>Jacobs Engineering Group Inc.</i>	\$76.50	47.9%	98%	61.4%	14.3 x	40.5%
<i>Bird Construction Inc.</i>	\$7.89	-30.5%	32%	-6.0%	26.9 x	178.7%
Median	\$44.65	8.4%	57%	-0.8%	9.7 x	2.2%
Average	\$43.92	10.2%	63%	4.0%	11.9 x	24.7%

30 M&A MULTIPLES PRE-2016 ELECTION

	Implied Enterprise Value	Implied Enterprise Value / LTM		
		Revenue	EBITDA	EBIT
Total Observations	369	157	54	44
90th Percentile	340.8	188%	20.3x	30.5x
Median	17.0	68%	8.4x	11.5x
10th Percentile	1.3	22%	3.7x	4.4x
Average	207.4	99%	10.0x	16.4x

Small Company Subgroup (Enterprise Values <\$50mm)

	Implied Enterprise Value	Implied Enterprise Value / LTM		
		Revenue	EBITDA	EBIT
Total Observations	248	94	25	22
Median	7.6	53%	5.7x	7.8x
Average	11.6	68%	9.6x	16.1x

3 | M&A MULTIPLES POST-2016 ELECTION

	Implied Enterprise Value	Implied Enterprise Value / LTM		
		Revenue	EBITDA	EBIT
Total Observations	100	46	11	9
90th Percentile	883.0	278%	31.2x	NM
Median	26.9	83%	12.5x	20.7x
10th Percentile	1.7	22%	3.7x	4.7x
Average	434.1	NM	13.7x	NM

Small Company Subgroup (Enterprise Values <\$50mm)

	Implied Enterprise Value	Implied Enterprise Value / LTM		
		Revenue	EBITDA	EBIT
Total Observations	62	24	NA	NA
Median	10.1	83%	NA	NA
Average	14.7	NM	NA	NA

32 TAX REFORM

- We are in a new paradigm of higher estate/gift/GST exclusion amounts, significantly lower corporate tax rates, and a mixed bag of changes to personal income tax rates.
- Wealth planners are being advised to contemplate both the transfer tax and the income tax simultaneously.
- Industry leaders are urging advisors to build flexibility into estate plans given continued flux in the political climate, and the sunset of the new personal income tax provisions on 1/1/26

33 IMPACT ON BUSINESS VALUATIONS: C CORPORATIONS

- All else being equal, the value of a C corporation has generally increased due to a reduction in the tax rate on income to 21%. Pre-TJCA, C corporation earnings above \$100k were taxed at approximately 35%.

	Federal Rate	State Rate	Total Effective	Pre-Tax Income	Net Income	Implied Savings
2017 Marginal Tax Rate	35.0%	5.0%	38.3%	1,000,000	617,500	
2018 Flat Tax Rate	21.0%	5.0%	25.0%	1,000,000	750,500	21.5%

- Can be large variations from state to state.

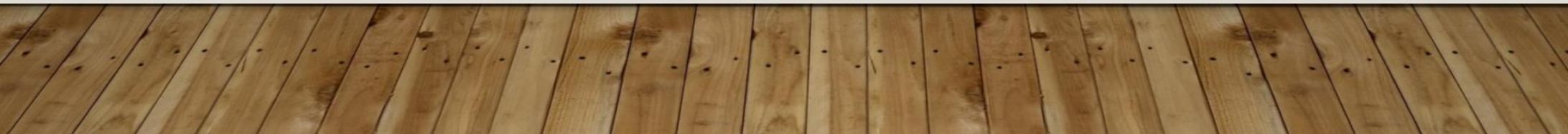
34 IMPACT ON BUSINESS VALUATIONS: PASS-THROUGH ENTITIES

- New Marginal Tax Rate Brackets for Business Owners and Individuals/Married Couples; New Top Rate of 37%.
- New Two-Tiered System: Specified Service Business vs. Other
- For those businesses engaged in an “SSB”, qualify for the 20% special deduction under Section 199A, potentially reducing the effective tax rate from 37% to 29.6%.
- Offsetting Factor: State and Local Taxes (“SALT”) no longer deductible for federal tax purposes above \$10,000

35

PASS-THROUGH ENTITIES VS. C CORPORATIONS (OPERATING COMPANIES)

- Valuation professionals generally agree that a pass-through structure has its advantages, and conduct an analysis on a case by case basis to ascertain whether or not the advantages have material economic value.
- Does the entity make distributions over and above the pass-through tax liability?
- Two layers of tax vs. one layer; avoidance of dividend tax.
- Build-up in outside basis due to accumulated, undistributed earnings.
- Historically, and subject to the facts in any particular case, appraisers might have opined that a valuation premium up to 25% was warranted.
- This is logical in that the majority of closely held companies choose to be structured as pass-through entities (S Corps, LLCs or FLPs).
- New Paradigm under TJCA – generally speaking, C Corp. Valuations are much higher; gap between C Corps and Pass-Through Entities has shrunk or closed.



36 Habit 3: Put First Things First

	Urgent	Not Urgent
Important	I Fire Fighting Crises Pressing problems Deadline-driven projects	II Quality Time Prevention, capability improvement Relationship building Recognizing new opportunities Planning, recreation
Not Important	III Distraction Interruptions, some callers Some mail, some reports Some meetings Proximate, pressing matters Popular activities	IV Time Wasting Trivia, busy work Some mail Some phone calls Time wasters Pleasant activities

- Put first things first – help clients with procrastination
- Focus on Quadrant II
- Schedule time

37 IDENTIFY BENEFITS OF CREATING A PLAN

- Protect employees
- Preserve legacy by leaving business intact or in growth mode
 - Avoid fire sale of business
 - Many businesses that go to market each year don't sell.
- A majority of owners don't know what their business is worth.

38 OVERCOMING RESISTANCE

- Unresolved family conflicts
 - second marriage
 - never feeling like adult
 - inherent rivalry
- Business equates to family member
 - brings personal gratification
 - sense of achievement
 - tied up with identity in many cases
 - extremely difficult to part with
 - raises mortality concerns
- Resentment

39 FRICTION COMPOUNDED AT SON'S LEVEL

- Desire for increasing responsibility to demonstrate maturity
- G2 newer ways of addressing situations
 - business school; other work experience
- Aspires to have freedom to act and make strategic decisions
- Personal satisfaction and lifestyle - depend on father's generosity
- Tired of waiting for "turn"
- Some children never go down this road
- Friction with other children

40 HOW DO WE SOLVE THIS?

- What should Steven do?
 - Address control issues
 - Gift shares to children
 - Sell shares to a trust for one or both children
- Should value of the company drive the action?
 - When is the right time to part with shares?
 - Children's situation – home/family
- Integrate succession plan into estate plan

4 | HABIT 4: THINK WIN-WIN

- A "win" for all ultimately better long-term resolution than if only one person in the situation had gotten their way.
- Character-based code for human interaction and collaboration.



42 GOAL = MAXIMIZE VALUE FOR RETIREMENT OR NEXT PHASE

- Succession plan needs to address this
- Key areas of inquiry can drive or detract from value
- Typical areas to address, both when preparing for sale and in the context of succession planning, include the following:
 - Does the company have a high customer concentration?
 - Strong management team?
 - Accounting services appropriate for current operations?

43 CONSIDERATIONS FOR INCREASING VALUE

- Key employees incentivized?
- Noncompete and confidentiality agreement
- Do employees have well-defined roles?
- Does the company have well-documented and defined processes?
 - Does the company have title to critical intellectual property?
- Information systems
 - Is financial reporting well-developed?

44 HABIT 5: SEEK FIRST TO UNDERSTAND

- Use empathetic listening to genuinely understand family/management which compels them to reciprocate the listening and take an open mind to being influenced
- Atmosphere of caring/positive problem solving



45 COMMUNICATION

- Should Steven let go of equality among children?
 - Equal distribution may not be possible
- Consider non-business assets available to family members outside of business
- Manage expectations in family

46 ALTERNATIVE LEGACY OPTIONS FOR CHILDREN OUTSIDE BUSINESS

- Nonbusiness assets
- Life insurance
 - Term/whole
 - Second to die

47 ALTERNATIVE LEGACY OPTIONS FOR CHILDREN OUTSIDE BUSINESS

- Private financing
 - senior generation sells to child, providing private financing
 - Set terms that allow projected company cash flows to assist with funding buyout
- Trusts
 - Use trust or certain charitable structures to ensure continuation.
 - Steven Jr. continues to lead the company; ownership separate.
 - Benefits
 - long-term legacy for future family generations,
 - reduced future death taxes
 - furtherance of family values

48 MODIFY COMPANY STRUCTURE

- Non-voting interests
 - Making children who are not involved in the business “silent partners” might be the right option.
- Ownership - voting and non-voting interests
 - Voting control to successor
 - Non-voting shares
 - benefit from distributions
 - share in the proceeds if sale

49 HABIT 6: SYNERGIZE

- Combine the strengths of people through positive teamwork, so as to achieve goals no one person could have done alone.
- Get the best performance out of a group of people through encouraging meaningful contribution and modeling inspirational and supportive leadership.

50 HABIT 7: SHARPEN THE SAW

- Implementation – address time horizon
- Master checklist
- Establish action steps, time frame and responsibility

51 TWO TAKEAWAYS:

- **Involve other advisers**
- **Engage clients in the discussion where possible**
 - Keep in mind psychological barriers to planning
 - Seek to understand client's goals for planning