Ownership Transfer Techniques That Work

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There Are Only Three Alternatives

- Internal transfer
- External transfer
- Liquidation

Three Components of Ownership Transfer Planning for All Three Alternatives

- Ownership transfer plan
- Management succession plan
- “Red Truck” or contingency plan
Factors Creating Salability & Value (1 of 2)

• Profits
  – Size and growth
  – Volatility
  – Recurring

• Type of customers, services and markets
  – Strategic appeal to potential buyers
  – Service component
  – Negotiated/less price sensitive
  – Recurring client opportunity

Factors Creating Salability/Value (2 of 2)

• Critical mass
• Management and organization
• Growth potential
• Synergy with buyer
  – Client base
  – Cost structure

• Location
• Scarce resource
  – Real estate
  – Material reserves
  – Permits
  – Technical or operational capability
  – Labor
Objectives and Motivation (1 of 3)

• Financial and risk issues
  – Fulfill financial needs
  – Resolve estate planning issues
  – Reduce personal risk
  – Maximize value

Objectives and Motivation (2 of 3)

• Lifestyle and personal issues
  – Desire to retire or do something different
  – Willingness to be an employee and give up control
  – Desire to manage a larger business
  – Ensure continuity
Objectives and Motivation (3 of 3)

• Business issues
  – Resolve management succession issues
  – Provide growth/diversification opportunities for business
  – Resolve dissension in management or family
  – Provide opportunities for management
  – Alleviate declining market/increasing competition

U.S. Surety Industry Survey

Method Used by Clients Successfully “Cashing Out” of Their Contracting Business

<table>
<thead>
<tr>
<th>Percentage</th>
<th>Method</th>
</tr>
</thead>
<tbody>
<tr>
<td>33.0%</td>
<td>Sold to key employees</td>
</tr>
<tr>
<td>30.7%</td>
<td>Sold or gifted to family</td>
</tr>
<tr>
<td>20.0%</td>
<td>Liquidated</td>
</tr>
<tr>
<td>5.9%</td>
<td>Sold to outsider</td>
</tr>
<tr>
<td>5.8%</td>
<td>Sold to ESOP</td>
</tr>
<tr>
<td>4.6%</td>
<td>Merged with another firm</td>
</tr>
<tr>
<td>100.0%</td>
<td></td>
</tr>
</tbody>
</table>
The Internal Option

Surety Industry Survey

Most Common Reasons for Ownership Transfer Plans Not Working

- Children not capable of running business: 17%
- Key management leaves because of no ownership transfer plan: 16%
- Unaware of possible alternatives of ownership transfer: 9%
- Other: 2%
- Price owner wants is too high: 16%
- Competent management leaves because of nepotism: 9%
- No competent successor management: 31%
Reasons Why Plans Don’t Work

- People issues
- Poor communication
- Inadequate profits
- A lot of good/bad and bad/good advice
  - Tax, legal and estate planning
  - Consulting

Ownership Transfer Profile

A: Own 100% today; sell 90% in year two, and retain 10% for 9 years
B: Own 80% today; sell 10% per year for 8 years
Management Succession Profile

Key Facts and Assumptions

- People side is the hardest
- **B Y O W Y O $**
  - Time frame without external financing of 5-10 years
- Internal sale can maximize value
Why do Owners Hesitate to Sell Stock to Employees?

- Requires disclosing financial information
- May create unrealistic expectations and inappropriate actions
- Owner has to discriminate among employees
- Potential for financing a competitor
- Usually requires continuing indemnification
- Owner is still at risk during the buyout
- Fear retirement and loss of income

Why Might Employees be Hesitant to Buy Stock?

- You may be asked to provide personal indemnification for bonding or banking
- You will probably have to borrow money or dedicate savings and income to a purchase
- Control of the company and policies will remain with the majority stockholder(s)
- More authority and perks may not be given—these items should still be based on performance and position
- Could be a risky investment
Why Owners Hesitate to Plan for Management Succession

- Management style not conducive to the development of successors
- Believes one person is better than a team
- Reluctant to make decisions about successors
- Fears development of successor management
- Complete identification with business
- Fears a lessening of importance—both in the company and in the community

Advantages of Selling Stock to Employees—To the Owner

- Can retain and motivate key employees
- Allows owner to retain control
- Provides for owner’s continued involvement
- Significant flexibility as to structure of the transition
- Value can exceed 3rd party sale
Disadvantages of Selling Stock to Employees—To the Owner

- B Y O W O $
- Requires disclosing financial information
- Usually requires continuing indemnification
- Owner has to discriminate among employees
- May create inappropriate actions
- Sale typically takes 5 to 10 years

FMI’s Laws of Management Succession (1 of 2)

**Law 1:** The people who own the business should run the business

**Corollary:** Minority interests may motivate some people some of the time

**Law 2:** Control is only important when you need it

**Corollary:** Don’t give up control as long as you are at great financial risk
FMI’s Laws of Management Succession (2 of 2)

**Law 3:** Blurring the distinction between compensation and return on investment causes confusion

**Corollary:** Pay management and employees what they are worth and provide owners return on their investment

**Law 4:** After age 25, age becomes a factor in effectiveness; maturity is the issue

**Corollary:** You never know if a dog can hunt until you put him in the woods

FMI’s Laws of Management Succession – Family Issues (1 of 4)

**Law 5:** Business relationships caused by accidents of birth have a low probability of success

**Corollary:** Children should be treated fairly and equitably – not equally
FMI’s Laws of Management Succession – Family Issues (2 of 4)

**Law 6:**
There is no such thing as a contractor gene. Women give birth to babies—not contractors

**Corollary:**
Family members given responsibility beyond their capability are going to be angry—at you

**Corollary:**
Family members “pressured” into the business will never forgive you

**Corollary:**
Being a son or daughter does not automatically imply incompetence

FMI’s Laws of Management Succession – Family Issues (3 of 4)

**Law 7:**
The number of family members employed in a business is inversely proportional to long-term profitability

**Corollary:**
The number of family shareholders has a similar relationship

**Law 8:**
The quality of non-family management employees is inversely proportionate to the number of family members in the business

**Corollary:**
Never promote relationship over competence
FMI’s Laws of Management Succession – Family Issues (4 of 4)

**Law 9:**
Parents are not capable of objectively evaluating the competence of their children

**Corollary:**
The offspring with a proven, unaided track record has an excellent chance of winning the respect of the employees

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**Buyout Issues**

- Projected profitability – now & projected
- Employee capital & compensation available
- Asset base & working capital requirements
- Management succession
- Banking & bonding requirements
- Business structure (e.g., S, C corporation, LLC, etc.) and tax issues
- Nonoperating, real estate or excess assets in business
- Voting control & power
- Control requirements
- Owners liquidity requirement & risk tolerance
- Who, when and how much
Primary Methods of Internal Transfer

- Direct sale/redemption
- Stock options
- Restricted stock
- Stock bonus
- Sub-S buyout
- ESOP
- Brother/Sister
- Permanent joint venture

- Recapitalization
- Parent-subsidiary
- Spin off/split off/split up
- Family limited partnership

The External Option
Is a Straight Sale Feasible?

• Management succession is in place?
• Value meets expectations of owners?
• Backlog and asset base to sustain business?

Preparation

• Evaluation of alternatives
• Trends in the marketplace
• Feasibility of sale
• Presale changes
• Business valuation
Search Process

- Package preparation
- Candidate identification
- Candidate contact

Negotiation

- Buyer evaluations
- Deal structure
Transaction Complete

• Closing the transaction
• Integration plan implemented

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- Project and Process Improvement
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Questions

Up Next: Lunch in Biscayne and Chopin

Breakouts resume at 1:30