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EXIT STRATEGIES FOR HVAC/SHEET METAL CONTRACTORS

STRATEGIES FOR EQUITY AND OWNERSHIP TRANSFER

NEW HORIZONS FOUNDATION
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2010 Prepared By:

FMI

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1 INTRODUCTION

This report presents the results of a study commissioned by the New Horizons Foundation to identify and evaluate approaches for exit strategies and equity transfer for heating, ventilation, and air conditioning (HVAC) and sheet metal contractors. The interest is driven by industry demographics and the desire and necessity of many business owners to explore these alternatives. The study, which was conducted by FMI Corporation, a construction industry resource for business management solutions, consisted of both primary and secondary research, including a survey of HVAC and sheet metal contractors' current opinions and practices concerning exit strategies and ownership transfer methods and practices.

In its examination of exit strategies for HVAC and sheet metal contractors, FMI[1] covered the following topics in addition to presenting the survey results in detail:

1. Reasons for and benefits of developing exit strategies and equity transfer plans.

2. A description of the various equity transfer planning alternatives, including, but not restricted to, employee buyouts, third-party sales to a strategic or financial (private equity) buyer, employee stock ownership plans (ESOPs), public offerings, and other available options. These alternatives were viewed from both a buyer's and a seller's perspective.

3. A review of the positives and negatives of these alternatives with an emphasis on the HVAC and sheet metal industry.

4. A review of the different methods for determining the value of the enterprise, including market-based, asset-based, and earnings-based approaches.

5. A description of the past market experience with roll-ups, consolidation, and other mergers and acquisitions-related activities and trends for the industry, with an emphasis on the HVAC and sheet metal industry.

2 SURVEY HIGHLIGHTS

Appendix A in this report presents and examines the results of FMI's online survey for sheet metal and HVAC contractors. The survey was completed by 174 respondents from across the country and is a good sample representing sheet metal, HVAC, and mechanical contractors.

One of the most telling findings that illustrates the need to conduct the present study is that approximately three-quarters (76 %) of respondents older than 50 plan to sell all of their stock in their company within the next 10 years, while only about half (48%) of the owners older than 51 are currently working on ownership transfer plans. Therefore, in the next 10 years, there will be a tremendous change in ownership for owners of sheet metal, HVAC, and mechanical contractors.

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[1] 5171 Glenwood Avenue, Suite 200, Raleigh, NC 27612, T.919.787.8400, F 919.785.9320, www.fminet.com

However, less than half of the companies surveyed are working on an ownership transfer plan.

Another key finding is that less than half (42%) of owners older than 50 have competent successor management that could run the business today. About 20% had no successor and expected to hire externally. As will be discussed in the Exit Strategies section, management succession and leadership development are the key challenges for transition, whether selling to family, employees, or a third party.

A third key finding was that the two major concerns for about half (55%) of owners about transferring ownership were (1) employees cannot afford to purchase the company, and (2) owners were not yet ready to transfer ownership. Therefore, while transitions are imminent, many owners are hesitant. And as might be expected, hesitancy can lead to inaction, which can lead to poor transition options.

Finally, on the acquisition front, only 6% of companies expect to grow by acquisitions; however, 22% expect to transition by selling to a third party. As in most construction markets, sellers are expected to outnumber buyers. Therefore, it makes sense for sellers to develop transition options in addition to a sale. There were also mixed opinions on whether the industry will consolidate further or retain its current fragmentation. This topic is addressed in the Exit Strategies section, where acquisition history is discussed.

3 EXIT STRATEGIES FOR HVAC/SHEET METAL CONTRACTORS

Strategies for Equity and Ownership Strategy

Every generation of construction firm owners faces the succession issue of transitioning management and ownership to the next generation. Publicly traded firms have a market for their stock, but they still face the management transition issue. This section will address the exit strategies for construction firms and, more specifically, HVAC and sheet metal firms. “Exit” addresses only half of the problem unless an owner is liquidating the business. Most owners expect their businesses to continue operation through a sale to a third party, employees or a transfer to family members. In this case, “transition strategy” better describes the topic. In this section of the report, the following topics are addressed:

1. The internal option sale to family or employees—why plan?
2. Equity transfer techniques for sale to family and employees.
3. Third-party sale, private equity, and public options.
4. The positives and negatives of transition options for HVAC and sheet metal firms.
5. Valuation of HVAC and sheet metal contractors.
6. Past market experience with roll-ups, consolidations, and other acquisition activity.
7. Implementing a transition and pitfalls to avoid.

1. The Internal Option Sale to Employees or Family—Why Plan?

Many contractors do not plan for succession. This is confirmed by the survey, which showed less than half of all respondents older than 51 working on a transition plan. It is understandable, as most business owners started their business to make money and have a career. Usually business owners enjoy running their business and doing the things it takes to make it successful. They do not necessarily enjoy doing the things it takes to implement a successful succession plan. In this section, the research team will explore why succession can be difficult and the benefits of developing and implementing a plan.

Why Don't Business Owners Plan for Succession?

FMI's experience is that, while business owners recognize the inevitability of a transition, they often do not plan for succession. FMI often finds that business owners have fantasies about what will happen with their business. Many assume they will live forever, or that, when they are ready to sell, they can raise their hand and someone will write them a check for the business. Some think they can continue to work indefinitely without negatively affecting the business. Some think they can work periodically or on an absentee basis, again without negatively affecting the business.

Business owners sometimes hesitate to plan for succession, because they fear being less important in the community, or they may fear retirement that would result in a drop in income or uncertainty about what to do with themselves. There are those who like to spend weeks or months in Florida or Arizona to get away from the business and then come back to run the business when they want to. While all of these scenarios are possible, they may not work. FMI's observation is that it takes a strong, incentivized management team to run a business in the owner's absence. Construction businesses are generally hands-on and need to have constant attention.

Some owners believe that potential successors will clamor for ownership, and all they have to do is say, "Who wants to be an owner?" and employees will step up and provide a plan to buy them out. FMI has found that, when employees are offered an opportunity to put together a plan, they often do not know where to start. Moreover, many times, potential successors are employees because they like being employees. If they wanted to own a business, they would have done that by now.

Business owners sometimes assume sons or daughters will step up to the opportunity. This happens in some cases, and sometimes the next generation may take the business farther than the parents could ever have expected. These parents should be very thankful.

Some owners are reluctant to make decisions about key employees or family members. Some do not want to reveal the company's financial position to their employees. Some are unaware or misinformed of equity transfer techniques and do not see an internal sale as a possibility.

> There are no "contractor or entrepreneurial" genes. The next generation may not provide the same quality of leadership or management as the founder, particularly if it has not been properly prepared.

While there are numerous reasons business owners do not plan for succession, there are also consequences for those who do not have a succession plan. First, if there is no succession plan, key employees may leave, especially the most motivated ones. Second, if no plan is in place and something happens to the business owner, the business may close. Business is difficult enough with active, experienced ownership; the loss of a business owner often takes the business down. Lack of planning could also result in insufficient working capital or bonding to run the business. That is why it is important to have a plan for maintaining the balance sheet through the transition.

Consider what would happen if a business were to end up in an estate. Unqualified heirs could end up owning the business, or it might be owned and operated by a spouse who may be better off selling or shutting down the business. Nonetheless, 65% of the owners older than 51 answering the survey for this report said that, in the event of their death, their stock passed to their heirs through their estate. Alternatively, the business might end up in the hands of employees who really do not have what it takes to run it. For instance, the survey revealed that only 30% of all owners feel that they have competent and capable successors who could run the business today without further training, and 19% said they have no one ready to run the business and would have to hire from outside the company. (See Appendix A, Figure A22.)

The Benefits of Planning for Succession

The first benefit of planning for succession is that it provides an opportunity to reinvigorate the business' strategic direction. The goal of a successful transition is to turn employees into owners and teach them to run the business. This is a great opportunity to think through the business strategy and plan how the next owners can take the business to new levels.

Second, it is an opportunity to develop leaders to grow the business. The current owners probably bring in the work, make the pricing decisions, and generally make key operating decisions. This is an opportunity to get the next generation to take increasing responsibility for these decisions and watch them grow as leaders.

Third, it is an opportunity to build a sustainable corporate culture. Some business owners view the transition as a transaction when they sell their stock back to the company or the employees. In FMI's experience, it is better to view it as a process where a sustainable transition model and corporate culture are established that will work when the successors and future generations decide to sell.

Finally, doing all of the above should make money for current and future business owners. The business owner should make money from the business in its ongoing profitability and sales of stock. For the employees, it is an opportunity to be owners and build wealth.

Reinvigorating the business, developing leaders, building a sustainable culture, and making money for the future business owners depend on having qualified successors ready to run the business. At this point, only 30% of those surveyed have qualified successors, and 50% said they have potential successors who need further development. In order to develop their successors, most owners responding involved successors in business development (78%), internal leadership development programs (66%), preparation of budgets (60%), and reviewing financial information (58%). When more potential successors understand the business, the depth in management capabilities strengthens both the owner and the business.

> While about 30% of construction businesses are eventually liquidated, particularly the small ones, it is the least desirable choice for most owners.

Key Facts and Assumptions for the Internal Sale

There are three alternatives for exiting a business—liquidation, third-party sale, or sale/transfer to employees and family. Liquidating the business includes finishing the projects, selling the assets, and laying off employees. While about 30% of construction businesses are eventually liquidated, particularly the small ones, it is the least desirable choice for most owners. In the case of owners answering the survey, only about 10% expect to liquidate the business, while 22% expect to sell to a third party; 19% were uncertain at this point; and the remaining 49% expected to sell to employees, family, or both employees and family members.

The second alternative is to sell the business to a third party. Many business owners assume that this is what they will do. In reality, only about 10% of transitions take place in a third-party sale. This is because there are few third-party buyers for contractors. The most likely potential buyer is another contractor. However, upon examination of the universe of contractors that would buy an HVAC or a sheet metal firm, it appears that there are only a couple of successful public consolidations, such as EMCOR and Comfort Systems. There was a time where utilities were investing in the mechanical business; however, most have divested of their interests in the industry. Historically, consolidation strategies have come and gone with mixed success. There have been more unsuccessful consolidations than successful consolidations. Many private firms might seem to be possible buyers, but they often have the same continuity problem that the seller has. Therefore, while there may be a buyer for a particular business, selling to a third party is not automatic.

The third alternative is to sell the business to employees or family. The majority of business owners will use this alternative. Contrary to what most assume, an internal sale is often as lucrative as or more lucrative than a third-party sale. This is because the typical internal sale is done over a period of time, typically a 5- to 10-year period, so business owners can continue to participate in the earnings of the firm during the transition.

More risk is associated with the internal sale, because the proceeds over time are dependent on the performance of the business. Owners often balk at an internal sale when they assume the next generation has little money to buy them out. In fact, from the survey results, the two major concerns from owners about transferring ownership were (1) employees cannot afford to purchase the company

> The two major concerns from owners about transferring ownership were (1) employees cannot afford to purchase the company (32%) and (2) owners were not yet ready to transfer ownership (23%). Therefore, while transitions are imminent, many owners are hesitant.

(32%), and (2) owners were not yet ready to transfer ownership (23%). Therefore, while transitions are imminent, many owners are hesitant. Therefore, owners tend to think that they are following a plan described by the acronym, BYOWYO$, or Buy You Out With Your Own Money. After all, the employees may have been working for the business owner for some time and may not have been paid large bonuses. The business owner, in order to make the internal sale work, assumes a portion of the business's profits will be given to the employees so they can buy stock. While it is true that an allocation of profits to employees is usually a necessary part of the structure for an internal transition, key employees should be helping to create those earnings through their activities working with key customers, running successful operations, and generally helping the business. Indeed, if the owner is not allocating some earnings to them in some form, potential successors are likely to leave, particularly the more entrepreneurial ones. FMI's experience is that, if properly planned, the internal sale can motivate employees to excel and keep the best and brightest around to grow the business and make the owner more money by the end of the transition.

Planning for a transition makes sense, and it increases the probability that the business will survive and the business owner will have a successful retirement. Family and employees are also likely to be appreciative of the business owner that plans.

2. Equity Transfer Techniques for Sale to Employees or Family

The Internal Transition Process

Exhibit 1 shows five steps in succession planning. First, objectives need to be defined for the business owners. The objectives for the business and potential successors should be defined as well. There is no fixed list of prescribed objectives, but objectives need to be practical. For instance, an owner may desire to sell to a third party, but the business may not be salable. Alternatively, the owner may want to transition the business to children, but the family may not have an interest in joining or owning the business. Having clearly defined objectives allows the business owner to test his/her objectives against the reality of the situation.

1. Defining the objectives and parameters.
2. Valuing the business.
3. Exploring and selecting the appropriate ownership transfer techniques.
4. Understanding and addressing the management succession issues.
5. Implementation and follow-through.

Exhibit 1: The Process

Second, the owners need a realistic understanding of the value of the business. Often owners have in mind a certain amount they want for their business; however, that amount may not be realistic in the third-party market. That amount may not be feasible for an internal sale, either, without putting financial stress on the business. Obtaining a realistic understanding of value makes the likelihood of success for the ownership transition plan much higher and will save time.

Third, the owner needs to explore and select appropriate ownership transfer techniques. There are certain keys to all techniques, such as business profitability and having management successors. There is no right answer for all situations. Selection of technique is driven by factors including the corporate structure; tax situation; time frame; existence of nonoperating assets or businesses; and the objectives of owners, the business, and next-generation potential buyers.

The fourth and most important step is understanding and addressing the management

> There are certain keys to all transfer techniques, such as making the business profitable and having management successors.

succession issues. None of the ownership transition techniques works if a next generation of leaders is not developed. There must be someone to take the chief executive officer's (CEO's) chair. Even though, as noted above, 49% expect to sell their stock to employees or family members, the 22% that expect to sell to a third party also benefit from having qualified successors and leaders in place. That importance becomes more urgent when considering that the 59% of owners answering the survey plan to sell all of their stock within the next 10 years.

Finally, after developing a plan, implementation and follow-through are required. Some owners develop a plan but never quite pull the trigger. Some are hesitant, and some just think they are too busy. Some get help in developing a plan but do not get help implementing the plan. FMI's experience is that plans take five years or more to implement. In fact, all businesses should have an up-to-date, ongoing management succession plan even if the owner won't retire anytime soon. This approach makes succession/transition part of the business plan and less of a special task that owners may not get around to doing.

The Mechanics of a Transition Plan

Three categories of ownership transition techniques are (1) traditional tools, (2) partnership tools, and (3) ESOP. Traditional tools include a direct sale of stock to employees and recapitalization. Both of these techniques use the existing corporate structure. Seventy-eight percent of respondents indicated they were using traditional tools for transition, with 40% gradually selling their existing stock, and 28% selling for a note and/or cash at an agreed-upon value. (See Appendix A, Figure A24.)

In the partnership tools category, instead of selling the existing company, a second company is started that is owned by select employees—often dubbed "Newco." The original company ("Oldco") then helps Newco to be successful. This is very popular in the construction industry as it works like a joint venture. A few variations of this concept will be reviewed in this section. While only 5% of respondents are currently using this technique, this is expected to grow as more companies are now using LLCs versus corporations and because of the flexibility this technique provides.

Finally, the third category to be addressed is the ESOP. Many firms have been using this popular technique successfully. Ten percent of the owners of HVAC and sheet metal companies answering the survey were currently selling their shares to an ESOP. This is a significant percentage, as ESOPs tend to have limited application for companies desiring to maintain family ownership or smaller companies in general.

Traditional Tools—Direct Sale

The direct sale is a sale of stock from the owner to the employees. One hurdle for implementing this approach is that the owner must first have employees who are interested in buying stock. When the research team asked survey participants if they had ever had nonshareholder employees approach them about buying stock, 76% said no. While this may indicate lack of interest by employees, it may also be that employees do see ownership as a possibility.

To implement a direct sale, employees normally fund the purchase to the extent they can with their personal net worth and to the extent they can borrow funds. Over time, they may supplement the funding of the purchase with a portion of their compensation and their share of profits. Business owners could also accept a note to be paid from the company's earnings over time.

The biggest problem with this technique is that employees typically do not have much money or a large borrowing capacity to make an initial payment. In addition, business owners are understandably reluctant to give up their stock and control without being substantially paid.

In addition, surety issues are created by the employees now owning the business; they typically do not have the net worth and experience to satisfy the bonding company without the prior owner's guarantee.

An owner using this technique is likely to have covenants on any notes accepted to provide protection should the employees not perform. They are also likely to remain involved in the business for a transition period to satisfy bonding and banking requirements and to help with management succession issues. The reality is that, in selling for a note, the owner retains the risk of the performance of the business; therefore, another of the techniques discussed are often used.

Despite the potential problems with this technique, 28% of respondents indicated this is the technique they are using.

Traditional Tools—Subchapter S Buyout

The premise for a Subchapter S ("Sub-S") buyout is that an S corporation pays no tax at the federal level, because it is a pass-through entity. The corporation's income is allocated to the corporation's shareholders on a pro rata basis according to the shares owned. This allocated income is included on the shareholders' individual tax returns. Further, the shareholders' basis in their S corporation stock is what was paid for the stock plus their share of earnings that are retained in the company. This contrasts with a C corporation where a shareholder's basis is what was paid for the stock or originally invested in the business. Retained earnings do not add to the basis in the stock of a C corporation.

Another flexibility that an S corporation affords is that the company may distribute current income or the accumulated adjustments account (AAA) without affecting its taxation. (The AAA represents a shareholder's share of a Sub-S corporation's retained Sub-S earnings.) In contrast to the S corporation, when the C corporation distributes earnings, the earnings are taxed as dividends. In the S corporation, retained earnings can be moved in and out of the corporation freely without creating a taxable event.

When selling to employees for a note, the owner retains the risk of the performance of the business.

The procedure typically used in structuring a Sub-S buyout is something like the following:

1. **Distribute excess capital to the owners**. For example, if the company has a $5 million net worth and only $2 million is needed for bonding and operations, $3 million could be distributed to the owners. Distributing retained earnings makes the company smaller, which makes it easier to sell it to the employees.

2. **The employees buy as much stock as initially feasible**. This may not represent a large amount of money to the sellers, but it puts employees' "skin in the game." Funds may come from employees' savings or proceeds from a home equity loan.

3. **Annually distribute all or most of the profits as compensation or Sub-S dividends**. Net worth will remain fairly level for a period, and most of the earnings will be paid to selling and buying owners as Sub-S distributions or compensation. If the company is in a growth period, an amount of the profits may be designated to be retained.

4. **Annually, after paying tax on their distributions and compensation, the employees buy additional stock from the current owner**. The selling owners retain their share of distributions and compensation and sell stock to employees. By doing this, most of the earnings have gone to the selling owners by distribution and employees taking their share, paying taxes, and then buying stock from the owners.

5. **Repeat the above procedure until the selling owners are bought out**.

Exhibit 2 below shows an example of this process.

In practice, if employees can achieve 20% ownership, then repeating the buyout can achieve a complete buyout in a reasonable period of years. Sub-S buyouts usually take a minimum of 5 years to complete; they can take 10 years or more, depending on profitability. The key to moving the transition along is the return on equity and a fair valuation.

This technique works well as it aligns the seller's and buyer's interests. It is in the owner's interest to drive profitability, because the higher the profitability, the faster the buyout proceeds and the more money the owner receives. The higher the profitability of the business as the plan unfolds, the sooner the employees will own all of the shares.

An Example

	Year 1		Year 2		Year 3		Year 4		Year 5	
	$	%	$	%	$	%	$	%	$	%
Pretax Corporate Income	500,000		500,000		500,000		500,000		500,000	
Existing Shareholder's Portion	475,000	95.0%	467,000	93.4%	456,440	91.3%	442,501	88.5%	424,101	84.8%
Employee Shareholder's Portion	25,000	5.0%	33,000	6.6%	43,560	8.7%	57,499	11.5%	75,899	15.2%
Income Taxes (30%)	9,000		11,880		15,682		20,700		27,324	
New Dividend Incomed to Employee	16,000		21,120		27,878		36,799		48,575	
Beg. Year Stock Ownership	50,000	5.0%	66,000	6.6%	87,120	8.7%	114,998	11.5%	151,798	15.2%
New Purchase	16,000	1.6%	21,120	2.1%	27,878	2.8%	36,799	3.7%	48,575	4.9%
New Ownership Total	66,000	6.6%	87,120	8.7%	114,998	11.5%	151,798	15.2%	200,373	20.0%

Notes: 1. Assume equity of $1,000,000 is held constant throughout the period.
2. Key employee owns 5% of stock in year one.
3. All earnings are distributed annually through dividends or cash bonuses.

Exhibit 2: Employee Purchase of Stock Using Subchapter S Distributions

Control does not change hands for several years. This transition period is an excellent time to train employees, to give them more responsibility, and to get them involved in business development and planning.

Selling 5 to 20% to the employees is typically the maximum that is feasible as a starting point. Therefore, the owner typically still owns 80 to 95% of the company after the initial sale. The typical result is that control does not change hands for several years. This transition period is an excellent time to train employees, to give them more responsibility, and to get them involved in business development and planning, so the selling owners can gradually reduce their activities in the business.

Some other considerations in setting up a Sub-S buyout should be noted:

1. If control is an issue, and it is desirable for selling owners to maintain control beyond when their ownership drops below 50%, a second series of nonvoting or lesser voting stock can be sold to employees. Alternatively, the selling owners can be issued a series of stock with super voting rights.

2. The Sub-S transaction is typically done with little debt. In this industry where maintaining a strong balance sheet is important because of volatility and bonding needs, a minimally leveraged transaction makes sense.

3. If growth is anticipated, instead of distributing all of the earnings, some earnings can be retained to fund additional working capital or to expand bonding capacity. This may slow the transition, but it protects the business.

One final point to cover on the Sub-S buyout is the selection of a valuation method for the buyout. The example shown above used book value (or net worth per the business's financial statement) as the valuation methodology. More often than not, companies use book value in their buy/sell or shareholders' agreements. A third-party valuation or other valuation metrics can also be used. However, if the valuation is too aggressive, it can be self-defeating to a successful transition. If a transition is modeled based on profitability and the balance sheet required, and it takes 15 to 20 years to complete, the employees are not going to buy into it. The valuation should be such that the transition will take place in a reasonable time frame, such as 5 to 10 years. Further, it should be sustainable such that when the next-generation employees retire, the plan will work again using the same valuation methodology. Having a conservative valuation to begin with will increase the odds of the plan succeeding.

Selling owners are also encouraged to consider not just the value received for their stock but also the proceeds from the distributions and compensation as well as the AAA distribution prior to sale. If all these proceeds are added, the total often compares favorably to a third-party sale.

The Sub-S buyout is a very flexible technique and requires minimal legal agreements. A buy/sell or shareholders' agreement is required. Most companies with multiple

If the valuation of the company is too aggressive, it can be self-defeating to a successful transition.

The Subchapter-S buyout is a very flexible technique and requires minimal legal agreements.

shareholders already have these agreements. Beyond that, legal agreements are not required. FMI recommends that the selling and buying shareholders agree to a plan defining objectives, procedures, and models describing the buyout. The following examples explain why binding legal agreements are not recommended. The first assumes that there was a legally binding agreement for employees to buy stock, and, after a year or two, employees say, "I don't want to do this anymore; it's not working for me. I don't want to be an owner." In this case, it does little good to have them legally bound, because if they do not want to own it, they are not likely to be effective at running the business. An alternative assumption is that, two years after starting the transition, the owner feels these employees are not stepping up, they are not turning out to be good owners, and the owner does not think they can be successful. The selling business owner needs the option to say, "Wait a second; this is not working," and slow or stop the process.

Recapitalization

Recapitalizations are sometimes used with C corporations. Unlike S corporations, C corporations pay tax on their income at the corporate level, and dividends to shareholders are taxable. In this technique, the stock of the company is "recapitalized" into two classes of stock. Class A is typically a preferred stock that receives a fixed return on investment. Class A stock will be owned by the selling owners. Class B stock is typically common stock that receives the earnings after Class A gets its fixed return. In essence, the return is being fixed for the selling shareholders, providing them a fair return for their equity. Then, assuming the company is profitable and creates increasing earnings beyond the Class A allocation, the common stock is allocated a significant amount of earnings. This enables the buying employees to build up equity and drive the growth of the business. After the value of the Class B common stock builds to where the company can function without the equity in the Class A stock, the selling owners can redeem their Class A stock for cash.

From a technical standpoint, there are no immediate tax consequences for recapitalizing the business to provide for two classes of stock. This technique is used only occasionally, as the C corporation has been in less favor in the last 25 years due to the Tax Act of 1986, which lowered personal tax rates below corporate tax rates.

Oldco/Newco Strategies

In conventional strategies, the stock of the existing company is sold to the next generation. In Oldco/Newco strategies, the next generation of employees forms a new company (Newco), and the selling generation retains the old company (Oldco).

As shown in Exhibit 3, the new owners will set up Newco and contribute what money they can, and again, as with the Sub-S buyout,

The C corporation has been in less favor in the last 25 years due to the Tax Act of 1986, which lowered personal tax rates below corporate tax rates.

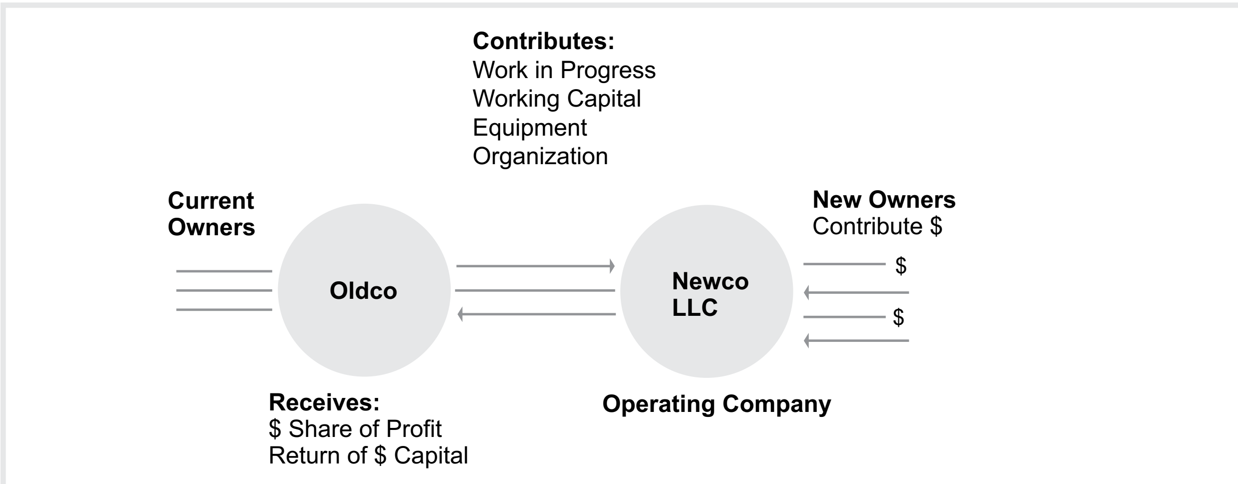


Exhibit 3: Oldco/Newco LLC

this is limited to what they have saved or can generate from a home equity or other type of loan. Oldco will also be an investor in Newco, but instead of contributing cash, it contributes work in progress, including contracts; working capital, such as receivables and payables; and equipment. Then all or most of the organization moves to Newco as well.

Newco is typically set up as a Limited Liability Company (LLC). The exception is California where contractors cannot be LLCs. The operating agreement defines the profit split between Oldco and Newco. Profits are usually split according to the value of the contributions of Oldco and the Newco investors but can be slanted to the new owners in recognition of their "sweat equity" if desired. In practice, LLCs allow flexibility when determining how profits are divided between parties.

As Newco goes forward and makes money, the new owners in Newco accumulate earnings to increase the company's net worth. Generally, distributions are made to the Newco shareholders only in order to pay their taxes. Oldco will receive distributions of its share of the earnings and return of capital. After a period of years, Newco accumulates sufficient capital so that Oldco's support is no longer needed.

The advantage of this technique is that the selling shareholders can retain any nonoperating assets in Oldco. For example, the business's office building might be owned in Oldco, and there is no need to sell that to the employees, because that would only make the transaction larger. Alternatively, perhaps there is another business in the Oldco that the selling shareholders want to retain and that the employees do not need to buy. The selling shareholders can also defer taxation on the sale or liquidation of Oldco because Oldco is still active.

Another potential advantage relates to family situations. When family members sell stock to other family members, Internal Revenue Service (IRS) rules require the price to be

When family members sell stock to other family members, IRS rules require the price to be "fair market value," or the stock may be deemed a gift.

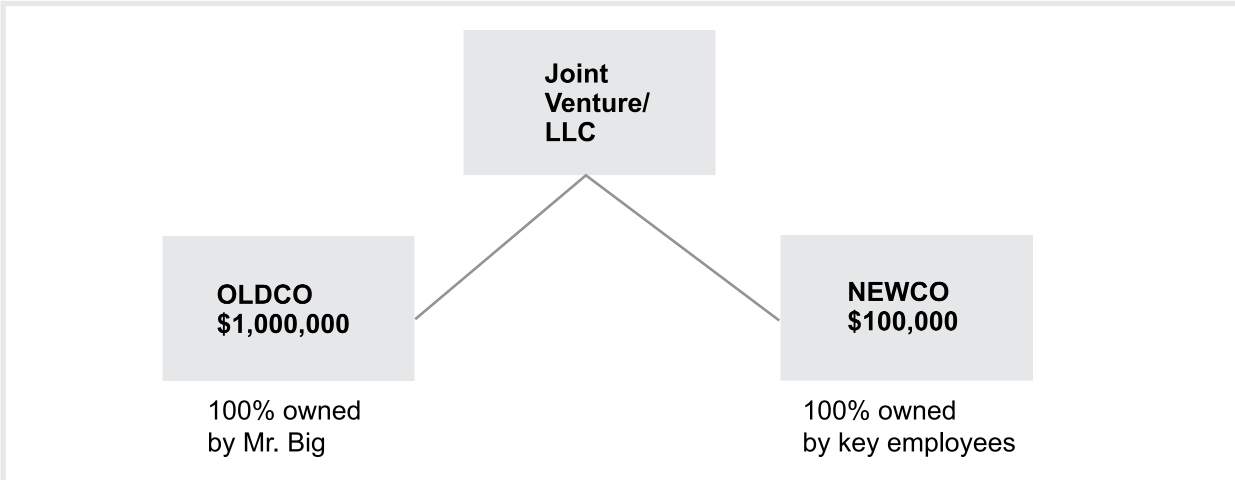


Exhibit 4: Permanent Joint Venture

"fair market value," or the stock may be deemed a gift. In the Oldco/Newco structure, shares are not being purchased by the new shareholders, so valuation risks are lessened.

In California, Newco would probably be set up as an S corporation, and a joint venture might be set up as shown in Exhibit 4.

Oldco and Newco can continue their relationship indefinitely, but typically the relationship will end once Newco has a sufficiently strong balance sheet with adequate working capital to operate and bond its work. In essence, the Oldco/Newco structure is a method to increase the profit participation of the employee group without selling any stock of the existing company and without major investment by the employees. This technique is used frequently and works very well in the construction industry. Because it has many characteristics of a joint venture, accountants and tax lawyers serving the industry are familiar with the accounting and legal aspects of operating this structure.

A variation on the Oldco/Newco technique is the Brother/Sister structure. With the Brother/Sister approach, the employees capitalize a new company, Newco. Instead of Oldco investing in Newco, or Oldco and Newco entering into a joint venture agreement, there are separate agreements where Oldco may lease or rent fixed assets to Newco, or Oldco may lend money or capital to Newco. Oldco might provide loan guarantees or bonding for Newco. Oldco and Newco could also joint venture on select jobs. Oldco might keep certain accounting functions and may provide those services to Newco. Oldco may also retain some employees. This is an arms-length relationship where Oldco is just assisting Newco in getting started, but not investing in Newco. The

While the survey indicated that only 5% of respondents were using these partnership Oldco/Newco techniques, the research team expects utilization to increase because of the flexibility of the technique, particularly in more complicated situations.

disadvantage of this technique for the selling shareholders is that they are giving up the upside, but they still have the risk of Newco's performance and ability to generate sufficient profits in order to pay the owners of Oldco for their services. While the survey indicated that only 5% of respondents were using these partnership Oldco/Newco techniques, the research team expects utilization to increase because of the flexibility of the technique, particularly in more complicated situations.

Employee Stock Ownership Plans (ESOPs)

An ESOP is a qualified retirement plan that invests in the company that sets it up. It is regulated by the Employee Retirement Income Security Act (ERISA) of 1974, as are other retirement plans such as 401(k) or profit-sharing plans. ESOPs are generally set up for the benefit of all nonunion employees; in some cases, union employees may participate. ESOPs may not discriminate as to which employees may participate in the ESOP and are subject to a vesting schedule. Employers contribute to the ESOP for the benefit of employees prorated to the employees' compensation up to a maximum set by the IRS.

The company may contribute up to 25% of eligible payroll to the ESOP annually. Usually contributions are not this high, as this reduces the profitability of the business. Contributions are sometimes made in lieu of a 401(k) and sometimes as a complement to a 401(k) or profit-sharing plan.

Exhibit 5 illustrates the ESOP structure. The board appoints a managing trustee for the ESOP. The company can be a C corporation or an S corporation. The ESOP will often borrow money guaranteed by the corporation to purchase the selling owners' stock or sometimes accumulate contributions to purchase stock later. The corporation will typically make annual contributions to the ESOP. The ESOP uses the contributions to pay down ESOP debt or to purchase stock from selling shareholders. If the ESOP borrows money to purchase the stock, the debt goes on the company balance sheet as a liability; this affects the bonding capability of the company.

ESOP companies often start by purchasing 30 to 50% of the company and may later become a 100% ESOP.

The advantage of starting as less than a 100% ESOP is that less debt is needed initially, which helps with bonding capacity and generally puts

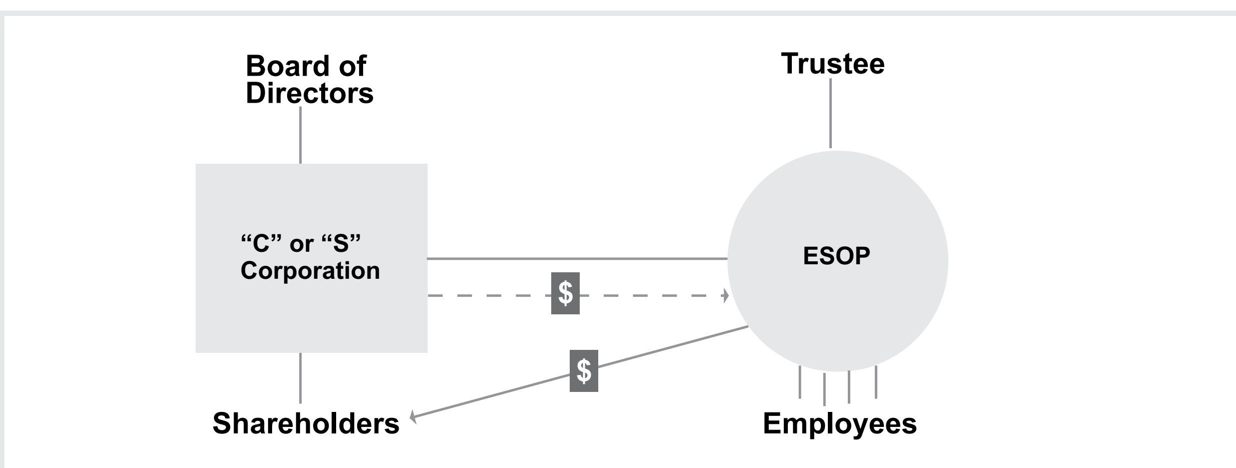


Exhibit 5: ESOP Structure

less leverage on the firm. If the company is an S corporation, using an ESOP can be a very powerful technique for generating capital. As an S corporation, the company does not pay taxes, and, since the S corporation is owned by a retirement plan (ESOP), it does not pay taxes when the income is earned. Taxes will typically be paid many years later after employees retire or are terminated by the company, roll over the proceeds into a personal IRA, and then make distributions from the IRA in retirement. With combined federal and state taxes likely to be in the 40 to 50 percent range, this means there will be close to twice the capital in the near term to fund the buyout.

A primary issue affecting the success of an ESOP is nonfinancial. Engineering and construction businesses are usually owned and driven by entrepreneurial leadership. FMI's observation is that contractors seem to function best when there is an active owner who is making the business decisions and setting the direction for the business. Since ESOPs may not discriminate among employees, a company with many employees may have ownership dispersed such that no employee owns more than a small percentage of the company. In this case, the question arises, who is the entrepreneur driving the business? Who makes the decisions for the business, and who signs the bonds? FMI's experience is that ESOP companies that make sure their executive team is properly incentivized and compensated are the most likely to have a successful ESOP experience.

FMI's experience is that ESOP companies that make sure their executive team is properly incentivized and compensated are the most likely to have a successful ESOP experience.

Exhibit 6 shows the vesting schedule minimum guidelines provided by ERISA. The vesting schedules will tend to work in favor of longer-term employees. In the first schedule illustrated, employees do not vest until after two years, and then they vest over the next five years.

Employee vesting schedules must be at least as aggressive as the following schedules.

	% Vested		**% Vested**
Year 1	0		0
Year 2	0		0
Year 3	20		0
Year 4	40	**OR**	40
Year 5	60		100
Year 6	80		
Year 7	100		

Exhibit 6: ESOP Vesting Schedules

Alternatively, the plan can be set up to have employees not vested until the fourth year, and then they can step up from 40% to 100% in years four and five. The effect of these schedules is that, if the business has high turnover, as is often the case in construction, the ownership will tend to concentrate in the hands of longer-term employees.

Exhibit 7 on the next page lists advantages and disadvantages for construction industry ESOPs.

In summary, the ESOP is a technique that is used a fair amount in the industry and many companies like it, but many companies buy it out or sell to a third party. The ESOP is usually the most tax-efficient way to sell stock from one generation to the next. However, if the business owner is going to use an ESOP, he/she should understand the issues and complexities that surround the ESOP.

Advantages:

To the selling stockholders, an ESOP

- Creates an "internal market" to sell stock.
- For a C corporation, seller may defer capital gains if the ESOP purchases more than 30% of outstanding stock.
- For an S corporation, federal income tax is deferred, increasing capital available to purchase stock, pay ESOP debt, or grow the company.
- Non-ESOP shareholders can continue to control the company.
- Stockholders can diversify personal assets.

To the company, an ESOP

- Can be a positive incentive for employees.
- Can increase capital available to the company.

To the employee, an ESOP

- Can build a retirement asset.
- Provides ownership incentive.
- Defers dividend taxation for stock held by the ESOP until retirement.

Disadvantages:

- Retirement funds are being invested in one construction company.
- There is repurchase liability for shares owned by ESOP.
- Downsizing can cause repurchases.
- For bonding, ESOP debt is treated as a liability of the corporation.
- Stock must be valued annually by a third party.
- ESOP trustees have fiduciary liability.
- There are many stockholders with minority rights.
- DOL and IRS reporting is required.

Exhibit 7: Advantages and Disadvantages of Construction Industry ESOPs

The survey indicated that 10% of respondents are selling to the ESOP. FMI expects the percentage of companies using the ESOP to remain about the same or perhaps increase as industry participants get larger. It is a very tax-efficient technique; however, the complexities make it less desirable for smaller companies. It also does not meet the objectives for owners who want their companies to remain owned by family members.

3. Third-Party Sale, Private Equity, and Public Options

There are three options for a sale not involving employees or family members: (1) sale to a third party, (2) recapitalization with a private equity partner, and (3) reorganizing to become a publicly traded company. Each option is very different with it own nuances. Each is discussed individually.

The ESOP is usually the most tax- efficient way to sell stock from one generation to the next. However, if the business owner is going to use an ESOP, he/she should understand the issues and complexities that surround the ESOP.

Sale to a Third Party

Many construction industry owners assume they can sell their companies when they are ready. The reality is that only about 10% of companies sell to a third party, with about 60% of companies sold or transferred internally to employees or family. The remaining 30%, particularly small companies, liquidate. Therefore, the first question a business owner who wants to sell should ask is if a third-party sale feasible for his/her company.

Alternatively, if the owners are not ready to sell, what will a third-party buyer look for in the owner's business, and how can the owner position the business for a third-party sale?

Fundamentals of the Construction Industry

Before addressing what makes a business salable and how it might be positioned in the market, some of the fundamentals of the construction industry that affect the marketability of industry firms will be reviewed. First, the construction industry is fragmented; across the country and internationally, there are tens if not hundreds of thousands of construction businesses. And despite numerous consolidation efforts, the industry has remained fragmented. One reason for that fragmentation is that most construction markets are local. There are some consolidators, like EMCOR and Comfort Systems, which have built national businesses, but it could be argued that even those businesses are made up of numerous local businesses, having local managers with local relationships in their markets. Another reason the industry remains fragmented is that there are limited economies of scale in the construction industry. There may be buying advantages for the larger player, but larger companies often lose their entrepreneurial focus. There is nothing quite as focused as an owner in a local market making things happen versus a large corporation with a division manager in a particular market. Often the local company is found to out-compete the national company. Suppliers will also often support local companies so they do not cede control of the market to larger companies, and often margins are better for the suppliers from the smaller companies.

The second fundamental of construction is that market opportunities come in waves. Currently, a wave of construction is going on in the energy space in alternatives and upgrades to the grid. There is also an expectation of a wave of nuclear power plant construction in the next 20 to 30 years. In the 2000s, there was a wave of residential construction. That wave washed ashore in 2007/2008. In the 1980s, there was a wave of commercial construction

Many construction industry owners assume they can sell their companies when they are ready. The reality is that only about 10% of companies sell to a third party.

> The buyer of a construction business should look for a business that has a sound organization and a history of finding new opportunities as the market changes.

of office buildings built to support growth and incentivized by then liberal depreciation schedules. In the last 50 years, numerous waves in the economy have affected the construction markets. As each wave moves through the economy, it creates threats and opportunities for growth. Successful companies will move from wave to wave at strategic times.

The third fundamental of construction is that construction firms often struggle during downturns. When times are good, businesses become more selective in their pricing and margins go up. When times are bad, businesses try to maintain backlog and keep employees busy so margins go down. Some companies may bid at or below cost and get away with that for a while. Inevitably, unanticipated events take down some in the industry. Banks and sureties tighten their lending and bonding criteria during downturns. Together, all these trends exacerbate the cycle and put the weaker contractors in jeopardy.

These fundamentals, fragmentation, market waves, and the susceptibility to downturns all affect the feasibility of a sale and the price a buyer is likely to pay when acquiring a business. Industry fragmentation means that there are many companies a buyer could buy; and many of them will have continuity problems or other reasons to be motivated sellers. Why should a buyer particularly want a specific company? Market waves signal to the savvy buyer that the market might be very different in five years. The buyer of a construction business should therefore look for a business that has a sound organization and a history of finding new opportunities as the market changes. If a construction firm struggles in the downturns, seasoned buyers will factor inevitable downturns into their decision and valuation of the firm. Construction is a slow-growth business subject to economic cycles. Taken together, these fundamentals lead to conservative valuations relative to many other industries.

What Drives Value and Salability in the Construction Industry?

What do buyers look for in an acquisition and what drives value? First, all buyers are looking for profitability, a return on the investment they might make. Therefore, when analyzing a potential acquisition, they like to see a history of profitability or a very good story as to how the business will make money going forward. They want to understand any volatility in earnings history as well as opportunities for recurring revenue from service or other means.

Second, a third-party buyer will want to see a good organization with a management succession plan in place. Dr. Emol A. Fails, the founder of FMI, preached that a construction company is a group of people who know how to get work, do work, and get paid for the work they do. The key is the people that make the business work. Take the people out of an HVAC company and what do you have? Take the top three, four, or five people who drive the business out of the business, then what do you have? The answer to both of these questions is, not much. Therefore, the first key to making a company salable is to have a strong organization of good people to drive the business for its new owners. Many businesses are very successful, but if the main driver of the business is the owner who wants to sell and leave the business, buyers beware.

Third, the business needs momentum. There needs to be a backlog and an asset base to sustain the business. The business must have good prospects for success going forward.

Fourth, the business owner needs a workable valuation expectation. A construction company is usually worth more to the owner than it is to anyone else. The reason for this is that owners understand their company better than anyone does; they understand the risks, and they live and breathe the company every day. In the case of the survey respondents, 17% expect to receive book value or net worth for their company when sold. Thirty-four percent expect book value adjusted for the market value of assets, and 36% expect the value of their company to be a multiple of earnings. On average, owners in the survey expect to receive 4.6 times pretax earnings (after adding back owners' bonuses and perks). (See Appendix A, Exhibit A15.) However, both buyers and sellers must realize that sales to a third party often hurt the value of the company just by the fact that ownership changes hands. This is because the company under a new owner will likely experience change in management if the seller exits the business, and the buyer generally brings some change and uncertainty in a transition. In the end, these changes may be healthy, but in the short term, change can be distracting.

The Realities of Buying and Selling Contractors

In the light of FMI's industry experience, the fundamentals of the construction industry and the factors that drive business value, the research team took a brief look at the realities of buying and selling construction firms. First, relatively few transactions are completed each year. As previously discussed, 10% or fewer construction industry firms change hands through merger or acquisition. Second, contractors tend to be bought by other contractors; occasionally, private equity or investors will buy a contractor. About 10 years ago, electric utilities went on a buying spree for construction firms, but they have largely exited the market. Most buyers of contractors are other larger contractors seeking to expand geographically or into a new market or service. Third, people and organizations are the most important assets to a buyer. Equipment and backlog can be purchased, but it takes a strong organization to make money and grow a business. Finally, the reality is that deals need motivated buyers and sellers in order to be completed successfully. As previously discussed, valuations tend to be conservative in this industry except for the occasional consolidator, financial buyer, or unique strategic circumstance. Because of this, the reason most owners sell businesses is that they want to retire, stop working, or reduce their risk. There are occasional exceptions to this where a consolidator or other motivated buyer is paying exceptional prices.

> Ten percent or fewer of construction industry firms change hands through a merger and acquisition.

Private Equity

A subset of a sale to a third party is a recapitalization by a private-equity investor. A private-equity firm raises money to invest in private companies. The money typically comes from high-net-worth individuals, pensions, foundations, and other sophisticated investors seeking alternatives to traditional stock and bond investments. Private-equity investors will typically own a business for three to seven years. Their usual strategy is to recapitalize a company with the management team retaining a stake and the private-equity firm holding a portion as well. Debt is often used to leverage the transaction. The private-equity firm then wants to see the management team grow the earnings and perhaps grow the business through acquisition. Eventually, the private-equity firm is likely to sell the business to a strategic buyer or another private-equity firm or perhaps prepare it for an Initial Public Offering (IPO).

Most private-equity firms focus on manufacturing and distribution businesses, but there has been some investment in the construction industry. A couple of examples in the mechanical space have been Limbach and Kinetics, both of which have private-equity investors. Most private-equity firms are looking for companies that have a minimum pretax profitability of $5 million per year, although some private-equity firms will look at annual pretax earnings as low as $2 million.

The advantage of private equity is that, for a business with the right characteristics, it creates an alternative buyer to the strategic buyer or internal sale. Private-equity investors are very flexible on how to structure deals; however, maintaining the management team to run the business with some level of continued ownership is a requirement of most private-equity investors.

The biggest complication with potential private-equity transactions is finding private-equity firms that are interested in the construction industry. A typical private-equity firm looks at hundreds of deals a year and makes only a few.

Private equity firms often use debt in transactions to leverage their returns. Debt can create problems for a cyclical business or a business requiring bonding. Without debt to leverage the transaction, private-equity valuations will be more conservative.

Going Public

Another alternative in the sale is to become a publicly traded company. There are two ways to become public. First and better known is to make an IPO; this is the approach taken by Comfort Systems and the predecessor to EMCOR. In today's world, a construction company would ideally have $1 billion of revenue or more to go public, though it might be done with less. Generally, IPOs are going to work best for larger diversified firms with strong "public friendly" management teams.

The key to going public is to have a growth story and a solid management team. Investors in public companies make money by increasing earnings or expanding the valuation multiple. Therefore, the investment bank underwriting the IPO and the investors buying the stock are looking for the growth plan. A good construction company with a record of accomplishment of making money, but not showing growth, may be a good moneymaker for its owners, but it is not a good candidate for going public.

The company will also need a CEO and chief financial officer (CFO) who can be the public face of the company to analysts and to investors. This may not be the same CEO and CFO who are successful in a private company. The public CEO is likely spending a lot of time at investor conferences and presenting to analysts. The CFO will have to deal with the nuances of Securities and Exchange Commission (SEC) regulations.

> The key to going public is size and having a growth story and a solid management team.

Another way to go public is to merge with a Special Purpose Acquisition Company (SPAC). A SPAC is a public company that is created by an investor group to acquire a business. Initially, the company will have cash on its balance sheet, but after being established will acquire or merge with a private business to make it public. The company may then grow organically or through acquisition. Primoris is an example of a company that has done this in the industry.

4. The Positives and Negatives of Transition Options for HVAC and Sheet Metal Industry Firms

The FMI research team has presented several options in the three exit alternatives shown below in Exhibit 8.

1. **Liquidation**

2. **Sale**
- Sale to a third party.
- Private equity recapitalization.
- Become a publicly traded company

3. **Sell to employees or family**
- Direct sale.
- Sub-S buyout.
- Recapitalization.
- Oldco/Newco strategies
- ESOP

Exhibit 8: Exit Alternatives for the Construction Business Owner

Most business owners view liquidation as the least desirable option. It has the principal disadvantages of being time-consuming and can erode value with the costs of winding down projects, continued overhead costs, and selling assets. Liquidation does have the advantage of not having to worry about succession issues or a sale process. It is most appropriate for smaller operations where one person principally drives the business.

A sale of the business has the great advantage of quicker liquidity. Usually, some of the purchase price will be held back in the form of an escrow account, but a seller will get his/her money sooner when selling to a third party. The seller also has less risk as to the performance of the business after a sale and does not have to be as concerned with management succession once the business is sold. The primary disadvantage of a sale is that it may be hard to make it happen, as the market for sheet metal and HVAC firms is lumpy, as previously discussed. By illustration, the survey results show that only 6% of owners expect their growth in the next five years to be due to acquisitions of other companies, while 59% expect mostly internal growth. (See Appendix A, Exhibit A7.) Nonetheless, 56% say there will definitely or at least possibly be more consolidation in the industry in the next 5 to 10 years. (See Appendix A, Exhibit A8.)

Considering the different alternatives within the sale category, sale to a third party, such as a strategic buyer, is the cleanest approach. There will typically be a purchase agreement providing substantial payment at closing and defined warranties and representation from the seller to the buyer.

A private-equity recapitalization is essentially a partial sale where some liquidity is realized; however, some interest in the business is retained. The advantage is getting some liquidity at closing; the disadvantage is having to wait for a second transaction to most likely meet the business owners' full sale objective. There is also risk as to whether the selling business owner(s) will get along with the private-equity firm. Private-equity firms can be great and understanding partners when the business is going well. They can be more difficult if the business is struggling. Private-equity firms have a fiduciary responsibility to their investors, so they are expected to make decisions that are in the best financial interest of their investors regardless of other considerations.

The private-equity alternative makes the most sense when the business owner wants to grow the business but wants to grow it using somebody else's capital. The seller should also be comfortable with the fact that the company will likely be sold or recapitalized again within seven years in a manner to maximize the proceeds for the private-equity firm. It is advisable for the seller to be happy with the proceeds from the first sale. The second sale should be viewed as icing on the cake to make the seller very happy.

Becoming a public company means entering a completely new world, as those who have done it will recount. The seller should have a desire to be public with all responsibilities that come with being public. Information on the business and personal compensation will become public information. Investors and analysts will expect the business to grow and increase earnings; just making money is not enough. The company will have to comply with Sarbanes-Oxley and other SEC regulations. Investors and analysts will need to be sold on the opportunity to invest with the public company's management team.

As sellers and shareholders, business owners will have limited liquidity opportunities because, although there is a market for the stock, analysts and other investors do not take a favorable view when management sells its stock.

As might be expected, the advantage of being public is that a greater valuation will likely be put on the business, as well as having a market to sell stock at some point. Very few sheet metal contractors would be good candidates to become public companies.

The internal sale is the most likely exit alternative for HVAC and sheet metal contractors. The decision of which of the internal structures will work best for an individual company is a function of the objectives of the selling and buying owners and the company, as well as other situational factors of the business.

The Sub-S buyout works very well for a business owner where the operation and assets to be sold are in one corporation without extraneous assets or business. Selling the existing company provides simplicity in that only one tax return must be submitted, and once the owners have sold all their stock, they can cut their ties with the business.

The recapitalization approach will work for the C corporation where there is a good reason not to elect Sub-S status. Before using a recapitalization technique, it is recommended to evaluate in some detail whether converting to Sub-S makes sense.

Oldco/Newco techniques work very well when there is a need for the selling shareholders to retain some assets or businesses or generally hold something out of the transaction. It does add a second entity that requires its own tax return be submitted. That adds complexity versus conventional techniques using one entity. FMI's prejudice is to use the simplest technique that is workable. Therefore, single entities should be considered before choosing the Oldco/Newco technique.

Becoming a public company means entering a completely new world, as those who have done it will recount.

ESOPs provide a very tax-efficient method to purchase a seller's stock, and, if the business is Sub-S, a very powerful approach for accumulating capital. Forming an ESOP does add a level of complexity that is not for most firms. Before utilizing an ESOP, simpler techniques should be considered. One should also consider how the ESOP will fit with the company's culture. ESOPs are probably appropriate for a select few HVAC and sheet metal contractors.

The technique that is best for a particular firm is very situation-specific. As previously discussed, determining what is best for the particular firm starts with understanding the owners' objectives and the situation of the business.

5. Valuation of HVAC/Sheet Metal Contractors

There are three approaches generally used for valuing construction companies—market-, asset-, and earnings-based. The market-based approach examines valuations for "comparable" companies. Two sources are generally available for valuations of comparable companies, trading values for public companies and published acquisition data. For public companies, valuations are published daily, and valuation metrics such as price-to-earnings ratios and price-to-book value can be determined. For acquisitions, metrics for transactions are sometimes published, though information is often incomplete, making it difficult to gain a full understanding of the valuation.

The key word in the discussion of the market-based approach to valuation is "comparable." For most private companies there is only limited comparability to public companies. Public companies are usually much larger than private companies; they are often in multiple businesses and typically more geographically diversified. That said, in the mechanical industry, it is useful to look at the valuations of companies such as EMCOR, Comfort Systems, and Matrix.

The asset-based approach starts with the balance sheet, particularly the accounting net worth shown at the bottom of the statement. Net worth may also be called book value or equity. This value is in fact used in many buy/sell or stockholders' agreements as the value at which a selling shareholder will sell stock to other shareholders or back to the company on exit.

While book value may accurately represent the value of a company, there are several inherent problems with it. First, there may be assets, such as equipment or real estate that may be worth more or less than shown on the balance sheet. Second, net worth does not indicate the liquidity of the assets nor does it indicate the costs to liquidate the balance sheet. Third, book value does not indicate how profitable the business is, or even whether the company has made money or not, or what the prospects are for the future of the company.

Addressing some of these limitations, two other asset valuation methods are sometimes used. Adjusted book value provides for adjusting the value of individual assets,

The key word in the discussion of the market-based approach to valuation is "comparable." For most private companies, there is only limited comparability to public companies.

such as equipment and real estate, to their "appraised" market value. Liquidation value adjusts the value for the cost of selling all the assets, paying the liabilities, and winding down business operations.

While market- and asset-based valuations are important, earnings-based valuation is usually the starting point for analysis. This is because a buyer is usually acquiring a business on the basis of the future earnings to be realized. Two primary approaches are used to determine an earnings-based value. The first is to capitalize historical earnings. This is accomplished by examining the earnings for the last year, three years, or five years and determining an earnings capacity for that business. Some adjustments may be made to the earnings in this determination based on what conditions might change when owned by the buyer. For example, the owner might take large or insufficient bonuses from the business, so a normalized market-based compensation needs to be determined for someone running the business. The owner might also have certain travel or other personal expenses that could go away when owned by a third party. The business might have had a large project where the earnings spiked up or down for a year, but that is expected to be a one-time occurrence. This exercise is called normalizing earnings, where the goal is to determine what the earnings capacity of the business was before the sale and to get a realistic picture of what expected earnings will be if owned by a third party.

The problem with basing value on historical earnings is that what a buyer is really buying is not what was made in the past, but what will be made in the next 3, 5, or 10 years depending on the buyer's planning horizon. That brings into account the discounted cash flow (DCF) method. In a DCF evaluation, earnings and cash flow are projected for five or more years. A terminal value at the end of the projection period will be estimated; terminal value represents either the value at which the business could be sold at the end of the projection period or the DCF of all earnings after the projection period. The problem with the DCF method, particularly in construction, is that projecting next year is hard enough; projecting five or more years is next to impossible. Therefore, while capitalizing historical earnings has limitations, it is usually relied on more than DCF except for more financially sophisticated buyers.

Capitalization of earnings is illustrated in Exhibit 9.

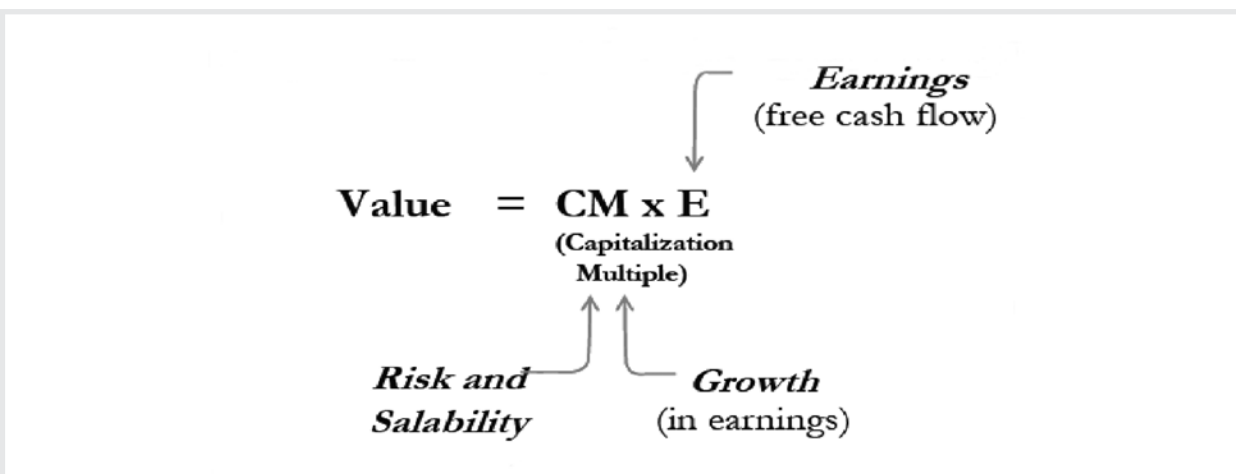


Exhibit 9: What Drives Value Capitalization of Earnings?

The value of the business is represented by the formula using a capitalization multiple times the earnings or free cash flow. While this is a very simple formula, there are a number of nuances to it. The capitalization multiple seen for most industry transactions falls in the range of three to six times earnings. Three times earnings is the most likely multiple for smaller, more risky businesses without a succession plan in place, and the high end at six times earnings is more likely for service-oriented businesses with recurring revenue.

The capitalization multiple captures the risk and salability of the business. A very sought-after firm in a desirable niche with a strong organization will have a higher multiple. A very risky firm with volatile earnings will likely have a lower multiple. The multiple factor also captures the growth of the business; a high-growth business in a high-growth market will attract a higher multiple.

The earnings typically used are pretax earnings. Often earnings before interest and tax (EBIT) is used, taking the interest and how the firm is capitalized out of the analysis. Some analysts will use earnings before interest, tax, depreciation, and amortization (EBITDA), which adds back depreciation and amortization to the earnings of the business.

The primary factor driving value is earnings; the higher the earnings, the higher the value. The second most important factor is growth in earnings. If the business is in a growing market and expects continued growth, a higher multiple and a higher value are likely to be paid. The third factor is salability. For example, in the late 1990s, there was a consolidation wave that drove up the value of HVAC firms. That was followed by utilities buying mechanical contractors. In today's market, there is limited consolidation activity, so selling opportunities are more limited and valuations are likely more conservative.

> The value for most HVAC and sheet metal contractors is going to be in the range of three to five times EBIT.

In conclusion, the value for most HVAC and sheet metal contractors is going to be in the range of three to five times EBIT. Service companies may command a higher multiple, and smaller firms will probably be in the three to four times EBIT range. Note that in the survey, respondents indicated an averaged expected valuation of 4.9 times pretax earnings. Human nature being what it is, it is not surprising that owners' expectations are at the high end of the range. From an asset perspective, the valuations are most likely to be one to two times book value adjusted to the market value of the assets. For sheet metal companies, that does not mean adjusting equipment values to new values but to a realistic appraisal of value.

Private-equity firms and consolidators may pay higher valuations than the multiple of book value above if the earnings justify it. They focus more on earnings versus asset value. If there is a difference in opinion on value between buyer and seller, sometimes an earnout is used to bridge the gap. Transactions with earnouts are structured with a base price at closing and additional future payment based on the actual earnings over a period of years.

6. Past Market Experience with Roll-Ups, Consolidations, and Other Acquisition Activity

The HVAC and sheet metal business is a highly fragmented business with numerous providers of these services in all local markets nationwide. Historically, this has been the case, and it is the case today despite efforts at consolidation. The classic reasons for fragmentation in the construction industry are

- Low barriers to entry. A technician with a bent towards business can often successfully start a new business.
- Absence of economies of scale. While there are some advantages in purchasing, there are challenges to managing a multimarket business.
- Mature technology.
- High transportation costs. Geographic markets tend to be locally serviced, so geographic expansion requires establishing local offices.
- Cyclicality of the business. Economic downturns require the financial strength and dedication to the business to survive.

Early Consolidators

There have been numerous efforts to consolidate the HVAC and sheet metal business. The motivation of the consolidators is simply to make money. Public consolidators do this by buying businesses at a private company multiple and being valued as a consolidator at a public company price. Private consolidators justify acquisition based on a return on investment, buying at an acceptable multiple and growing the earnings to provide an acceptable return on investment. For public and private consolidators, acquisition can be preferable to organic growth in both speed and expected cost. For the private seller, consolidators provide a market for their business usually at better prices with less risk than a sale to employees or another private business.

The first known public consolidation effort in the industry that was Fischbach and Moore. This company was started in the late 1950s and early 1960s and was built with the acquisition of numerous electrical and mechanical contractors. The public entity came under control of Victor Posner and ran into trouble. Some of its companies were eventually sold, and what was left ended up owned by AIG, its bonding company. It has since been sold off in pieces. As with most failed consolidations, the good employees survive and migrate to entities that are more successful.

The second public consolidation effort was JWP in the late 1980s. JWP, formerly Jamaica Water Properties, was a water utility in the New York area that had to sell its water assets to local authorities. It used the proceeds of that sale to buy electrical and mechanical contractors. It also bought Computer Land. When the recession of the early 1990s hit, JWP got into financial trouble and went through bankruptcy. It emerged from bankruptcy in the mid-1990s and changed its name to EMCOR. Today EMCOR is the nation's largest mechanical and electrical contractor and has become a successful public company. It largely sat out the consolidation wave of the late 1990s but has made a number of acquisitions in the last decade. EMCOR is predominantly union today, but has some nonunion businesses.

The 1990s

The 1990s brought two acquisition trends to the industry. The first was the roll-ups, followed by the acquisitions by a number of public electrical utilities. The roll-up trend did not start with construction but in other industries such as landfills, funeral homes, professional services, and numerous other local businesses. The theory was to find local businesses in a fragmented industry, buy a large number of them, and combine them under a corporate office. If companies could be bought at a private multiple and a public multiple achieved for the combined entity, the originators of the consolidation could make money on the spread. Ultimately, the roll-up concept did not work very well in or outside of the construction industry.

American Residential Services (ARS) was one of the early roll-ups in HVAC and plumbing. It was a combination of companies primarily targeting the residential market. Being independently public did not work very well, and the business was later bought by Servicemaster, a roll-up of several service businesses. It was later sold to Caxton Iseman, a private equity firm. It currently operates in more than 20 states with several hundred million dollars in annual revenue.

Service Experts was another roll-up of residential HVAC and plumbing service providers. It also struggled as an independent company and is now owned by Lennox, the manufacturer of HVAC equipment. Lennox has 120 locations nationwide.

Comfort Systems was created in Houston by Byron Snyder, a creator of numerous roll-ups across several industries. Its acquisition target was nonresidential HVAC companies, and it started with a number of companies nationwide. It grew through acquisition, and initially its stock performed well. It suffered, as most roll-ups did in the late 1990s but, after the sale of some of its companies to EMCOR, was able to stabilize its balance sheet and business. In recent years, it has started to grow and make acquisitions again. It is a nonunion business.

Group Mac was created in the same era as Comfort Systems from a combination of mechanical contractors across the country, going public in the mid-1990s. At about the same time, John Ledecky created a public "blank check" company, raising $500 million for acquisitions. This company acquired a group of nonunion electrical firms nationwide and called itself Building One. After the acquisition of this group, Building One made numerous acquisitions nationwide. Eventually, Building One merged with Group Mac to create Encompass, the largest nonunion electrical and mechanical services provider. In the late 1990s, the business softened and its bonding company stopped supplying bonds. At its peak, annual revenues were more than $3 billion; however, its tangible net worth (equity less goodwill) was negative. It started selling companies, many back to the original owners and management teams, and filed for bankruptcy.

Also in the 1990s, electrical utilities went through a period of acquiring mechanical contractors. This was at the time when Enron was flying high on the success of its nonregulated businesses. While it was selling at PE multiples of up to 50, most utilities were selling for less than 20. To emulate Enron's success, many electrical utilities developed strategies to expand their nonregulated businesses. One of the strategies that several utilities adopted was to acquire mechanical contractors. The theory was (1) it placed the utility closer to its customers, (2) the utility could use its balance sheet and acquire companies at a multiple that would be accretive to earnings and, (3) it put the utility in a business where earnings could grow. Utilities such as PP&L, First Energy, PSEG, Keyspan, UIL Holdings, and Northeast Utilities pursued this strategy. This strategy continued until Enron collapsed into bankruptcy; following this, most utilities returned to their core strategy. Most utilities also had problems managing the entrepreneurial, service-oriented contracting businesses in their regulated utility culture. Many utilities divested these businesses; however, a few remain owned by the utilities.

Because of the opportunities for consolidators to make money in a consolidation and there being no shortage of potential sellers desiring an exit strategy, consolidation efforts are expected to continue.

The Present

While all this higher-profile consolidation activity was happening, a significant number of private companies grew organically and through acquisition and are successful today. APi is a large privately owned company that has made numerous acquisitions to create a nationwide company. It is active in mechanical, fire sprinkler, and other trades. Kirlin is another large private mechanical firm working in several eastern markets. ACCO Engineering Systems and Southland Industries have also grown into large multitrade firms on the West Coast. Limbach, Service Logic, and Kinetics are examples of large mechanical firms that have private-equity investors. After EMCOR and Comfort Systems, ENR lists 16 companies over $200 million in annual revenue and another 31 with revenue of more than $100 million. This does not include some companies that do not choose to list with ENR. Manufacturers in addition to Lennox, such as Carrier and Trane, have active service organizations that they have built through acquisition and organically. There are numerous smaller, very successful independent companies. Some focus on a single market; some are multimarket-focused. Many are firms that sold themselves to consolidators or utilities but have since bought themselves back. FMI's observation on the mechanical business is that, while it is subject to cycles and needs strong local management, it is generally a profitable business. The difficulties associated with consolidation are among the reasons that independents have prospered and will continue to do so.

While consolidation is difficult, it is important to remember that EMCOR and Comfort Systems have become successful as public companies, and a number of the others mentioned have become successful multimarket private companies. Because of the opportunities for consolidators to make money in a consolidation and there being no shortage of potential sellers desiring an exit strategy, consolidation efforts are expected to continue. It should be expected that successful private companies, existing consolidators, private-equity firms, and equipment manufacturers could all be active in the market. It is also expected that, despite consolidation, the industry will remain fragmented, and there will be plenty of room for the independent firm to succeed.

The survey showed more than half of respondents thought the industry may consolidate further, while 40% expected little change. FMI's view is that the changes will be a matter of degree, and despite the best efforts by consolidators and manufacturers, the industry will remain fragmented to a large degree due to the nature of the industry.

7. Implementing a Transition Strategy and Pitfalls to Avoid

Personal Planning in Preparation for a Transition

The ideal situation when selling a firm to employees and family is that the owner(s) will have built a nest egg outside of the business. Having the nest egg provides the sellers the flexibility to sell the business over time and to take more risk. When asked if they have significantly built personal net worth outside their company ownership, 59% of our survey respondents said yes. That number improves to 66% for those owners older than age 51. This bodes well for those who have built a strong net worth outside the business but creates a planning challenge for those who have not.

Exhibit 10 provides a model personal balance sheet for analyzing a business owner's net worth, breaking assets into the three categories suggested by Ashuin Chhabra in a Merrill Lynch white paper, *Beyond Markowitz*—protective, market, and aspirational.

Assets	Liabilities
Protective	Debt
Market	Personal Guarantees
Aspirational	Net Worth

Exhibit 10: Personal Balance Sheet

Protective assets are low-risk assets, such as a home, an insurance policy, or cash in the bank. Market assets are investments to make a return, such as pension plans like a 401(k), stocks and bonds, and investment real estate. These are investments that the business owner is not active in managing but that are held for a return. Aspirational assets are "get-rich" assets, ones that the business owner is actively managing to earn a higher return. An HVAC or sheet metal business is a good example of this, or it could also include real estate that is being developed. While the goal of protective and market assets is preservation of capital and income, the business owners' wealth-creating opportunities are found in aspirational assets.

The liability side of the balance sheet may include debt related to the business, a home mortgage, or other personal debt. It might also include personal guarantees for bonds or to the bank. The difference between these assets and liabilities is a business owner's personal net worth.

FMI's recommendation for the business owner is to go through the exercise of assembling a personal balance sheet and then to ask himself/herself the following questions:

- How much in assets net of liabilities does he/she have excluding the business?
- Could he/she live at a desired standard of living off the income from the assets outside the business?
- Is the risk associated with selling the business to family or employees acceptable, given the likelihood of the purchase taking 5 to 10 years to complete?
- Are assets outside of the business appropriately diversified?
- How much income is wanted when he/she retires, and how much net worth will it take to generate this income?

For many company owners, particularly younger ones, personal balance sheets will indicate that most of the owner's net worth is in the company, that is, in aspirational assets. The owners have not necessarily built up their protective assets; they may have a mortgage on their home and may not have a large retirement plan. That is because they have invested in the business, which is appropriate for the young owner. However, as an owner ages, it is prudent to pay more attention to the protective

FMI's recommendation for the business owner is to go through the exercise of assembling a personal balance sheet.

and market asset categories. That is when the above questions become most important.

In today's world when one may live to be 80, 90, or 100 years old, it is hard to predict how long retirement will need to be funded. The prospect of retiring at 50 and then living another 50 years is daunting, particularly given the inflation that some think may be on the horizon. Therefore, it is important when planning a transition that the owner's personal balance sheet is in good shape. So the question is posed again: is the business owner appropriately diversified, and is his/her risk level appropriate?

One other comment on the assets categories—protective assets being lower-risk by nature will provide lower returns, perhaps in the 3 to 5% range on average over a long period. One may think his/her house may appreciate more than that, but for a home to appreciate 3 to 5% over a 20-year period is very good, given the periodic flat markets that tend to occur.

Market assets, such as stocks, bonds, and investment real estate, where the business owner is not involved, might be expected to return 9 to 10% on average over a period of decades. As is apparent from the decade beginning in 2000, there are some decades where the return can be zero.

For aspirational assets, valuation of most HVAC and sheet metal companies was discussed to be in the three to five times earnings range. If an asset is worth three to five times its earnings, the implication in a slow-growth industry is that the annual return on the value of the business is 20 to 33%. That is significantly higher than the 9 to 10% from market assets. If this is the case, it begs the question, "Why would a business owner sell an aspirational asset yielding 20 to 33% to likely invest in a market asset or a protective asset expected to yield less than 10%?" The answer is that the business owner wants to retire or reduce risk. Contractors often go one job too far or sail into the headwinds in a tough market and end up losing everything they have made.

Aspirational assets are good for building wealth. But later in a business owner's career, it makes sense to take money out of the business to pay off a mortgage or other debt and invest in market assets to provide income and diversification in retirement. If this is done, when it is time to sell stock to employees, the business owner already has a nest egg outside of the business and can be flexible as to how to structure a sale.

8. Potential Pension Liability Issues in Any Transition Strategy

An important consideration in planning for the transfer of ownership is the potential for liability associated with an underfunded pension plan.

Under current law, an employer may experience a liability from a multiemployer pension plan in a variety of circumstance. Pension liability may be an issue in some types of transfer of ownership, and not in others. Potential pension liability issues must be carefully assessed as part of any transition strategy, as they may have a significant impact upon the particular exit strategy that is ultimately employed by the

As an owner ages, it is prudent to pay more attention to the protective and market asset categories.

contractor. Any comprehensive exit strategy must involve an analysis of the potential for the imposition of withdrawal liability in the event of a change in business operations, or ownership, as part of a transition strategy.

It is essential to consult with legal counsel familiar with withdrawal liability issues early on in the planning process. For more information on this subject see Appendix B.

4 IMPLEMENTING THE TRANSITION

There are four steps in the implementation of a transition:

1. Defining Objectives.
2. Understand Transition Options.
3. Set a Timeline.
4. Implement.

These four are discussed in the following paragraphs.

1. Defining Objectives

The first step for a business owner in assembling a plan is to define personal objectives, answering questions such as

- When do you want to retire?
- How do you want to retire, cold turkey or in a transition?
- What do you want to do in retirement?
- What income will you have outside the business?
- What assets and liabilities do you have outside the business?
- What income do you want from the business in a transition?
- How much money do you expect for your stock?
- Who is going to manage the proceeds from the sale of the business?
- How soon can you get off any banking or bonding guarantees?
- Who do you want to have the opportunity to purchase the business—specific employees, family members or a third party?

From the answers to these questions, the business owner can define his/her objectives. Objectives should also be defined for the business and the potential successors.

2. Understand Transition Options

While only 11% of those answering the survey said they were unsure or unaware of transfer or transition techniques, only 37% were currently working on an internal transfer plan; yet, as mentioned above, 49% expected to sell to employees, family, or both. Therefore, the research team acknowledges that there is still a large gap between understanding and implementing the ownership transition.

Once the owner's objectives have been defined, the next step is to gain an understanding of the technical options to facilitate a transition. What is the business worth not just to the owner, but also to a third party or in a realistic transition model? Are the business salable to a third party? Again, the FMI research team has reported that 10% of companies in this industry change hands through a sale. Therefore, even if the business is successful, there may not be a buyer. Does the business qualify for a financial buyer? Again, FMI has indicated that that private equity is very selective within the construction industry. Finally, the owner must determine if an internal sale would work for him/her, if he/she has the successor employees, what structure for an internal transition might work for the business, and how it would work for him/her.

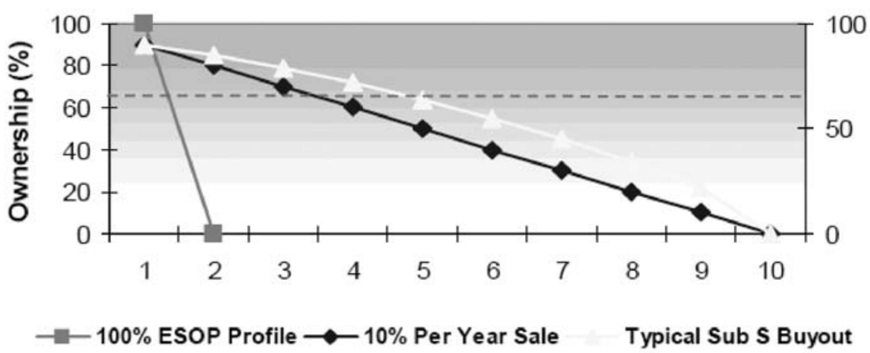
3. Set a Timeline

Exhibit 11 shows typical timelines for an internal transition. Note that most internal transitions occur over a several-year period. Longer timelines are usually driven by the need to allow the business to generate enough profits to fund a transition. This actually increases the odds of the transition working because sudden change can be disruptive to an organization, while slow change provides the opportunity for successor manager/owners to develop. It provides time to train and observe the next generation. Longer timelines also put less financial stress on the business, as the business is more likely to maintain a strong balance sheet.

For a third-party sale or private-equity recapitalization, once the decision is made to go forward, it could take six months to a year or two, depending on the market. As previously discussed, having an internal transition option as a backup to the sale is a prudent strategy.

4. Implement

Making the decision to start a plan for an exit strategy is often the hardest step. It is so easy to put ownership decisions off another year,



Management Succession Timeline

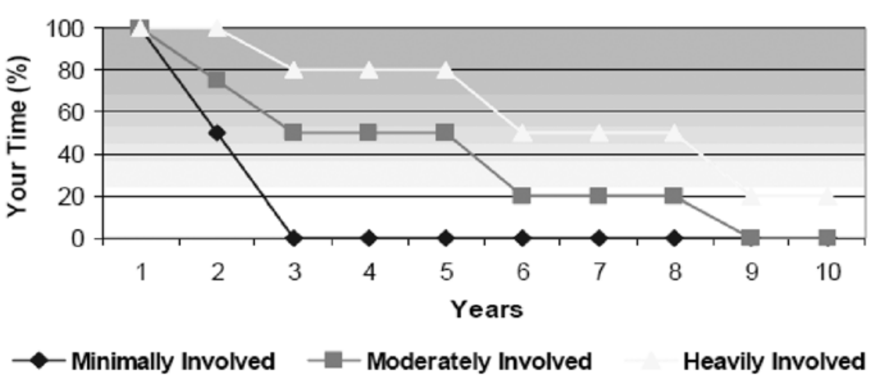


Exhibit 11: Ownership Transfer Timeline

particularly when the business is busy or some uncertainty lingers. Hesitating in many cases can work against the owner as key employees may leave, the business may drift, or acquisition markets may change.

5 CONCLUSION

The first step in solving a problem is recognizing that there is a problem. The next step is to understand how large or important the problem is in order to prioritize and devote the right amount of attention and resources to solve the problem. However, that is not the last step; the problem is not solved until there is a plan to attack it and that plan is fully implemented. In this report and in the analysis of the results of the survey below, the FMI research team has shown that the problem of recognizing the need for and planning an exit strategy should be a high-priority concern for all owners of construction firms. For most owners, selling their stock and exiting the business is a once-in-a-lifetime occurrence, and, for reasons discussed above, there is a tendency to put those decisions off until later. Nonetheless, FMI has also tried to show that, even if the owner is not planning to retire this year, there are many benefits to having a working exit strategy and ownership transition plan. While some owners may think they have too many irons in the fire to worry about it now, preparing leaders and successors who will one day become majority owners of the company will help to manage the day-to-day problems as well. Even if there is a plan to sell the business, the buyer will place a higher value on a company with a succession plan and depth of leadership.

FMI often recommends allowing 5 to 10 years for implementing a successful transfer of ownership, depending on the goals of the owner and the means of transfer and other factors. In reality, every company should have an ownership transfer plan in place even if the owners do not plan to retire for many years. For one thing, bonding companies like to see an ownership transfer plan in place, but it should also be part of good business planning and strategy. Ultimately, a successful exit from the business will preserve the value of the business that the owner has built over the years. It will also help to retain the best talent who one day may be owners and continue to grow the business for generations to come. After all, 68% of the owners answering the survey consider the business to be a family business. Fifty-three percent of those businesses have been in the family for two generations or more. Building a legacy and building wealth for the owners and those who work for the company require a long-term view, and management succession and plans for ownership transfer are a key part of continuing success for the company.

Ownership transfer is best viewed not as just a one-time event, but as a continuous growth strategy at the heart of the business. Whether ownership transfer is a sale of the business to a third party or the transfer to family and employees, for future success and continuity of the business, all companies need to work on bringing up the next generation. A formal coaching and mentoring process will help the current owners to prepare the next owners and leaders to keep the business going strong as one owner moves aside and another takes the helm. Coaching provides insight and focus so that a person can more efficiently move forward to where he or she wants to be. A mentor teaches skills based on the mentor's personal experience to one who is usually less experienced and often in the same profession. The coaching process does not rely on the coach's experience or being in the same profession. Instead, the coach guides the client on a unique path in order to help the client meet his/her goals and objectives. In preparing and executing an exit strategy, it becomes clear that the owners of the company are not just working in the company; they are working on the company to leave a body of work or an ongoing and healthy business to the new owners or the next generation, thereby realizing all of their own hard work and preserving the wealth they have built up in their company over many years.

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7 APPENDIX A

Survey of Sheet Metal Contractors, Results

Online Survey Results Summary for the New Horizons Foundation: *Exit Strategies for HVAC/Sheet Metal Contractors ... Strategies for Equity and Ownership Transfer*

Survey Highlights

Much has been written about the great potential for wealth transfer expected over the next 50 years from the baby-boomer generation, somewhere around $41 trillion, according to some estimates. However, those estimates were made before the Great Recession. Nonetheless, there are a great many successful businesses being led by owners of the baby-boom generation who should now be considering how they are going to transfer the ownership of their businesses and who their successors will be. The survey participants for this study, which was conducted for the New Horizons Foundation and sent to 1,650 sheet metal and HVAC contractors, are profiled below.

Profile of Survey Respondents

- The respondents covered a wide range of ages with 64% of respondents older than 51 and 25% older than 60. More than one-third, 36%, were age 50 or younger.
- Respondents also included companies with a wide range of sizes. Twenty-seven percent of the companies surveyed generated annual revenues of more than $20 million, and 36% had revenues of $5 million or below.
- Fifty-seven percent of the companies responding were HVAC or mechanical/HVAC businesses with the remainder focused in the sheet metal business.
- Sixty-one percent of all respondents worked in the commercial construction market with no other sector accounting for more than 15% (such as industrial, residential, or institutional).
- Seventy-five percent of companies worked in a single geographic market.
- A majority of respondents surveyed are family businesses.
  - Sixty-eight percent of all respondents consider their business to be a family business, with 72% of businesses having family members active in the business.
  - For thirty-four percent of all respondents, the business has been in the family for at least two generations, while 19% say their business has been in the family for three or more generations.
  - Nineteen percent of respondents have family members who own stock in the business who are not employed by the business.
  - Fifty-six percent of all respondents prefer that family members ultimately own the business.

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Major Findings of the Survey for Internal Transition

- The two major concerns from owners about transferring ownership were (1) employees cannot afford to purchase the company (32%) and (2) owners were not yet ready to transfer ownership (23%). Therefore, while transitions are imminent, many owners are hesitant.
- About half (49%) of respondents expect to sell to employees, family members, or a combination of employees and family members. Twenty-two percent expected to sell to a third party. Ten percent expected to liquidate the company. Nineteen percent were uncertain as to ownership transfer plans at this point.
- Forty percent of company owners are selling by gradually selling their stock over a period of time. Twenty-eight percent of company owners are selling for a note and/or cash at an agreed-upon value. Only 5% create a new company and use Oldco/Newco techniques. About 10% are selling to an ESOP.
- While about half of owners of family businesses who received their stock in a family transition purchased their stock in their company, about 40% received stock through inheritance or gifting. For the next generation, family owners expect to transfer their stock via sale 21% of the time; by estate or gift, 32% of the time; and a combination of the three, 43% of the time. This shows that, while owners often take advantage of the tax benefits of gifting and estate transfers, sales of stock are commonly used as well.

Management Succession Issues

- Only 42% of owners older than 51 said they have competent and capable management that could run the business today; 46% have potential successors that need further development. Overall, 19% of all respondents said they would need to hire successors from outside the company.
- More than half of all respondents had successor management involved in activities such as preparation of formal strategic/business plans and budgets and reviewing corporate financial information. About two-thirds of respondents had potential successors involved in leadership development and training programs. A large majority (78%) had successors involved in business development with significant clients. This shows most respondents are working with their successors to learn important ownership skills. For those who

The most significant challenge to a successful transition is likely to be preparing the successors. Preparation of successor management is also critical to the third-party sale.

Seventy-six percent of respondents over the age of 50 plan to sell all of their stock in their company within the next 10 years, while only 48% of the owners older than 50 are currently working on ownership transfer plans.

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Personal Planning Issues

- Sixty percent of respondents said they had significant personal net worth outside of the business. For those who do, this provides flexibility in planning.
- More that 66% of companies with more than one partner have a buy/sell agreement indicating that most have a mechanism in place to address shareholder terminations.
- In the event of the death of an owner, 70% of companies with revenues of less than $20 million will see the stock of the owner go into the owner's estate. Forty percent of companies with revenues greater than $20 million will see the stock go into the owner's estate. Therefore, despite having buy/sell agreements in place, in death, particularly, smaller companies will have an estate as an owner.
- Seventy-five percent of respondents older than 50 plan to sell all of their stock in their company within the next 10 years, while only 40% of the owners older than 50 are currently working on ownership transfer plans. Since transitions usually take years to develop and implement, this shows there is much work to be done by transitioning owners.

On the Acquisition Front

- Fifty-five percent of respondents thought there definitely would or might be more consolidation of the market, while about 40% thought there would not be much change in consolidation or the industry might be less consolidated than it is now. This indicates some difference in opinion on where the industry is going, and it is interesting to compare when reading FMI's discussion of past consolidations and fundamentals of the industry later in this report.
- While only 6% of companies expect to grow by acquisitions, 22% expect to transition by selling to a third party. As in most construction markets, sellers are expected to outnumber buyers, so it makes sense for sellers to develop multiple transition options.
- Fifty-nine percent of respondents characterized their growth plans as "more internal growth," while only 6% expected to grow by acquisitions. This indicates that, if the industry is to consolidate, it is likely to be driven by relatively few companies.

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Seventy-five percent of all owners older than 51 plan to sell all of their stock in their companies within the next 10 years.

In all, 75% of all owners older than 51 plan to sell all of their stock in their companies within the next 10 years. The question then becomes, what is the best way to transfer ownership to assure a smooth transition and give the owner or owners the best value from the businesses they have built? The following discussion will not fully answer that question, but it will detail the results of the survey in order to give readers a better idea of how others are considering their exit strategies and present some of the issues and concerns for a smooth transition of the business ownership.

Survey Methodology and Demographics

The survey form was prepared and sent electronically to a list of 1,650 sheet metal and HVAC contractors. FMI received 174 responses to the survey for a 10.5% response rate. All respondents to the survey were company owners, primarily company presidents, CEOs, board members, and other top executives (Figure A1).

Thirty-nine percent of respondents were between the ages of 51 and 60, 25% were older than 60, and 36% were 50 and younger (Figure A2). Response by annual volume was well distributed across the sample with 71% of companies representing annual volumes of less than $20 million and 36% with annual revenues less than $5 million (Figure A3). Business type was divided into six categories plus "other" with HVAC representing 33%, and the combination of mechanical and HVAC representing 24% of the sample. Other non-HVAC businesses included sheet metal work for custom fabrications, architectural, industrial, and residential markets (Figure A4). Sixty-one percent of respondents served the commercial market (Figure A5). Seventy-five percent of respondents said they worked in only one geographic market with a tendency for larger companies to work in several markets (Figure A6).

When discussing the survey results below, the research team will generally be using the statistical breakdowns for all respondents; however, where notable, breakdowns will be given of the results by either annual revenue or owner age groups. Annual revenue was divided between those companies with more than $20 million in revenue and those with less than $20 million in order to allow a sufficient sample of larger companies, which represented just 27% of the sample. The age division was selected to show a difference between the baby-boomer generation and the next generation, with the baby boomers representing 64% of the sample.

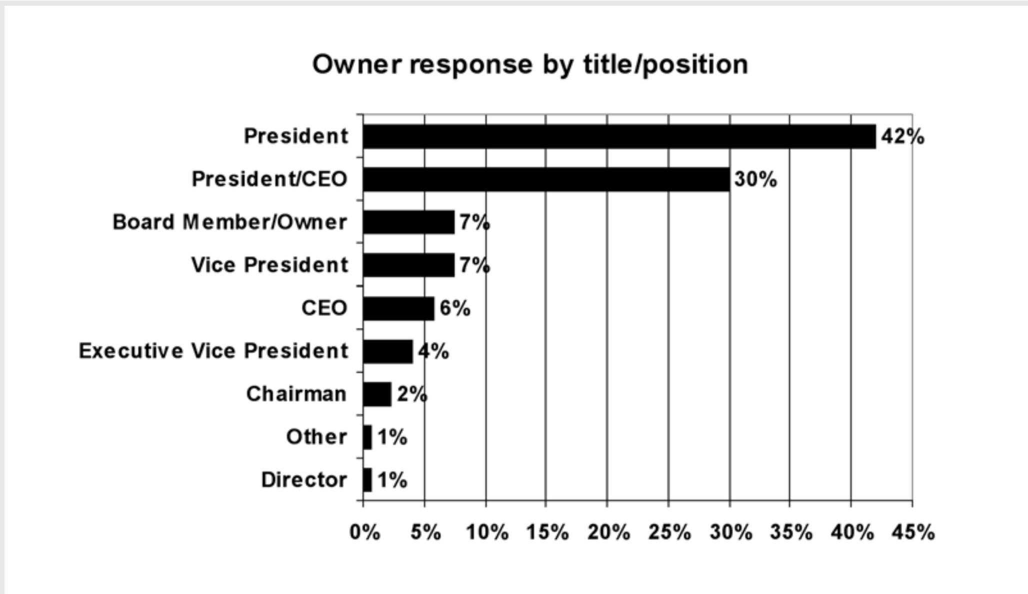

Figure A1: Responses by Job Title/Position

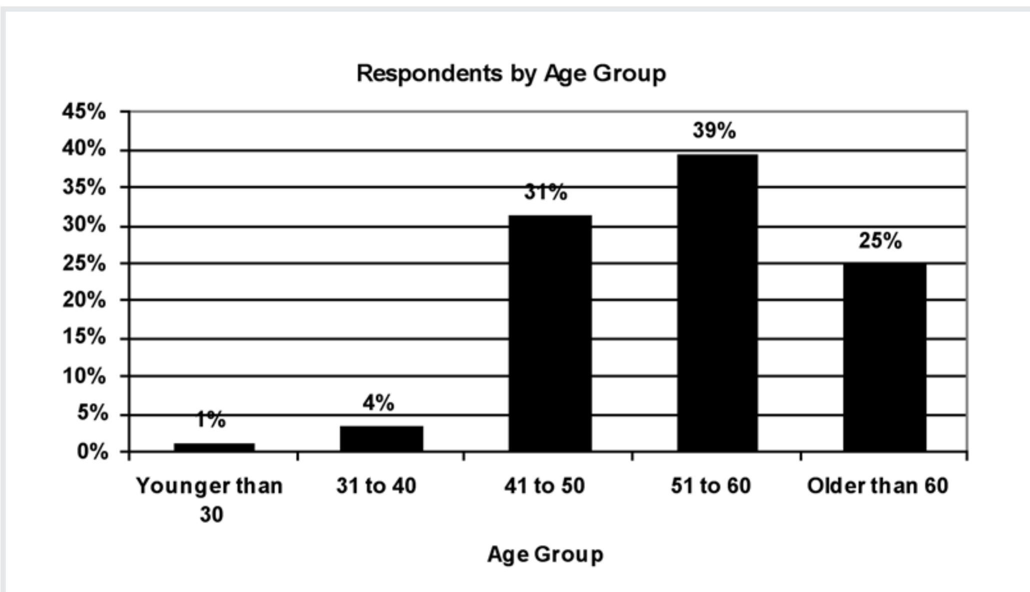

Figure A2: Responses by Age Group

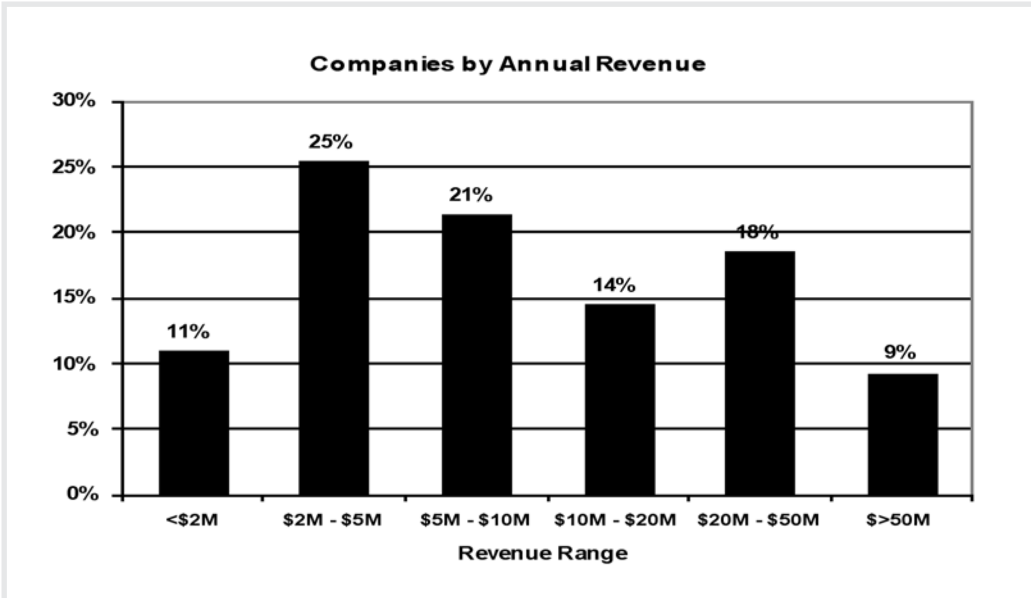

Figure A3: Responses by Annual Revenue

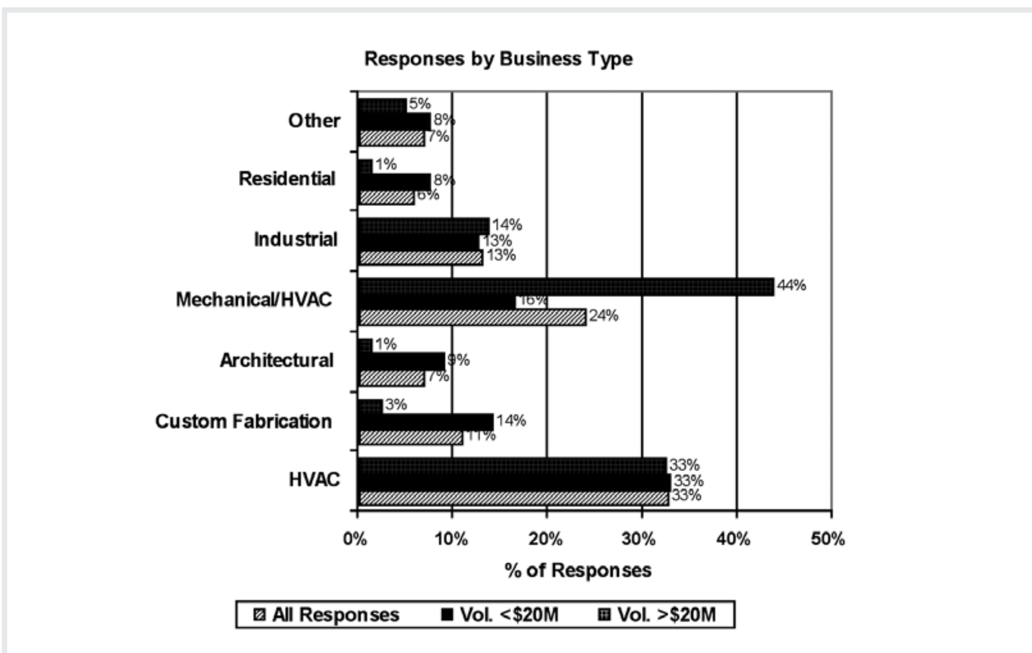

Figure A4: Response by Business Type

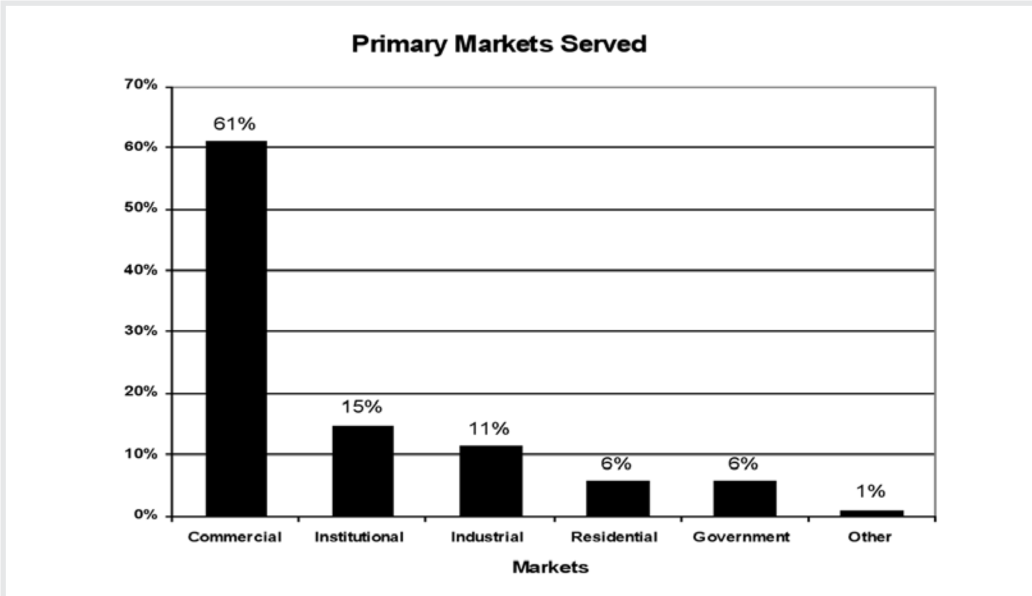

Figure A5: Response by Markets Served

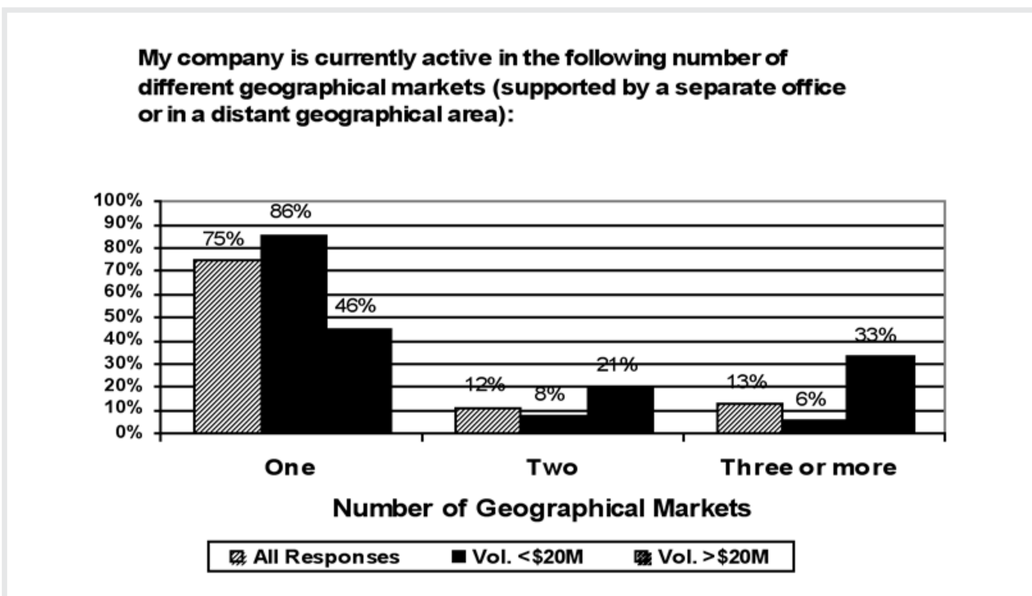

Figure A6: Geographic Markets Served

Growth Plans and Expectations for Industry Consolidation

Figure A7 shows owners' growth plans for their companies in the next five years with a comparative look at the response by volume. Fifteen percent of companies with volumes greater than $20 million expect to grow by acquisition, while only about 3% of companies with volumes of less than $20 million plan to grow by acquiring another company. Therefore, as might be expected, consolidation by acquisition is likely to be driven by larger companies. However, 69% of the larger companies expect more internal growth. A few large companies will likely lead consolidation, if it occurs. Contrasting that response with Figure A8 shows that about 40% of all respondents think there will not be much consolidation or indeed there is some chance the industry may deconsolidate. The survey did not probe why respondents thought this to be the case, but it is an interesting set of statistics to consider in light of the fundamentals of construction and history of consolidation to be discussed in Section I of this report.

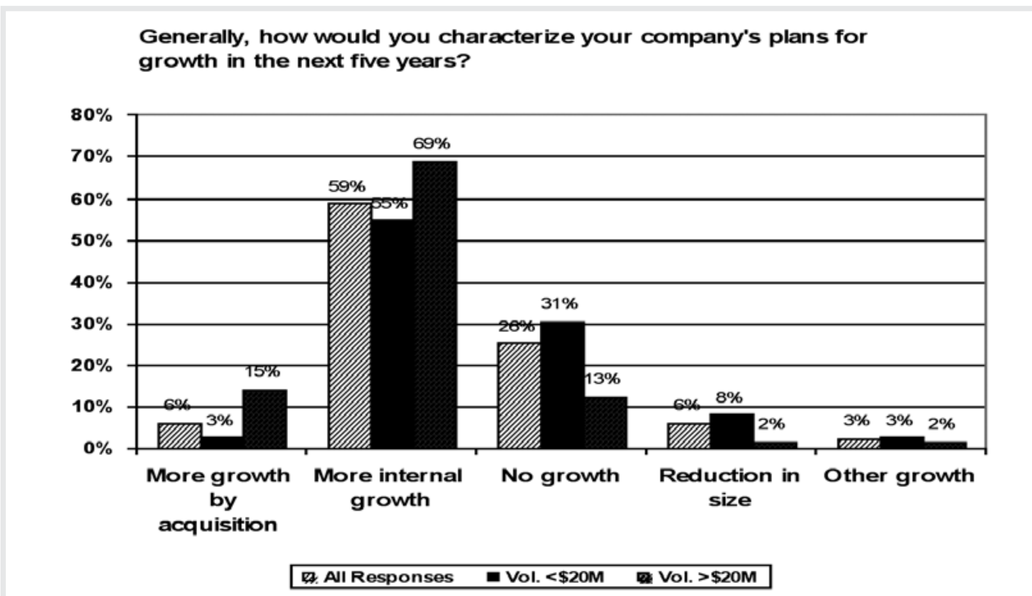

Figure A7: Growth Plans

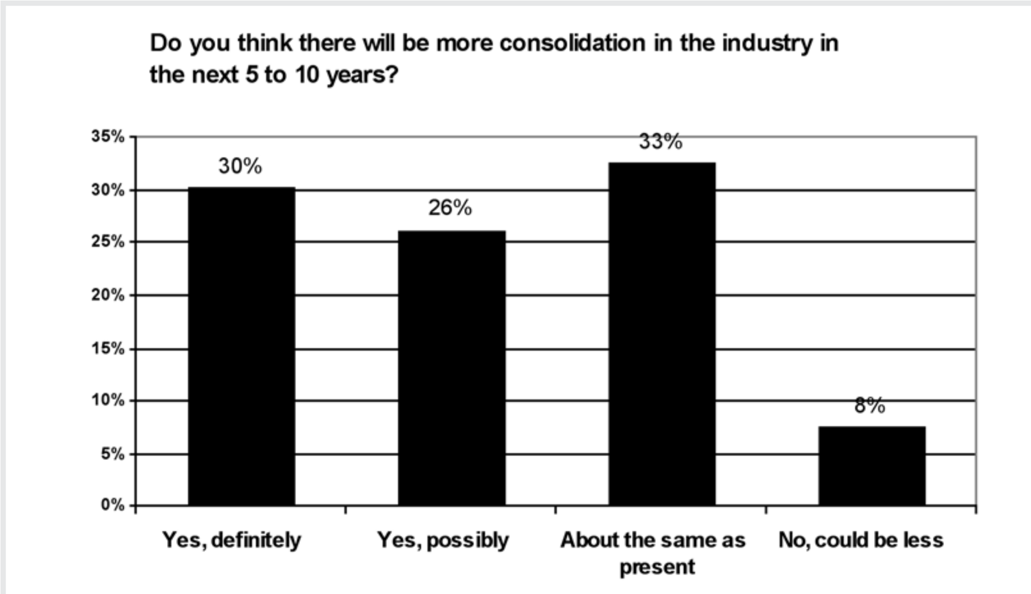

Figure A8: Expectations for Industry Consolidation

Potential Buyers and Sellers

If industry owners expect more industry consolidation, especially by selling their interests to a third party or acquiring another company for growth, considerable activity would be expected as buyers and sellers contact companies with potential deals in mind. In Figure A14, we see that 22% of owners expect their ownership transfer plans to include sale to a third party. Figure A9 shows that 24% of owners have been approached frequently by potential buyers, and 5% have been approached constantly, thus giving credence to there being a market for a third-party sale. Twenty-six percent of owners have had discussions with buyers at least once, and 9% have talked with buyers multiple times (Figure A10). However, these statistics do not indicate transactions, just contact.

Potential sellers have less frequently approached respondents, with 10% saying they have been frequently approached, and only 3% have been constantly approached by sellers.

When only larger companies are broken out, those numbers go up considerably to 25% for "frequently" and 10% for "constantly," indicating what the researchers would expect to see, that sellers are most likely to look to larger companies (Figure A11). This is not a surprising result, but it helps to point out the number of potential buyers there might be in the market when it comes time to sell a company.

Similarly, 25% of all respondents have acquired a company once in their careers, and 8% have acquired companies several times. Again, those numbers increase when just the results for companies greater than $20 million are considered, where 35% have been involved in at least one acquisition and 23% have been involved in a number of acquisitions (Figure A12).

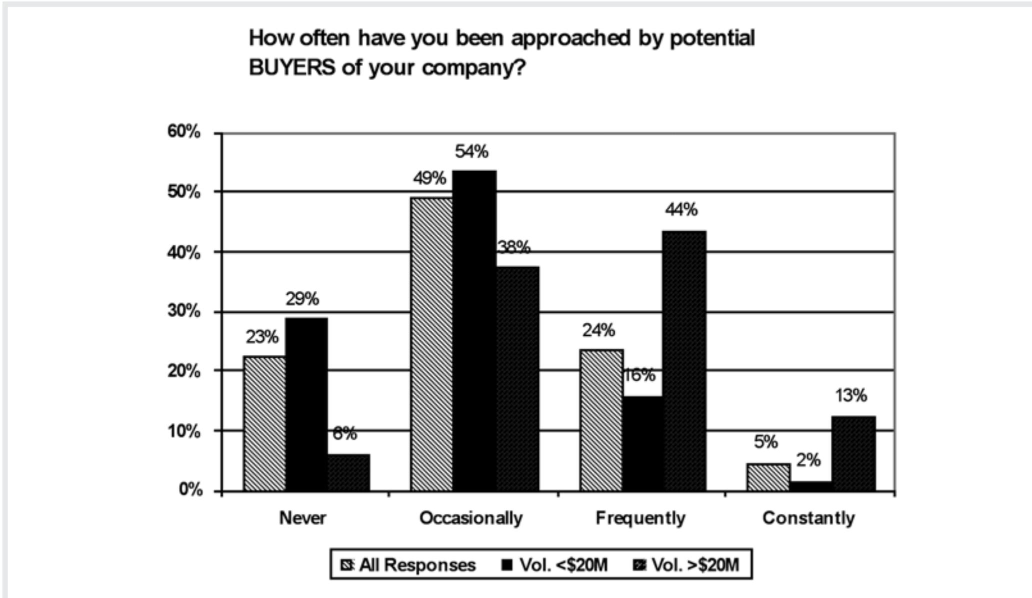

Figure A9: Potential Buyers

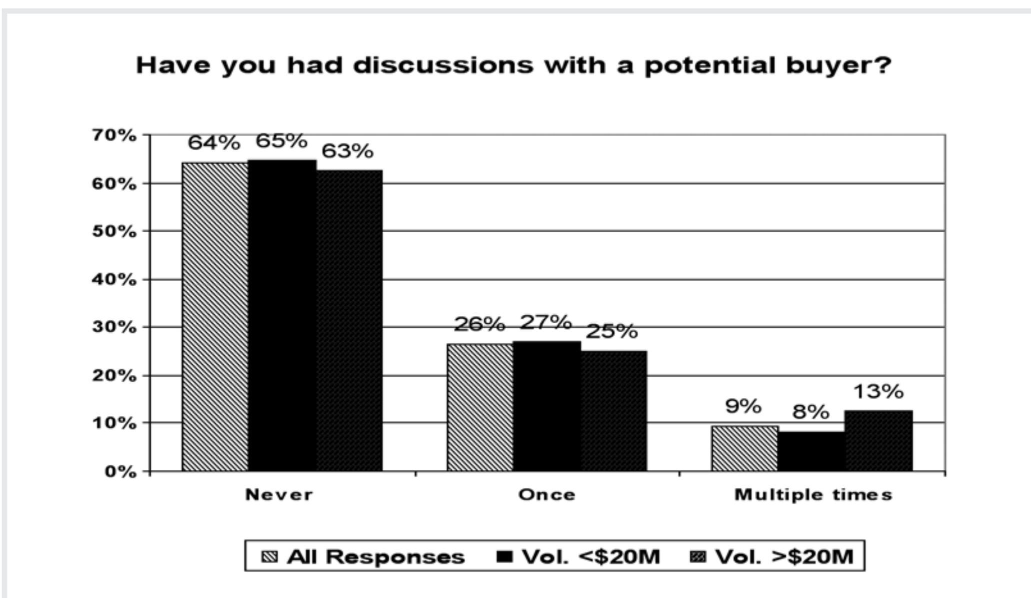

Figure A10: Discussions with Potential Buyers

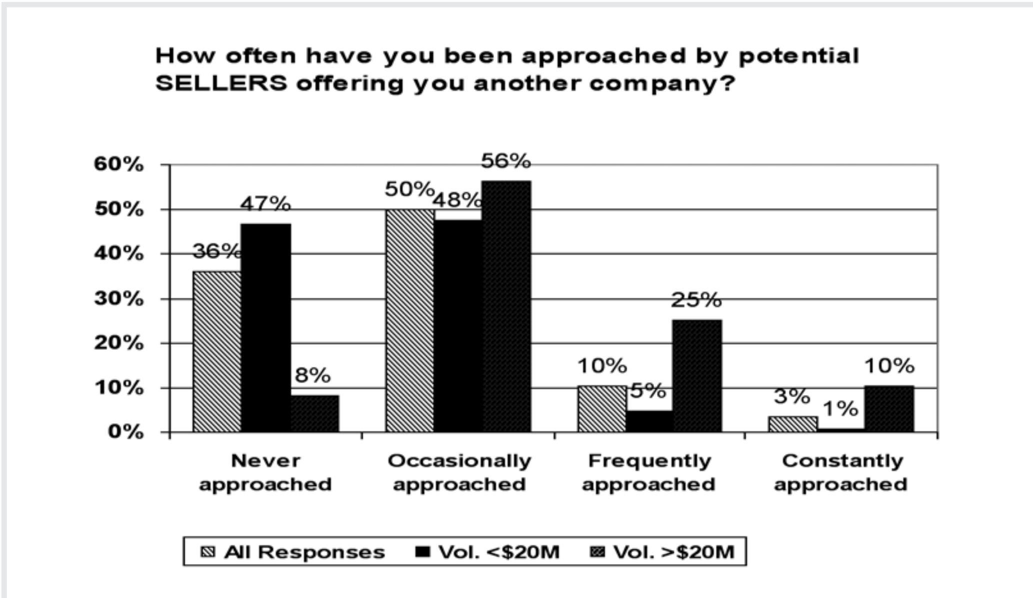

Figure A11: Potential Sellers

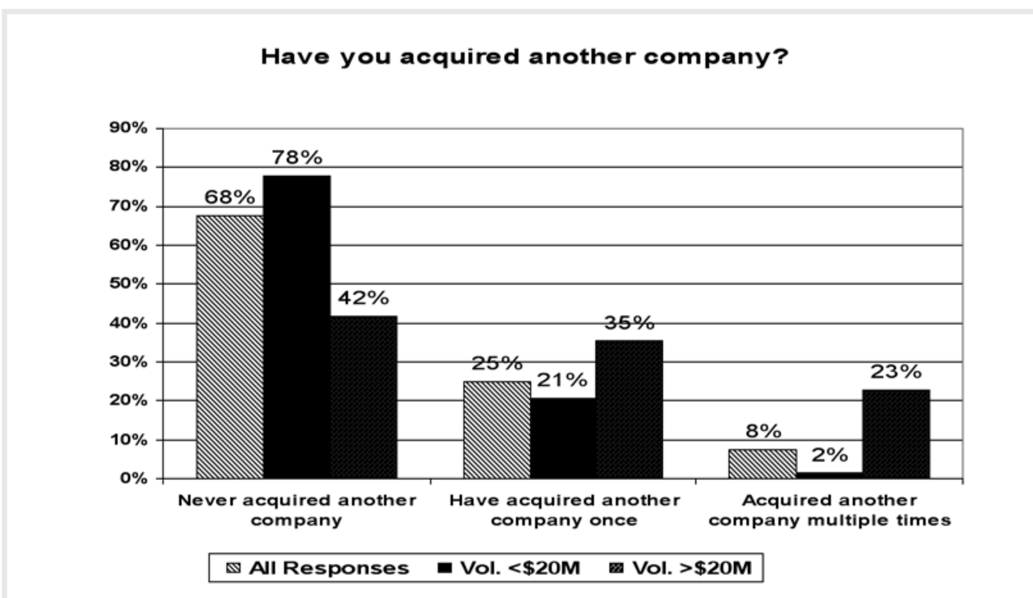

Figure A12: Acquisitions Experience

Ownership Transfer Plans

The core of the questions asked in this survey concerned ownership transfer plans, including how the owner plans to exit the business, sell his/her stock, as well as who the buyers might be and who will be the successors of the business. One influencing factor in the decision to transfer ownership is who the owner thinks should own stock. Figure A13 shows that 65% of owners think one person should hold a controlling interest, but multiple owners would be acceptable. Only 16% think a single owner should control all the stock.

FMI has broken out the responses to the question about ownership transfer plans to show some differences by company size. Larger companies are more likely to sell to employees or look to third parties to purchase the company. Only 3% of the larger companies are considering liquidation (Figure A14). When the value owners expect to receive for their companies is considered, it is found that 30% of owners with annual revenues of less than $20 million and 54% of larger companies expect a multiple of earnings. Only 17% of larger companies expect a book or adjusted-book-value valuation compared with 41% of smaller companies expecting a book or adjusted-book-value valuation (Figure A15). The average multiple expected by all owners is 4.6 times pretax earnings (after adding back owners' bonuses and perks). Note that these expectations do not necessarily represent current market trends.

Employee ownership and stock transfer are among the largest considerations for owners' exit strategies and match the trend in the broader market. Thirty-three percent of respondents said they are currently working on an internal ownership transfer plan, but only 28% said they have nonshareholders in their business who have approached them about buying stock.

If all the stock is not concentrated in the hands of a single owner, who else should own stock in the company? In Figure A16, the research team again breaks out the results to show some differences between responses by company size. In general, most responses indicated that top executives, including vice presidents and division managers, should be stockholders; however, the response is strong for the consideration of other department heads and field managers. This not only indicates a trend toward broadening the number of potential buyers, but also indicates broader company ownership than in the past. Therefore, if the ownership is to be held by a broader group of employees, it may be necessary to increase the interest in employee ownership to make this plan successful.

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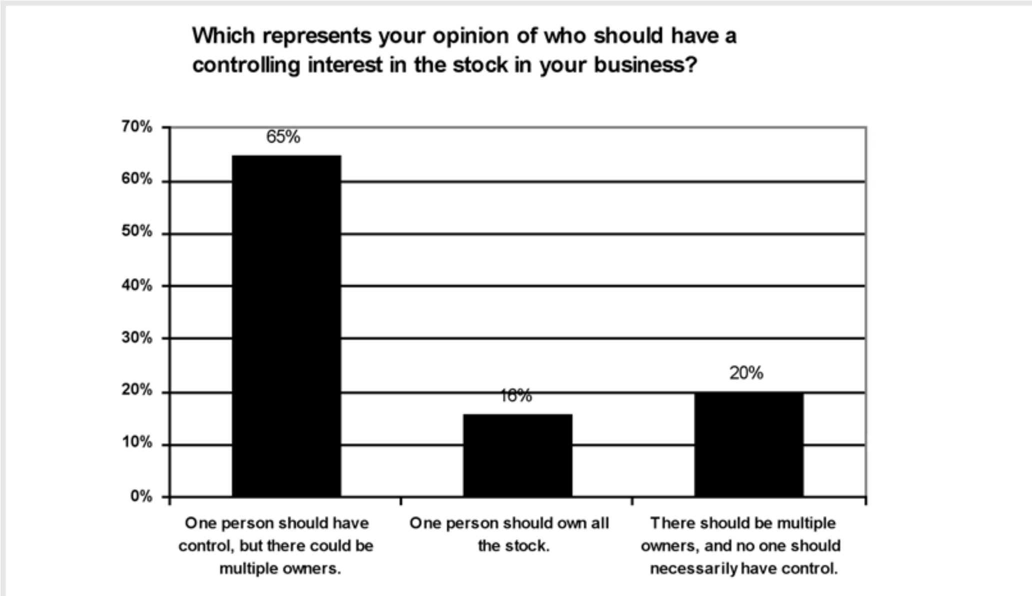

Figure A13: Who Should Have Controlling Interest in the Company?

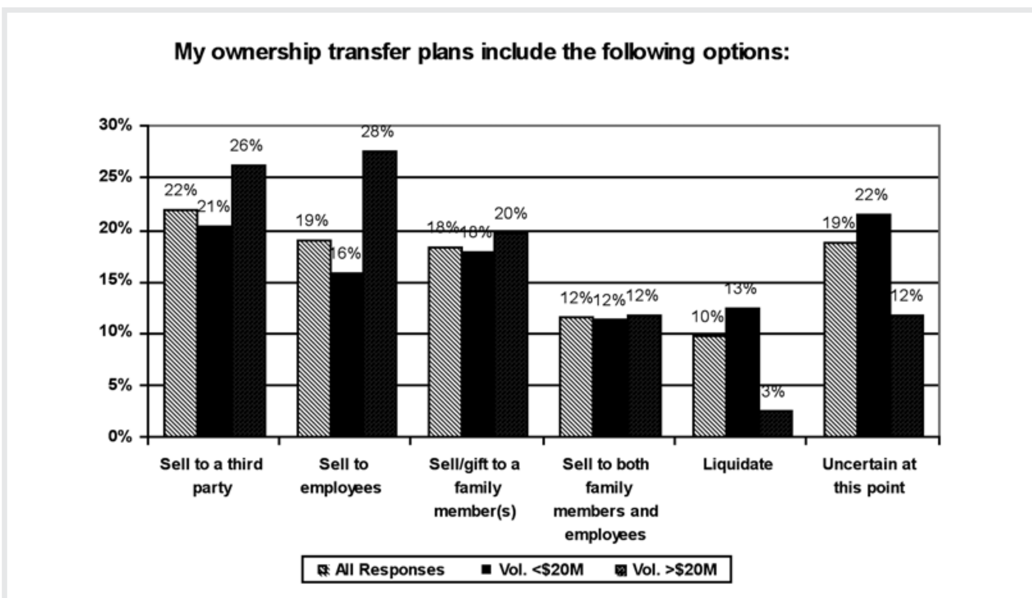

Figure A14: Ownership Transfer Plans

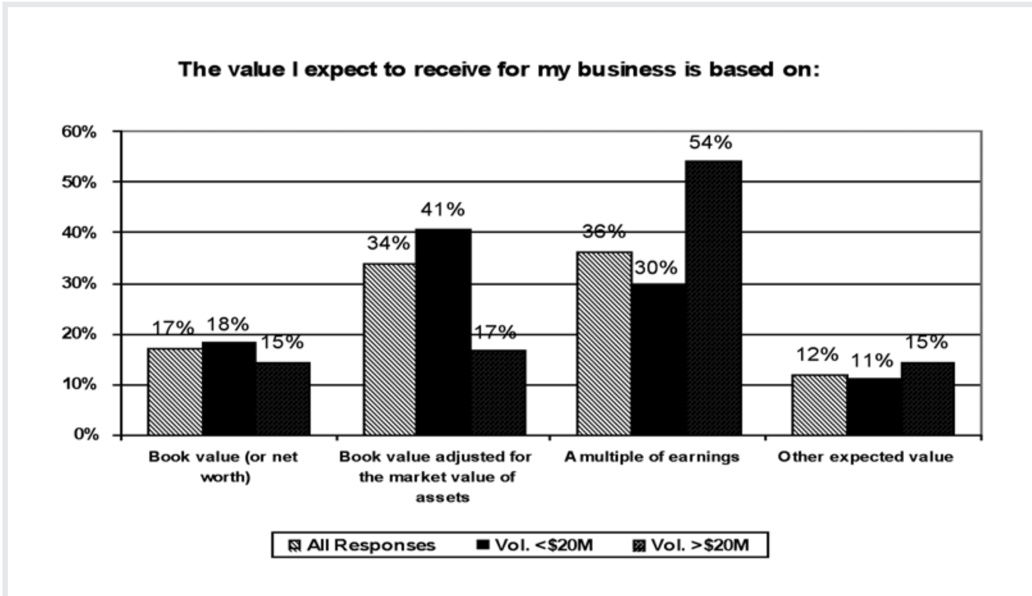

Figure A15: Expected Value

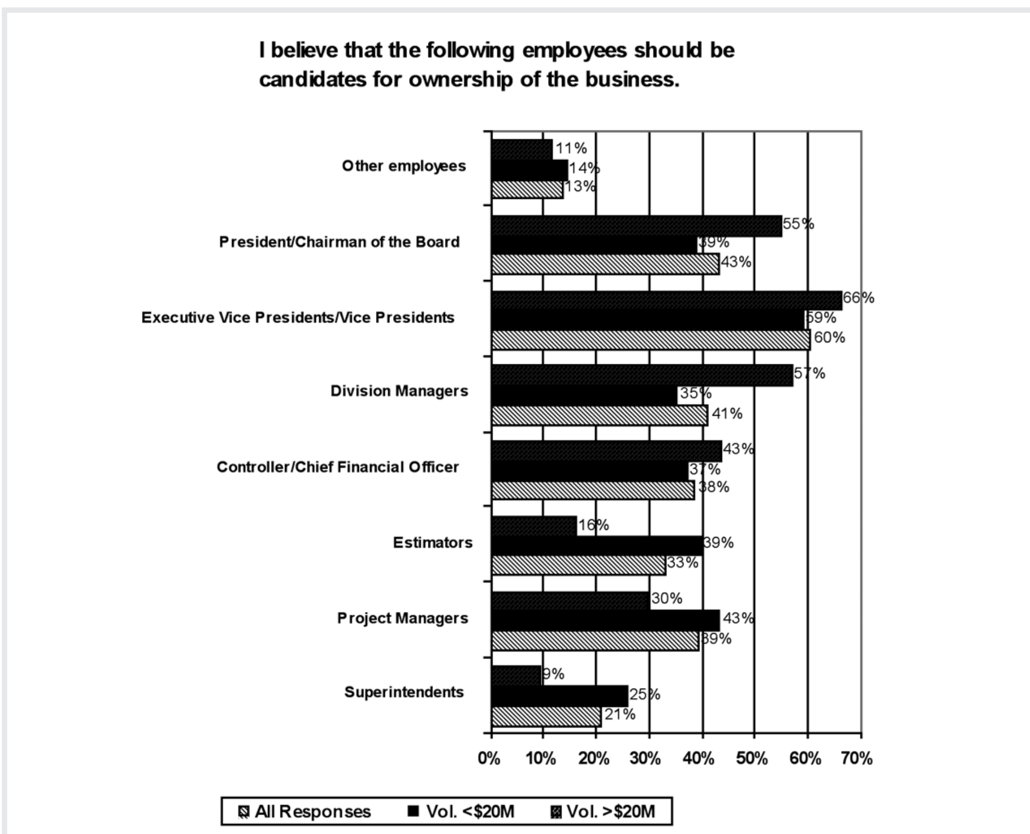

Figure A16: Employee Ownership

Only 16% of owners were concerned about whether or not they could sell to a third party.

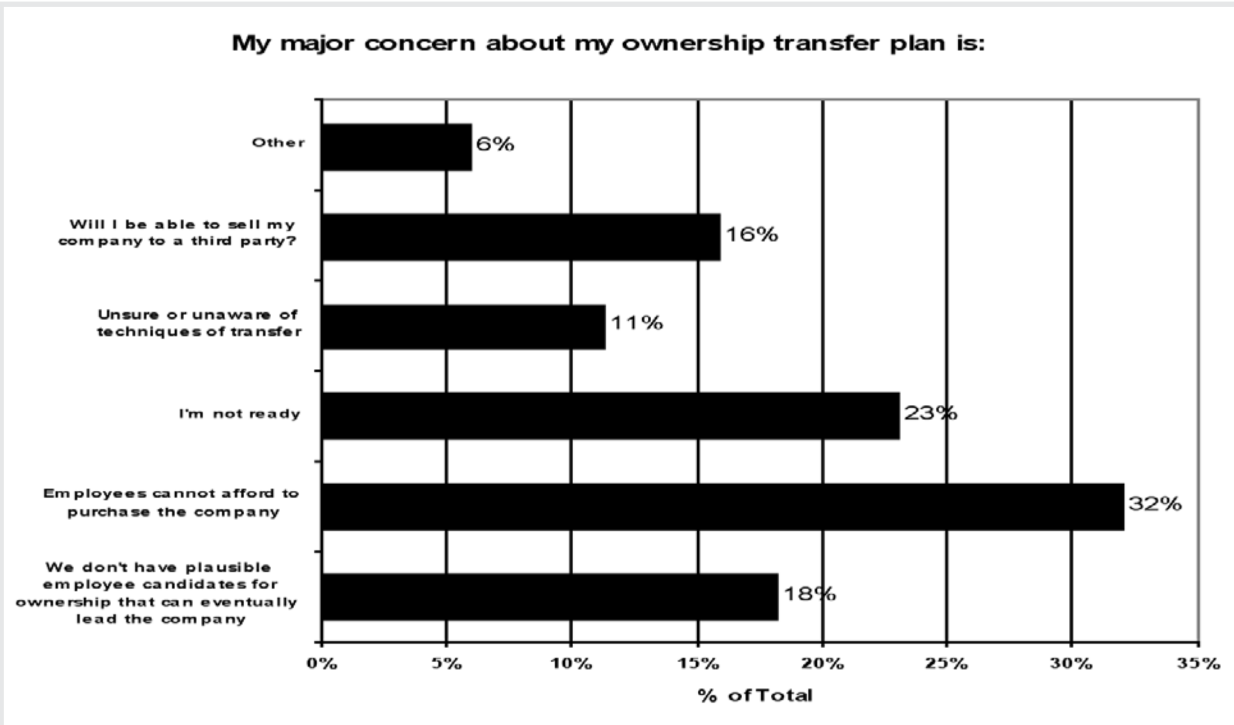

Figure A17: Ownership Transfer Concerns

FMI notes that a high percentage of owners expect to sell to employees or family members; however, when asked about ownership transfer concerns, the three that topped the list were (1) employees cannot afford to purchase the company (32%), (2) the owner was not ready to sell (23%), and (3) there were no plausible employee candidates for ownership and leadership (18%). Only 16% of owners were concerned about whether or not they could sell to a third party (Figure A17). Although only 11% were concerned about knowing the techniques of business transfer, these concerns point up some of the important issues that need to be worked on in advance of a smooth and successful transition of ownership.

One of the ownership transfer concerns that all owners should have is what happens to the stock in the event of the death of the owner or one of the owners. In this case, it appears that owners have made such plans, with 62% saying that the stock passes to their heirs through their estate and 19% having plans that the stock will be redeemed by the company, or, in the case of 16% of respondents, the partners in the company will purchase the stock. Breaking these figures out by size of company shows that 43% of the owners of companies with revenues of more than $20 million plan to have the company redeem the stock, and 70% of the owners of smaller companies will pass the stock ownership to their heirs (Figure A18).

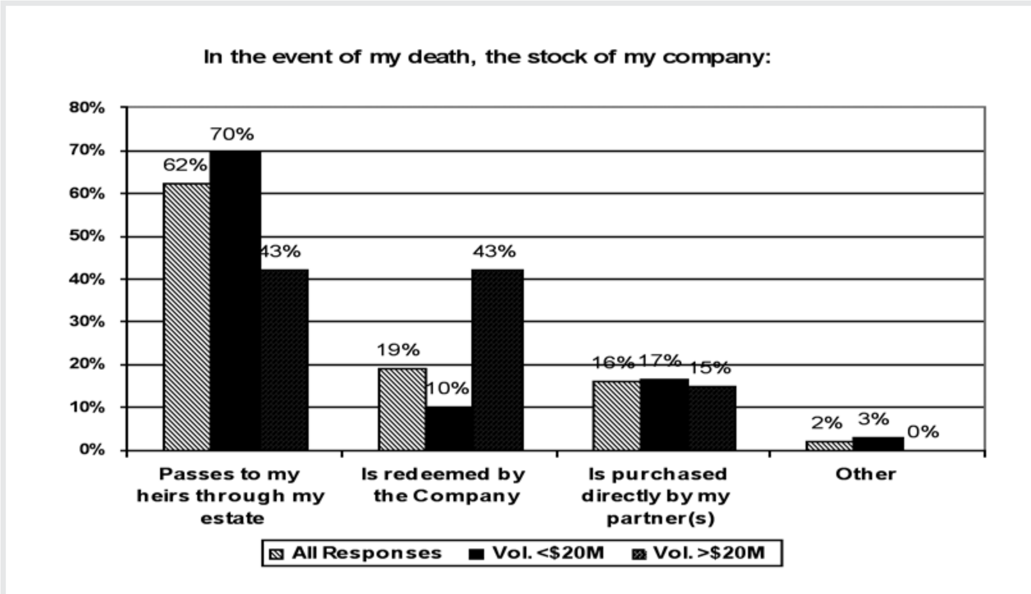

Figure A18: Stock Transfer in the Event of Death of Owner

Owner's Personal Preparations for Sale

As noted above, one of the chief concerns of owners was that they were not ready to sell out and pass on the reins of the company. One of the important considerations in this decision is whether or not the owner has built significant wealth outside the company or if the company represents the majority of an owner's wealth. It was found that only 69% of owners have significantly built personal net worth outside their ownership in the company. This topic is discussed in depth in the report above under the heading of Personal Planning in Preparation for a Transition; however, having significant wealth outside the company will help make it easier for the owner to plan his/her exit strategy.

Sixty-four percent of owners older than 51 have owned stock in their companies for more than 20 years (Figure A19). Thirty-eight percent of that group plans to sell all of their stock in the next five years (Figure A20). Altogether, within the next 10 years, 59% of owners plan to sell all of their stock in their companies. Not all of these sales will be from the baby-boomer generation, but it again points up the enormous potential for wealth transfer or reorganization over the next decade.

Owners' expectations as to when they will no longer be active in the day-to-day operations of the firm (Figure A21) parallel the results for plans to sell stock, showing that few owners plan to stay on after they sell their stock. Although 63% of respondents said they are currently working on an ownership transfer plan, only 58% as many respondents had worked on a succession plan with an outside consultant or advisor.

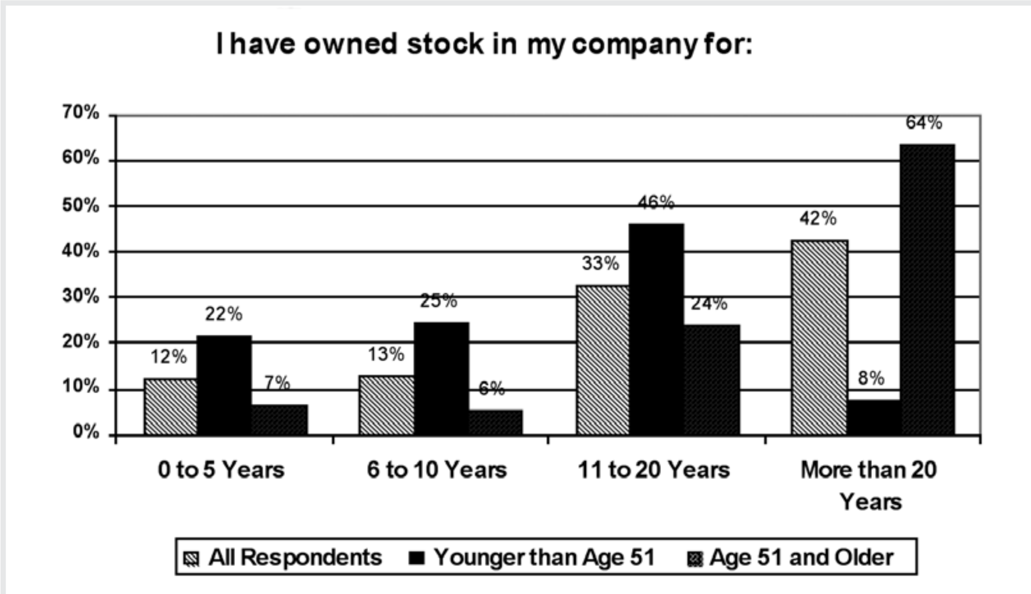

Figure A19: Stock Ownership Duration

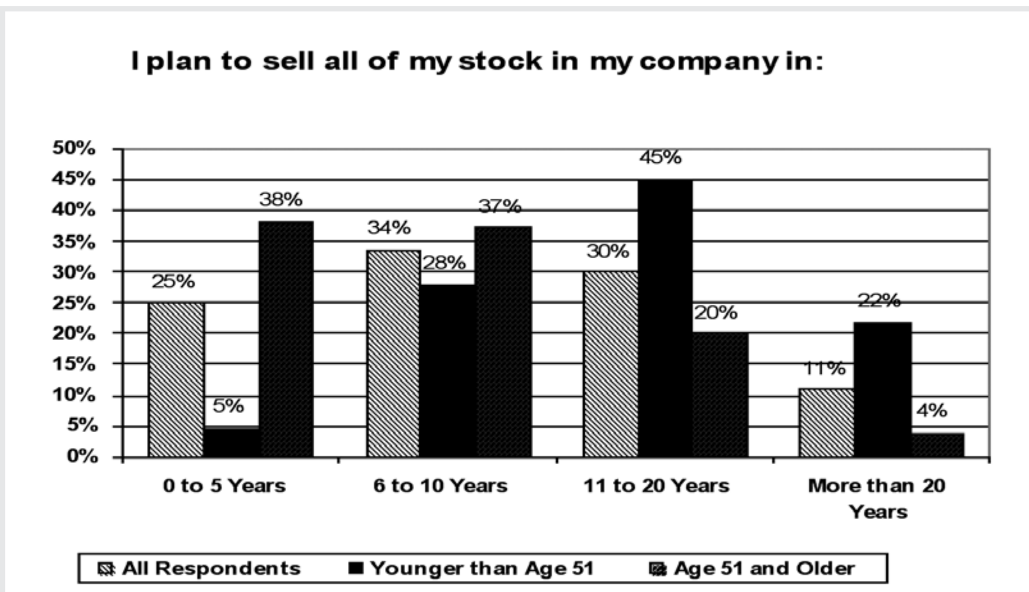

Figure A20: Plans to Sell Stock

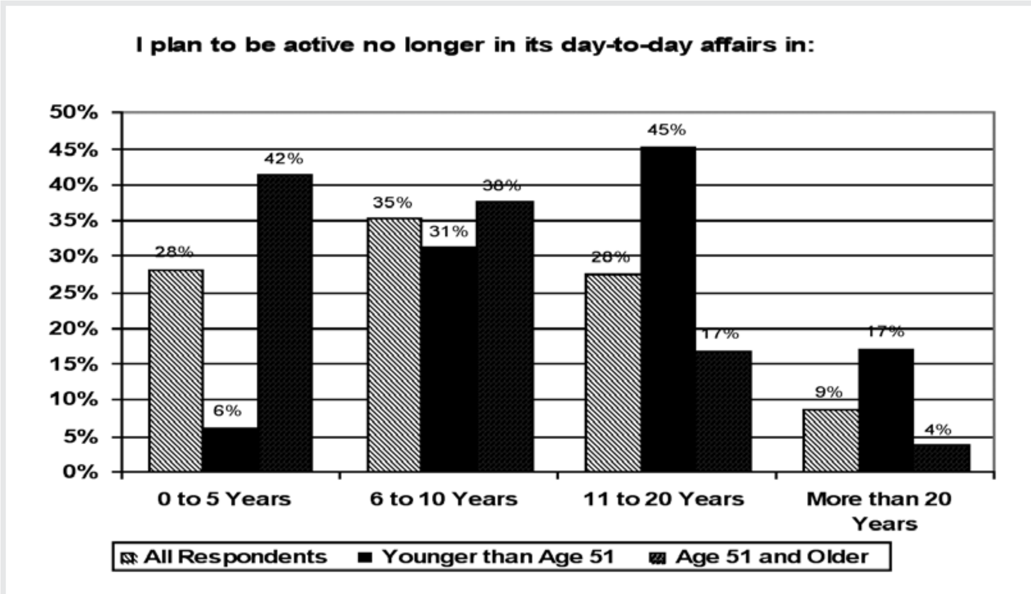

Figure A21: Plans to Be Active No Longer in the Day-to-Day Affairs of the Firm

Successor Management Preparation

No matter what method the owner or owners of the business choose as their exit strategy, the need to have capable people to take over the management and leadership of the company is critical for the success of the transition and for the company's success after the ownership transition. Only 30% of all respondents said they currently had capable and competent managers who could run the business now. That number improved to 42% when the results for the older than 51 age group were broken out. Overall, 50% said their current managers would need further development, and 19% said they would have to hire from outside the company (Figure A22).

As potential successors are identified within the company, it is necessary that they have the knowledge and capability to understand the operations of the company, including both financial and project management. For those owners who have successor management candidates, those successors were involved in a broad list of activities: business development (78%), leadership development programs (66%), and preparation of budgets (60%) (Figure A23).

No matter what method the owner or owners of the business choose as their exit strategy, the need to have capable people to take over the management and leadership of the company is critical for the success of the transition and for the company's success after the ownership transition.

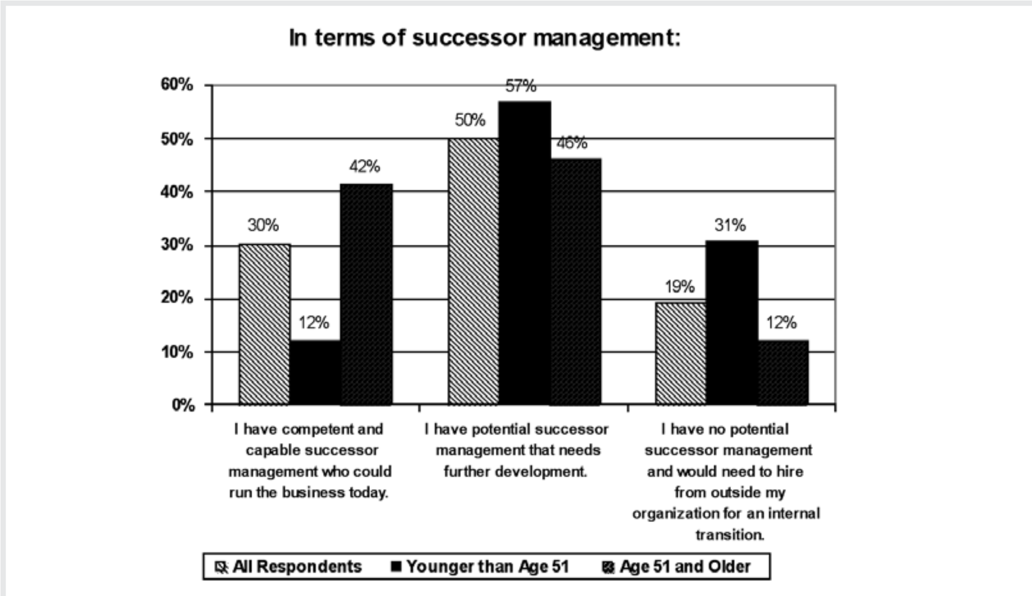

Figure A22: Successor Management

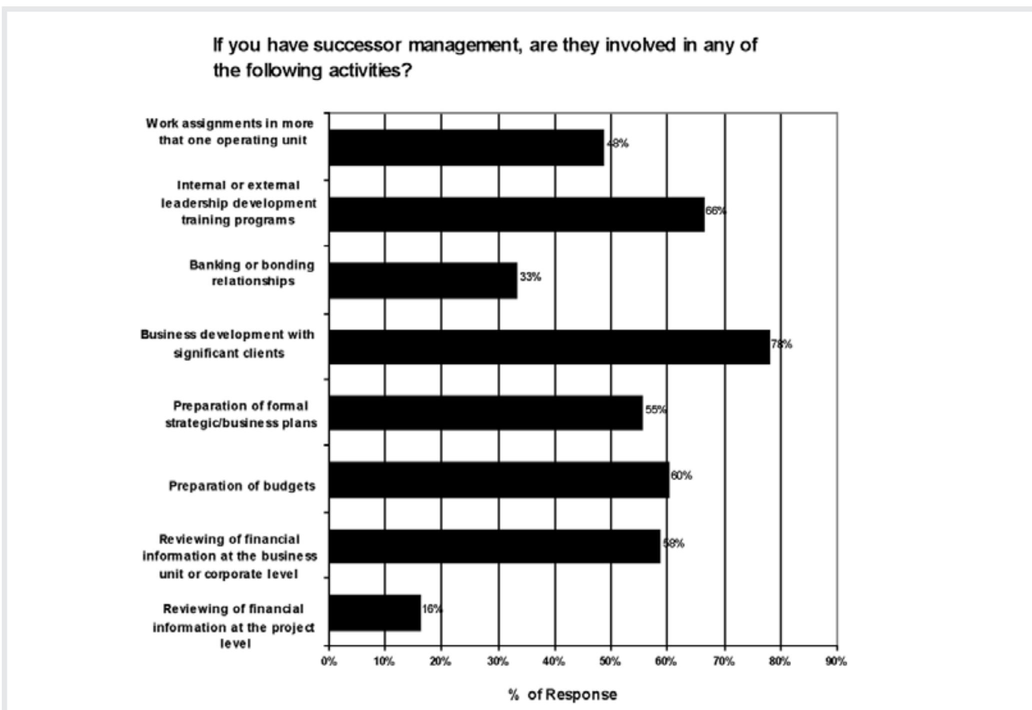

Figure A23: Successor Management Preparation

Methods of Stock Sales

There is much interest and talk about selling to an ESOP (Employee Stock Ownership Plan), and 10% of respondents are currently selling their stock to an ESOP. This is a significant number, given that many of the respondents are family companies for which an ESOP would not fit with the company remaining 100% family-owned, and many others are smaller companies for which administrative costs would make an ESOP impractical.

There is some difference in methods of selling stock between those who said they considered their business to be a family business (68%) and those who do not (32%). For instance, 41% of nonfamily businesses are selling their stake in the company by a note and/or cash at an agreed-upon value compared with only 23% of family business owners. While 12% of family business owners are selling their shares to an ESOP, only 6% of nonfamily businesses are taking this approach (Figure A24).

In the event of death, termination, or disability, 86% of the companies of more than $20 million in revenue have buy/sell agreements dictating the disbursal of the owner's shares. Thirty-four percent of the smaller companies said they had no partners with whom to make a buy/sell agreement (Figure A25). Of those who had buy/sell agreements, 85% have sufficient insurance to cover the obligations stipulated in the buy/sell agreement in the event of death or disability.

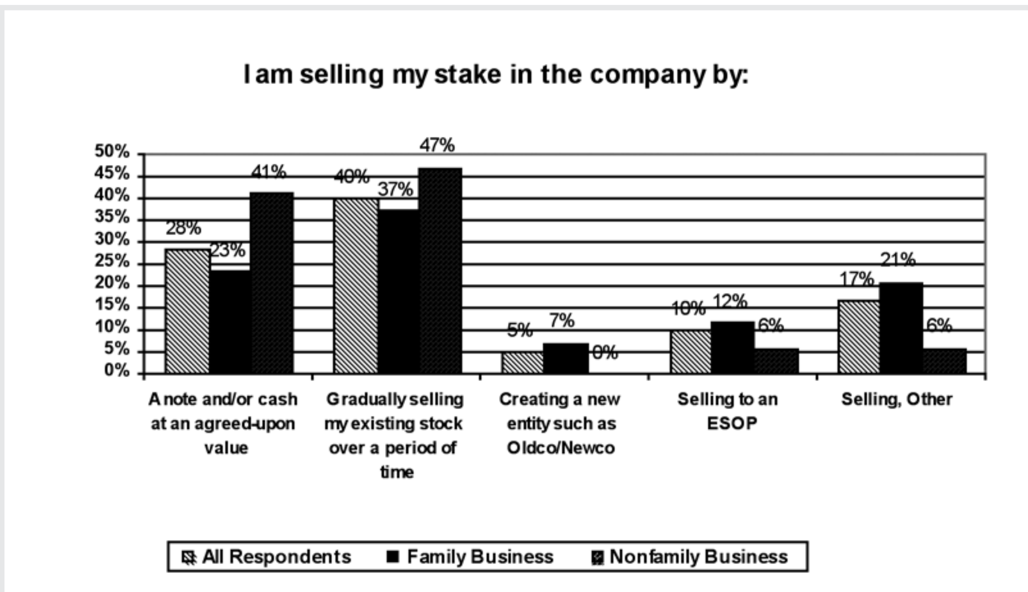

Figure A24: Stock Sales Methods

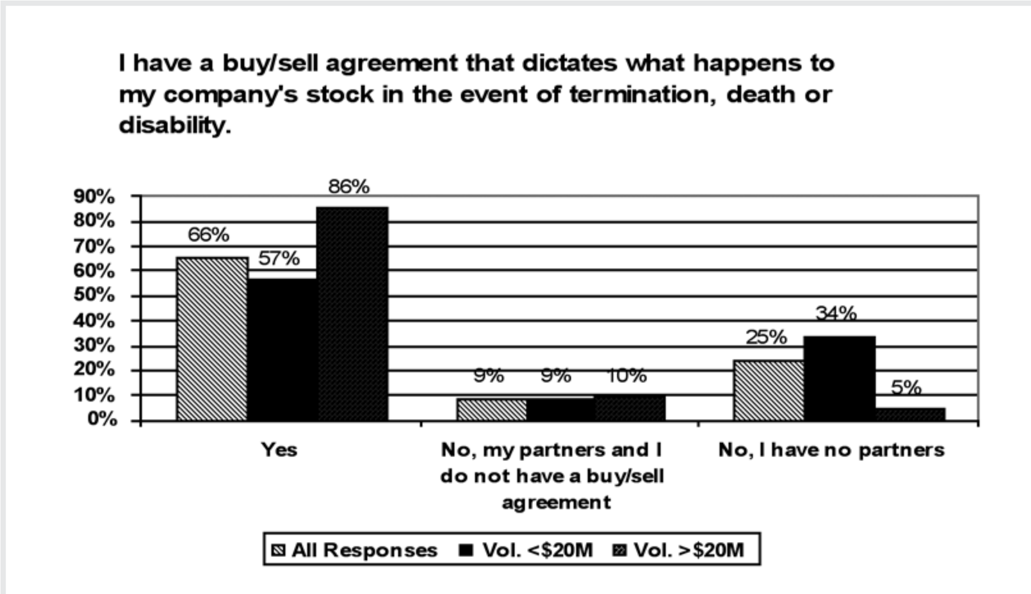

Figure A25: Buy/Sell Agreements

Family Business

Sixty-eight percent of all respondents said they considered their business to be a family business. Half of all respondents obtained their shares in the company from a family member, with 48% saying those shares were purchased from a family member, and only 15% of shares were inherited. For 47% of respondents, this is the first generation of the family business; but for 19%, the business has been in the family for three generations or more.

For those owners who see family ownership as an important factor in their transition plans, what are their expectations for family working in the business or owning stock? Seventy-two percent said they have family currently active in the business. Only 19% have family members who own stock who are not employed in the business. Sixty-six percent said family members will be recipients of stock in the event of their death. However, only 55% prefer for family members to own the business, and 52% said they preferred that family members ultimately run the business. For those who do intend for family members to run the business, only 21% expect those shares to be purchased, in contrast to the 48% who said they had themselves purchased shares from a family member. For 43% of the next generation, ownership will be obtained by a combination of methods, including purchase, inheritance, and gifting (Figure A28).

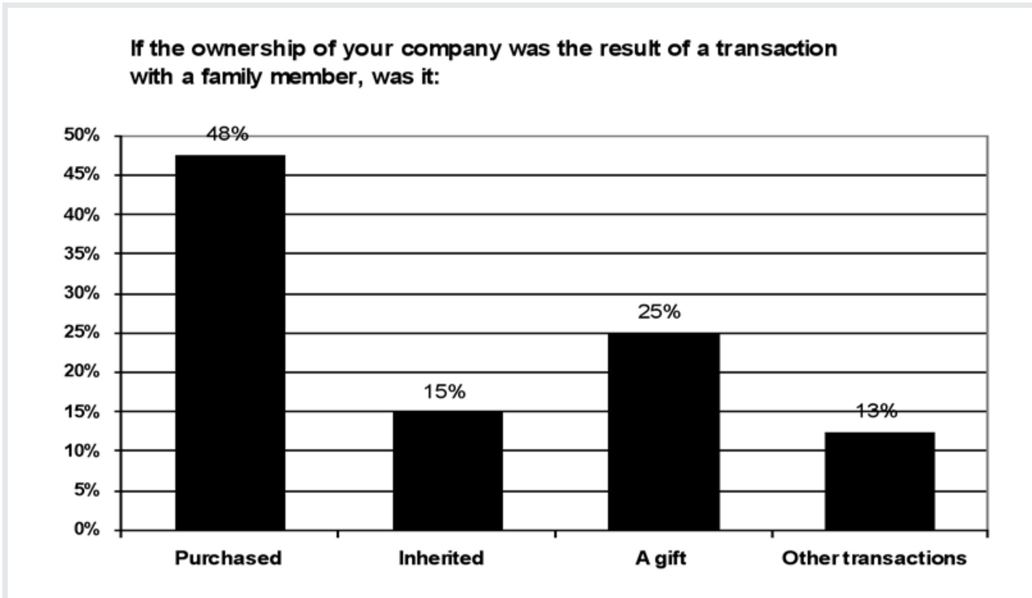

Figure A26: Ownership via Family Stock Transactions

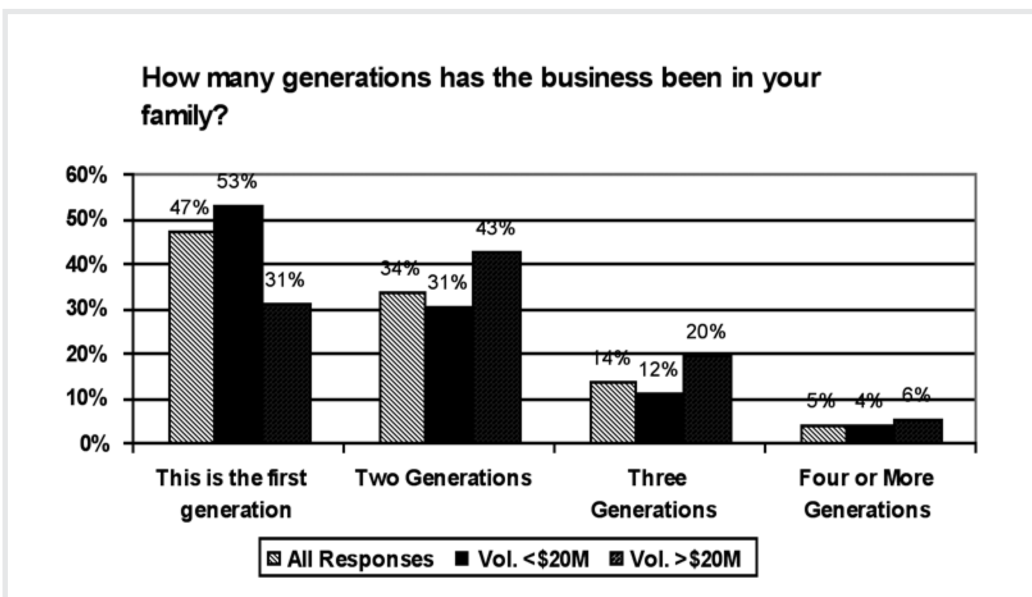

Figure A27: Generational Ownership

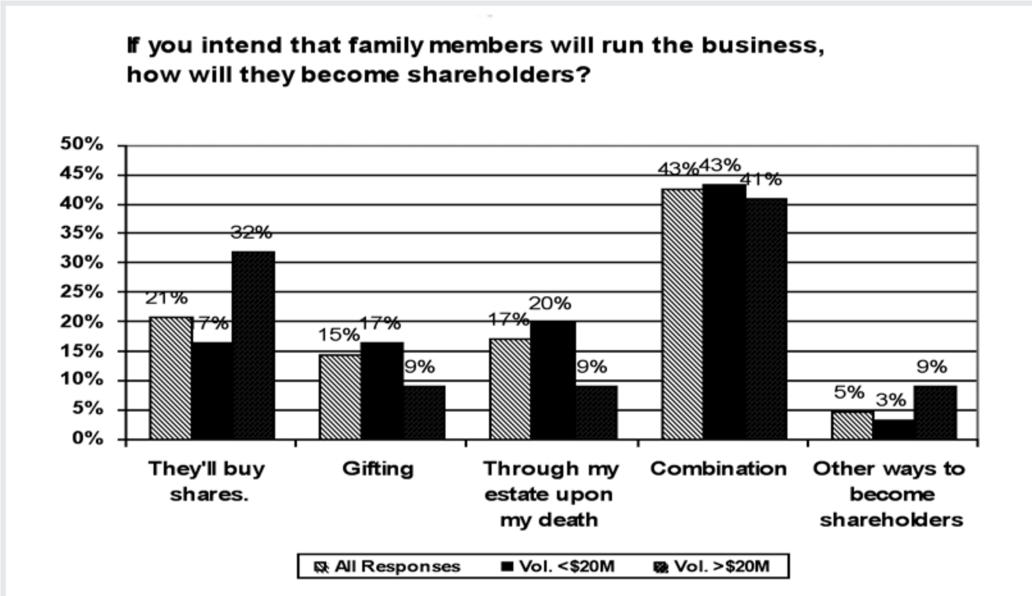

Figure A28: Next-Generation Family Stock Acquisition Methods

8 APPENDIX B POTENTIAL WITHDRAWAL LIABILITY ISSUES IN ANY TRANSITION STRATEGY *

What Is Withdrawal Liability?

An extremely important consideration in planning for the transfer of ownership is the potential for "withdrawal liability" to an underfunded, multiemployer pension plan. Simply stated, a pension plan is underfunded when the value of its assets is insufficient to pay all of the pension benefits that have become vested under that plan.

A federal law known as the Multiemployer Pension Plan Amendments Act of 1980 imposes withdrawal liability upon an employer that has contributed to an underfunded pension plan, but "withdraws" from that plan. In very simple terms, that liability is calculated by comparing the employer's total contribution to the underfunded plan over some period of time, in comparison to the contributions made by all contributing employers over that same period of time. That comparison will generate a fraction, which is then multiplied by the total unfunded vested benefits of the plan as of December 31st in the year preceding the withdrawal. That calculation will determine that employer's portion of the total unfunded vested liability. Depending upon the funding status of the plan, that withdrawal liability may be substantial.

How Does A Transfer Of Ownership Relate To Withdrawal Liability?

Under the law, an employer may experience a withdrawal from a multiemployer pension plan in a variety of circumstances. They include situations when the employer permanently ceases to have an obligation to contribute to the plan, when it permanently ceases all covered operations under the plan, or, if there is a dramatic decline in contributions to the plan by that employer.

Within this legal framework, a variety of events can potentially trigger withdrawal liability, including the sale of the business, the substantial downsizing of the business, negotiating contributions to the plan out of the collective bargaining agreement, or, simply ceasing operations.

In the construction industry, the issue is complicated by the fact that special, more favorable rules may be applicable to an employer that actually satisfies the legal definition of a "construction industry employer," and, has been contributing to a construction industry plan. The typical fabricate and install sheet metal contractor will very likely meet the definition of a construction industry employer, whereas, a company exclusively involved in the fabrication of duct may not. Contractors that fall within the definition of a construction industry employer may significantly benefit from these special rules, as withdrawal liability may not being assessed in circumstances where otherwise, it would be imposed.

A complete analysis of withdrawal liability would be very lengthy, and extremely technical. For these reasons, such a discussion is beyond the scope of this report. However, any comprehensive exit strategy must involve an analysis of the potential for the imposition of withdrawal liability in the event of a change in business operations, or ownership, as part of a transition strategy. It is essential to consult with legal counsel familiar with withdrawal liability issues early on in the planning process. Withdrawal liability may be an issue in some types of transfer of ownership, and not in others. Furthermore, even in those circumstances where withdrawal liability might otherwise be imposed, it may be possible to have that liability assumed by the purchasing entity in the sales transaction, so that it need not actually be paid by the seller. Finally, the issue may be dramatically impacted by a determination of whether the employer is in the construction industry, as such employers may not be subject to withdrawal liability in the case of bona fide asset sales.

All of these issues must be carefully assessed as part of any transition strategy, as they may have a significant impact upon the particular exit strategy that is ultimately employed by the contractor. It is critically important for the contractor to obtain advice from legal counsel that is thoroughly familiar with the issue, because the imposition of withdrawal liability may significantly diminish the value of the businesses being transferred.

* ***Steve J. Burton, Esquire***

Felhaber, Larson, Fenlon & Vogt, P.A. 220 South 6th Street, Suite 2200
Minneapolis, MN 55402-4504

Stephen J. Burton's area of expertise is labor relations law, including extensive work in the construction industry. Mr. Burton earned his undergraduate degree in business administration from the University of Minnesota summa cum laude, and received his J.D. cum laude from William Mitchell College of Law in 1977. He is a member of the Labor Law Sections of the Minnesota and America Bar Associations, and has lectured on various labor law topics and business seminars.

9 SURVEY SUMMARY

The results of the survey of sheet metal and HVAC contractors conducted for the New Horizons Foundation allowed the FMI research team to get an inside look at current practices and concerns for ownership transfer and exit strategies for sheet metal, HVAC, and mechanical contractors. The fact that 59% of all respondents plan to sell all their shares within the next 10 years points up the importance and immediacy of having a sound exit strategy for the business to assure business continuity and that the owner can receive good value for his/her hard work and investments. While many respondents are already working on ownership transfer plans, it is clear that there is a good deal of uncertainty about the markets for buyers and sellers and the need to prepare employees and others to become purchasers of company stock. At the same time, the survey showed the urgent need to prepare the next generation of leaders and owners, whether they will be made up of family members, current management, or a combination of both.