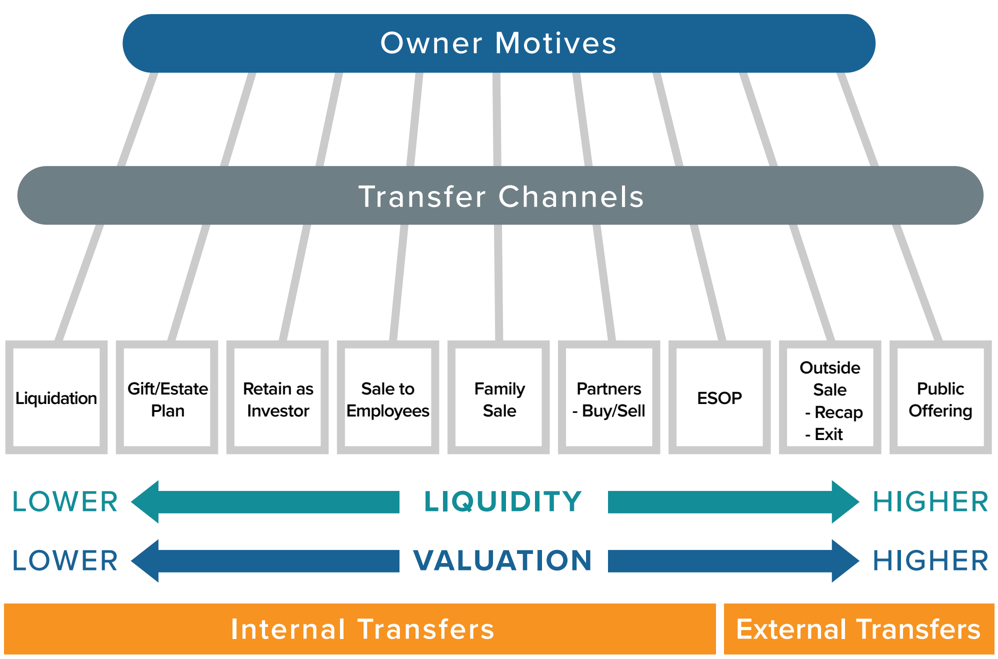
Management Methods Manual

Business Transition Options for the Mechanical Contractor

INTRODUCTION

One of the classic mistakes that owners of mechanical contracting firms often make when transferring ownership of their company is not fully exploring all of their options. Many owners do not realize how many transfer options are at their disposal. The process can be complex, as you can see from the illustration below. Executing a successful transfer requires a good deal of thoughtful advance planning and analysis.

BUSINESS TRANSFER SPECTRUM
Owner Motives Drive Decisions



Adapted from "Private Capital Markets" by Robert T. Slee

MCAA
Mechanical Contractors Association of America

Important

Owners should clearly identify the motives for the transfer. Motives define the choice of which transfer channel is the best fit.

OWNER MOTIVES DRIVE DECISIONS

As the illustration depicts, the first thing owners should do is clearly identify their motives for the transfer. Motives are what drive the transfer strategy and the transfer channel, which is another term for the type of transaction.

Many owners skip the step of thinking about their motives because they believe the process is a zero sum game to get the highest price. However, this narrow framing is usually a mistake. While money is always a motive, for most owners, it is rare that it is the only motive. Other objectives can include family issues, the legacy of the business, protection of employees' jobs, and the company's role in the community.

OWNERS SHOULD UNDERSTAND THE TRADEOFFS NECESSARY TO MEET THEIR OBJECTIVES

Tip

While ESOPs carry a lower valuation than other third-party sales channels, they provide job stability and good long term benefits for employees.

As you can see from the **illustration**, there are a wide range of transfer options available. Each carries a different valuation for the business and different liquidity options for the selling owner. For an owner whose motives extend beyond money, the process will involve tradeoffs that usually affect the value of the business as well as the amount of liquidity available to the owner. For example, ESOPs carry a lower valuation than third-party sales, but provide job stability and good long-term benefits for the employees who have helped build the business. In this example, the exiting owner may be motivated to protect employees, and he or she may be willing to accept a lower value in order to accomplish that objective.

There is no single way to go through this step of the process because few owners share the same motives. But it is critical to know that owners who are clear on their motives and understand the various transaction options available to them have the power to decide the tradeoffs that they are willing to make.

TRANSFER CHANNELS AVAILABLE TO THE OWNER OF A MECHANICAL CONTRACTING FIRM

Important

Seek advisors who are experienced with the various transfer channels.

It is important for an owner to get proper outside advice to understand the unique valuation issues, liquidity options, transaction structures, and tax implications of each transfer channel. Needless to say, owners should seek advisors who are experienced with these various transaction structures and can provide advice in the planning stages as they are considering options, as well as at the execution stage when going through the transaction.

Below is a brief overview of the various transfer channels noted in the illustration, ranked from the highest valuation and liquidity to the lowest.

Public Offering

It is rare for a mechanical contractor to go public, although there are mechanical contractors that are public companies. In order for this to be a viable option as an ownership transfer strategy, the company must have scale in order to attract capital and to cover the excessive regulatory costs of being a public company.

Outside Sale to a Third Party

Selling the business to a third party is a complex process. There are generally two types of buyers – strategic and financial.

Strategic buyers are typically other (often larger) mechanical construction firms. These buyers often pay more for the business because they have strategic reasons for owning it such as geographic expansion, new markets, new lines of business, and new market niches.

Financial buyers are usually private equity firms with one goal in mind when purchasing a company – earning a certain return on their invested capital. For that reason, they are limited in what they are willing to pay versus the strategic buyer. Whether selling to a strategic or financial buyer, the exiting owner usually does not continue in their role at the company for extended periods.

ESOP

An ESOP transfer strategy involves selling the company stock to a qualified retirement trust. ESOPs have become increasingly popular as a transfer strategy because they allow the owner to sell their stock while at the same time retaining jobs and providing a long-term benefit to their employees. ESOPs also afford the exiting owner a high degree of control.

Since no outside capital is being brought to the table, ESOP transactions involve borrowing money to fund the transaction, which limits the valuation. While complex to execute, ESOP transactions have some significant tax advantages for the company as well as the exiting owner, and the owner does not have to change their leadership role after the transaction. Additionally, an ESOP can be structured for all or partial interest in the company, so it can be used as a gradual exit strategy an owner can execute over time.

Shareholders/Partners – Buy/Sell Agreement

This transfer strategy is available for co-owners, and it allows the transfer of an exiting owner's equity interest to the remaining owner(s). This is principally executed via a clearly defined shareholders' agreement (also called a buy/sell agreement).

The shareholders' agreement should be updated as the business changes and shareholders age. Key elements of the agreement include the valuation formula, the events that trigger a transaction, the transaction structure, terms and conditions, and funding mechanisms (i.e., life and/or disability coverage). It should represent the economic bargain that the shareholders negotiate with each other and should be able to be readily measured and monitored.

Co-owner transactions often involve leverage in the form of seller notes or deferred compensation agreements, since capital is not freely available to fund the buyout of the exiting shareholder. Bank financing to fund these transfers is often difficult to obtain.

Family Transfer

A family transfer is a way to move the business to the next generation in a tax-efficient manner when the primary transfer motive is to maintain the legacy of the company for future generations. These transfers often involve multiple elements including sales of stock, deferred compensation plans, and gifting of shares. In these transactions, valuations are typically conservative and there is usually an absence of liquidity because neither of these are important goals. However, tax efficiency is a significant goal in these transactions and it can be achieved if the deal is properly structured and the family members involved are cooperative.

The family elements of these transactions are often harder than the structural issues and significant work is often required to prepare the next generation for leadership and keep family harmony in the transition process.

Sale to Employees

Selling to employees is often a last resort because it does not confer many benefits to the exiting owner. Valuations are exceedingly conservative because it is rare that the average group of employees has capital to bring to the table. Therefore, the exiting owners rarely get up front cash and often carry the note on the sale. This presents a significant risk to the owner and this strategy is only employed when other options are not feasible.

Retain as Investor

This is a non-transfer strategy. In this case, the owner does not sell their interest in the business but rather maintains their equity position and turns the reins over to an executive team. The owner can be paid dividends and continues to absorb the investment risk in the company, and he or she can also benefit from the upside potential of the business.

This strategy is not easy to execute since it requires a top-notch executive team whose incentives are aligned with the owner. It also requires the business to be "professionalized" with more structure, systems, reporting, and accountability. An active board is typically in place as a means for the owner to monitor their investment and the company's performance.

In these cases, the owner often moves the role of Chairman to oversee the direction of the company and monitor the performance of the company and executive team. This strategy reserves the right of the owner to select another transfer strategy at a later point.

Gift and Estate Tax Transfer

This strategy is reserved for family businesses in cases where the owners have taken enough money off the table that they do not require any money to transfer the business to the next generation. The overarching goal is to continue the legacy of the business and to execute the transfer in a tax-efficient manner from an income and estate tax perspective. There is significant cohesion required between the transfer strategy of the company, the estate tax planning of the shareholders, and the goals of the next generation of family members.

Liquidation

While this does not happen often, liquidating the business is the course of last resort for owners who have not planned their transfer strategy. It involves liquidating the business assets and paying off the company's debts. It is an expensive process, and owners will often get "fire sale" prices for their assets. They often do not end up with much in the way of proceeds, especially when you consider the wind down costs.

EXTERNAL VS. INTERNAL TRANSFERS – VALUATION AND LIQUIDITY ISSUES

The **illustration** groups all of these transfer channels into external and internal transfers. External transfers involve transactions with outside third parties, whereas internal transfers involve only the existing shareholders, partners, employees, or family members.

The biggest differences between external and internal transfers involve the valuation and liquidity for the exiting owners. Transactions with third parties imply that they will come to the table with capital to invest. They can be strategic buyers in the industry (i.e., another mechanical construction firm) or a financial buyer such as a private equity firm. Since these parties have access to capital and it is relatively cheap, they can afford to pay more.

Conversely, internal transactions have a very high cost of capital and therefore lower valuations. They often result in some form of seller or bank debt in the transaction, due to the absence of available investment capital from the buyer(s). Additionally, since inside buyers have limited access to capital, the valuations are lower because the buyer cannot afford to overpay. So, the valuation tends to be more conservative because the inside buyer cannot afford to be wrong since they do not have available funds in reserve if they overpaid.

IMPORTANT

The quality of the management team is the most important factor affecting a company's valuation.

There are several key items that can affect valuations. Perhaps the most important is the quality of the management team. Good managers produce consistently good results and will therefore drive higher valuations. Another factor is the amount and consistency of the company's cash flows from operations. This is usually a reflection of the company's competitive position in its market and its ability to efficiently execute its contracts. Additionally, for a mechanical contractor, the revenue mix between hard bid work and service contracts can affect the valuation. To the extent that revenues recur, the valuation of the company will increase. Lastly, valuations can be negatively impacted by customer concentrations as well as poor claims and litigation history.

SUMMARY

Many owners neither plan nor proactively seek the proper advice in exploring all their transfer options, but it is a good idea to do so. Not only are these options complex, but the decisions are very weighty because they affect many people including the owner, the family, and the employees. The business transition is often the largest transaction with which most owners will be involved.

TIP

Proactively addressing your situation or doing nothing are both decisions that have consequences.

While many businesses choose to ignore this in-depth planning and analysis, they do so at their own peril. A transition of every company's ownership will happen at some point – whether planned for or not – because time ticks on and our mortality will eventually bear on the situation. Proactively addressing your situation or doing nothing are both decisions that have consequences.

It is wise to invest time and money in the way of advice to think through your transfer motives, understand the details of each of the transfer options, and identify where they intersect. Being proactive and planning ahead will give you the best chance for success in the transition of your company.

Acknowledgements

Mario O. Vicari, CPA, is a Director for Kreisher Miller. In his role as a business advisor to privately-held companies, Mario helps clients address the unique challenges they face as they grow and to create value for their owners. Mario has over 30 years of experience working with entrepreneurs and private and family-owned companies in a variety of industries including construction, manufacturing, distribution, and services. His principal focus is on assisting companies in maximizing value for their owners and realizing that value through a clear transfer and exit strategy. Mario is an expert in private company transfer strategies and methods, and his work includes a wide range of advisory services including finance, valuation, strategy, and transaction structure.