

# Succession Planning: Options and Considerations

Monday September 23, 2019

CFMA 2019 Regional Conference

WEALTH ADVISORY | OUTSOURCING | AUDIT, TAX, AND CONSULTING

Investment advisory services are offered through CliftonLarsonAllen Wealth Advisors, LLC, an SEC-registered investment advisor



Create Opportunities

# Speaker Introduction

Mike Africk

- 30+ years construction experience
- National Construction Leadership Team
- Traditional Services
- Heavy focus on Succession
- *Succession by Design utilizing **CLA Intuition**®*
- Negotiations in M & A activities
- Board and Advisor Board Roles



# Speaker Introduction

Alex Warner

- 12+ years construction experience
- Oak Brook tax leadership team
- Compliance services
- Tax structuring and transactional services
- Active in M & A activities
- Frequent speaker on various topics



# Who is CLA?

**We are a professional services** firm with three integrated businesses working together to advance our clients' success, create uncommon careers for our people, and do what is right for the public, our clients and each other.

\$1.1B in revenue

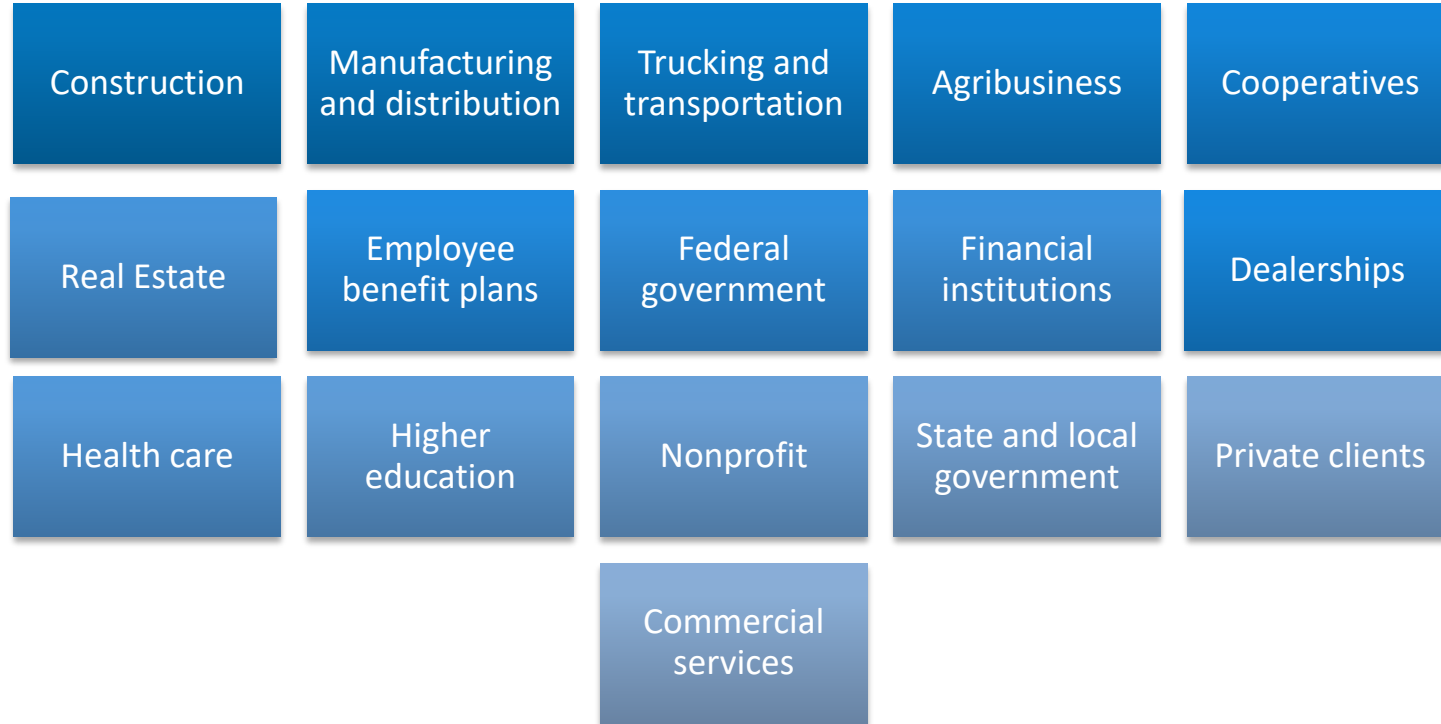
6,100+ employees

120+ offices

Currently serve 10,000+  
construction and real estate clients

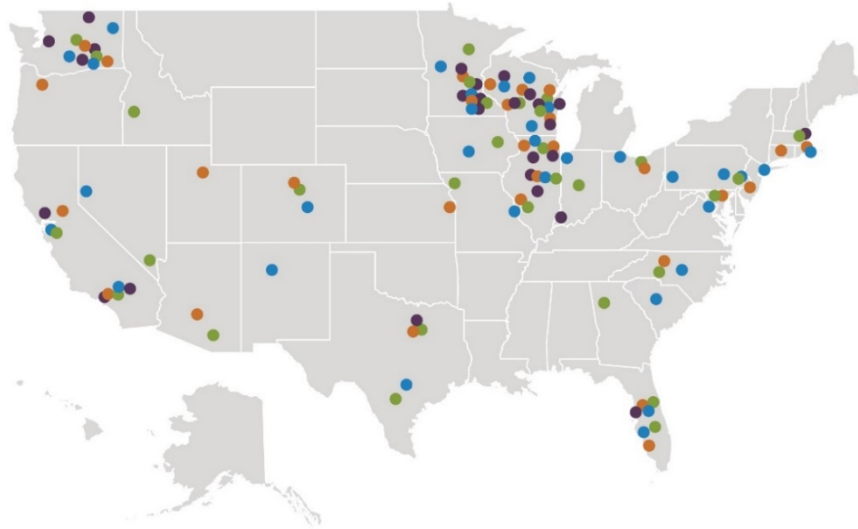
Offer 100s of services  
for 18+ industries

# Deep Industry Specialization



# Uncommon Industry Resources

From over 120 offices from coast to coast, CLA exists to create opportunities for our clients, our people, and our communities through industry-focused wealth advisory, outsourcing, audit, tax, and consulting services.



**350+**

construction  
professionals



of the contractors on  
the ENR top contractor  
lists are CLA clients

**5,250+**  
construction  
clients



more certified professionals  
on staff than any U.S. firm



Create Opportunities



# Seamless Capabilities for Construction Industry

- CLA offers a complete range of services
- We can provide nearly any service you may need. In addition to standard audit services, we also provide outsourced internal and compliance audits, taxation consulting, employee benefit plan audits, technology consulting, valuation services and several other services; some of which may be subject to independence rules



## Session Goals

- Why, What and When of Succession Planning
- Introduce the Value Triangle
- Comments on Construction Valuations
- Internal Succession Strategies
- External Succession Strategies
- Questions







# Succession Planning: Options and Considerations

*Why, What, When of Succession Planning*

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*Why are we talking about succession?*

## Some Expert Estimations About Baby Boomers

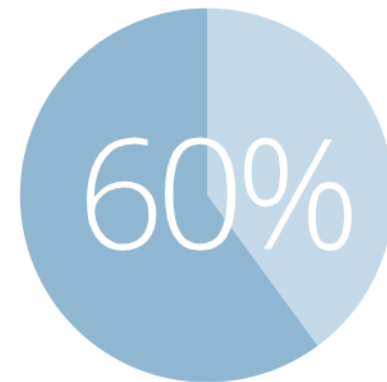
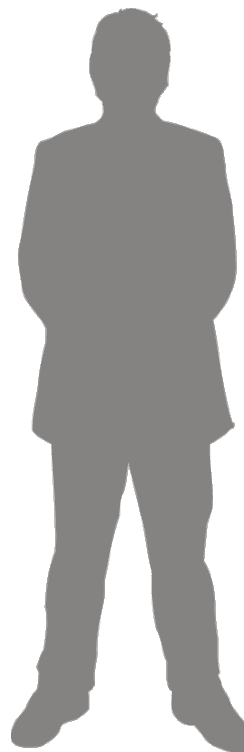
*60% of 15 million business owner's are baby boomers<sup>1</sup> (9 million)*

*Youngest baby boomers turn 55 this year.....Succession is happening*

*Significant number of transaction in next 10-15-20 years*

*Leaves 200k to 300k transactions per year to transition.*

*Dealogic reported 10,000 per year*



60 percent of  
business owners are  
baby boomers

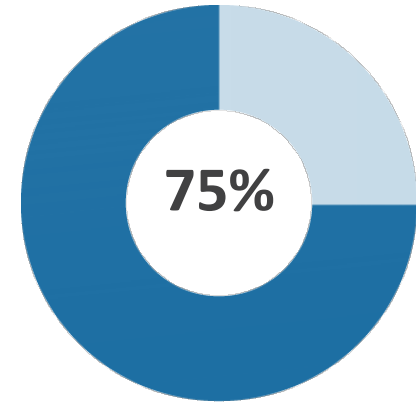
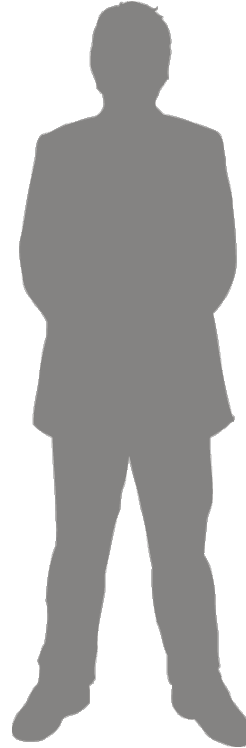
# Why are we talking about succession?

## Some Expert Estimations About Baby Boomers

*Many business owners do not have a realistic succession plan.*

*Most business owners will wait until the 11<sup>th</sup> hour to do a succession event or determine the value of their business.*

*Those who plan early and are deliberate, have best chance to build a “Succession Organization”*



75 percent of business owners don't have exit plans.

## Why Plan for Succession:

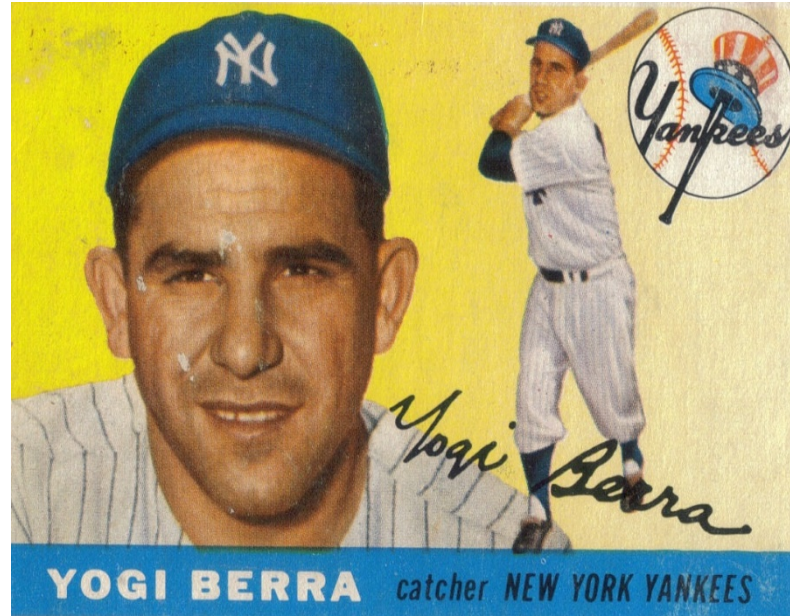
- **Owners can better control the outcome**
- **Plan for the unexpected**
- Business represents a significant part of wealth
- Opportunity to create tax efficiency
- Creates current Enterprise Value



# Why Plan for Succession?

*“If you don’t know where you are going, you might wind up someplace else.”*

Yogi Berra



# What is Business Succession Planning?

- Succession planning is not an estate plan
- Succession planning is not selling your business
- Succession planning is not necessarily retiring



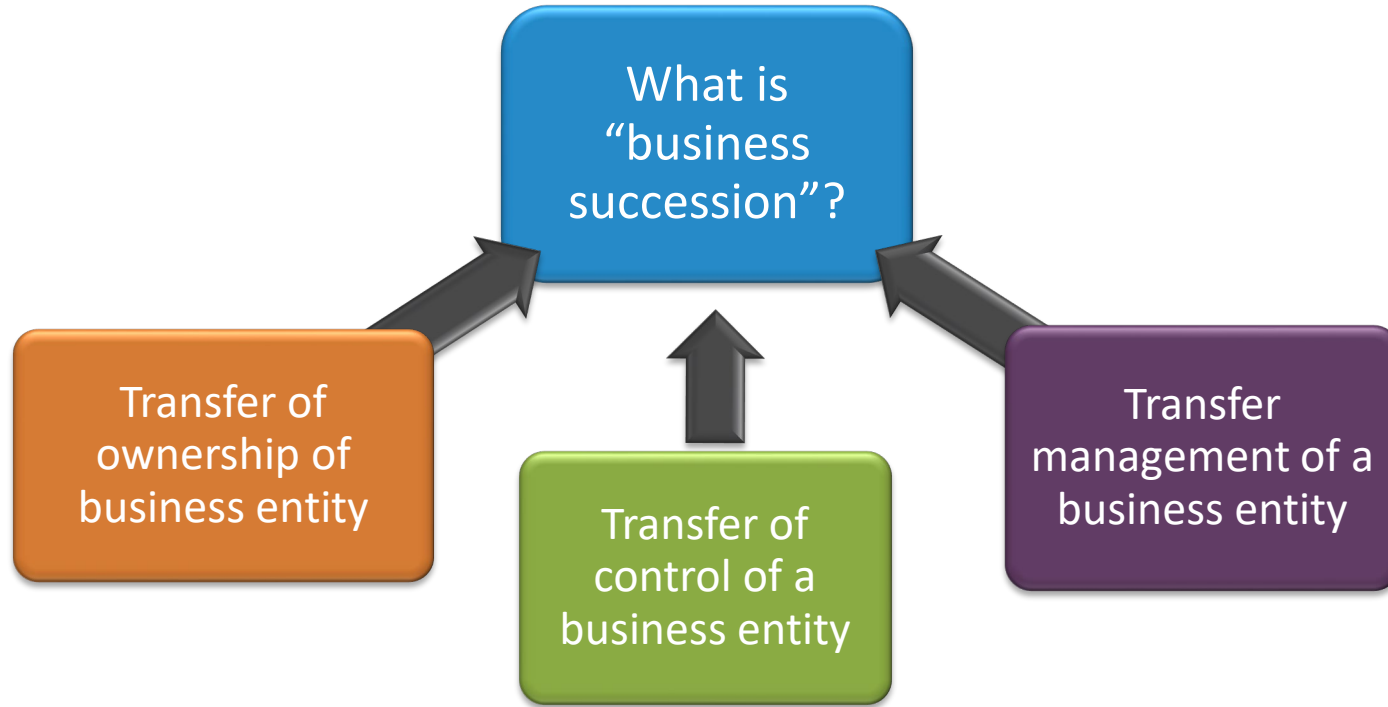
# Planning for Succession is About Creating Options



*Instead of starting by asking ‘what **structure** do I want’, start by getting clear on what **outcomes** you want.*

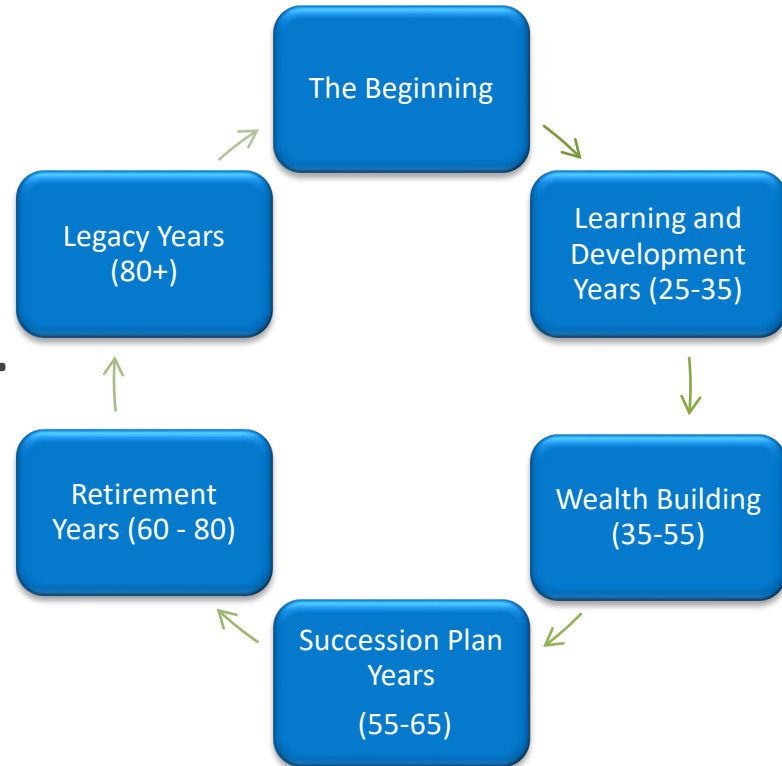


# Business Succession Planning



# Life Cycle of Your Business

- When should you start?
- Different for everyone.
- Need time to implement.



# When should I start Succession Planning?

- No right or wrong time to start
- Can be as much as five years before an event
- Communications is critical
- Allow time to assess and develop talent
- While you can still influence the decision
- A Journey not a race



# Understanding the Picture

- What does succession look like for the Owner(s)?
  - What are YOUR goals and dreams?
- What is important to YOU?
  - Legacy, Value, Employee Retention, Control



## Who Should be Involved?

- Advisors that understand the industry
- Understand impact on the financial statements
- Affects on bonding and banking
- Prequalification
- Union withdrawal liability, if applicable.

## Understand the Finances of an Event

- How does the company value fit into your finances?
  - The proper plan will provide comfort for owner to execute
- How much cash do you need up front?
- Are you willing to hold a note?
- Do you have other sources of income?
- Rental income from business?





# Building a Healthy, Sustainable Business

*Expanding your options using the Value Triangle*

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# Business Succession starts with the Shareholders

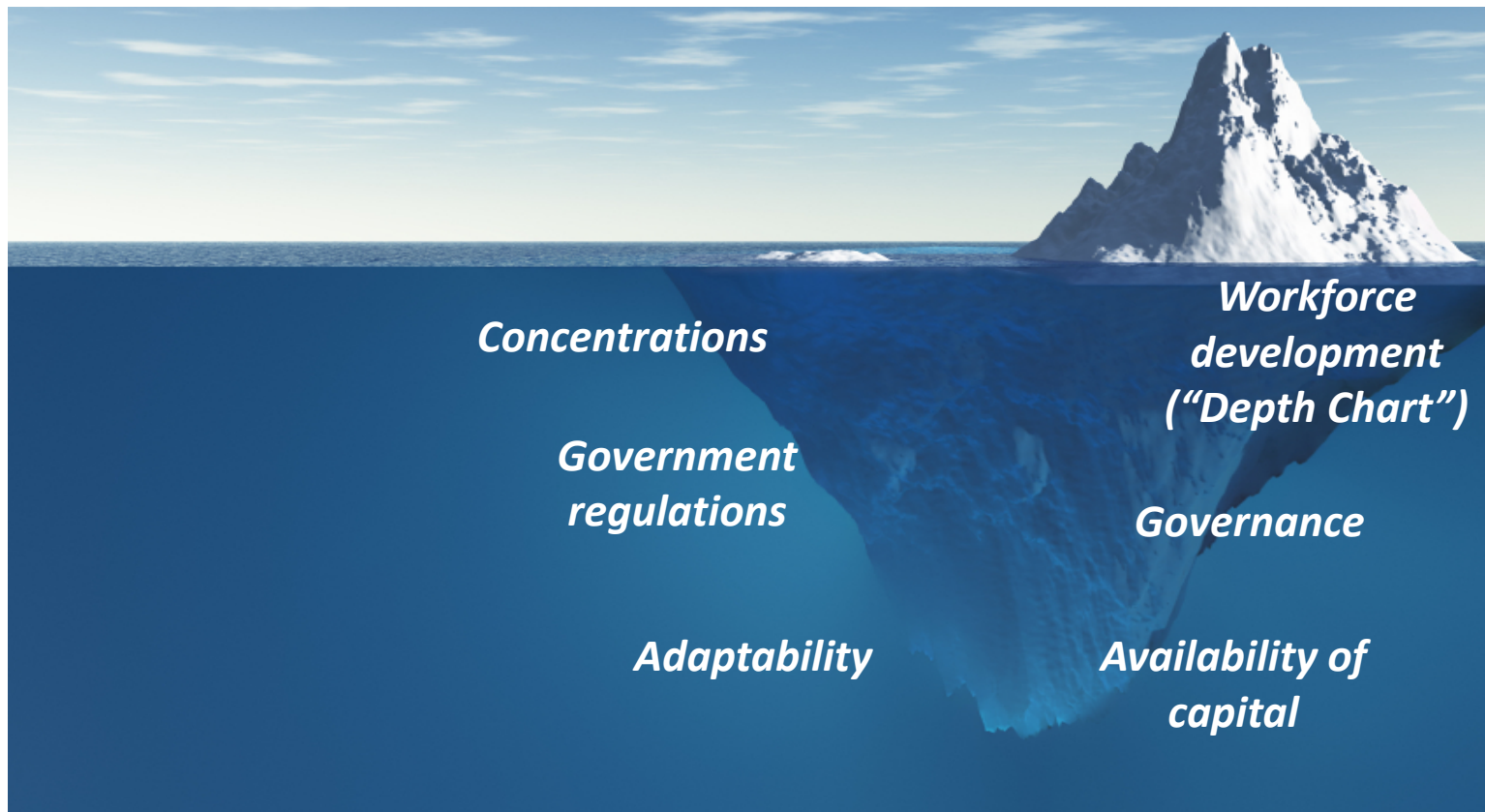
- “Value Triangle”
- Maximizing your options for succession
- Maximizing your value for succession
- Maximizing likelihood of succeeding



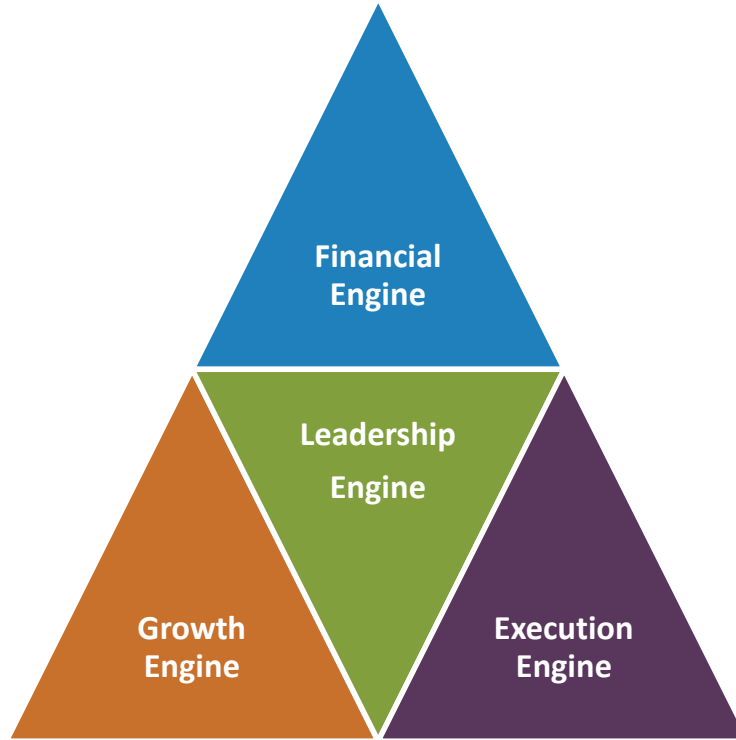
# It is about more than just numbers...



# It is about more than just numbers...

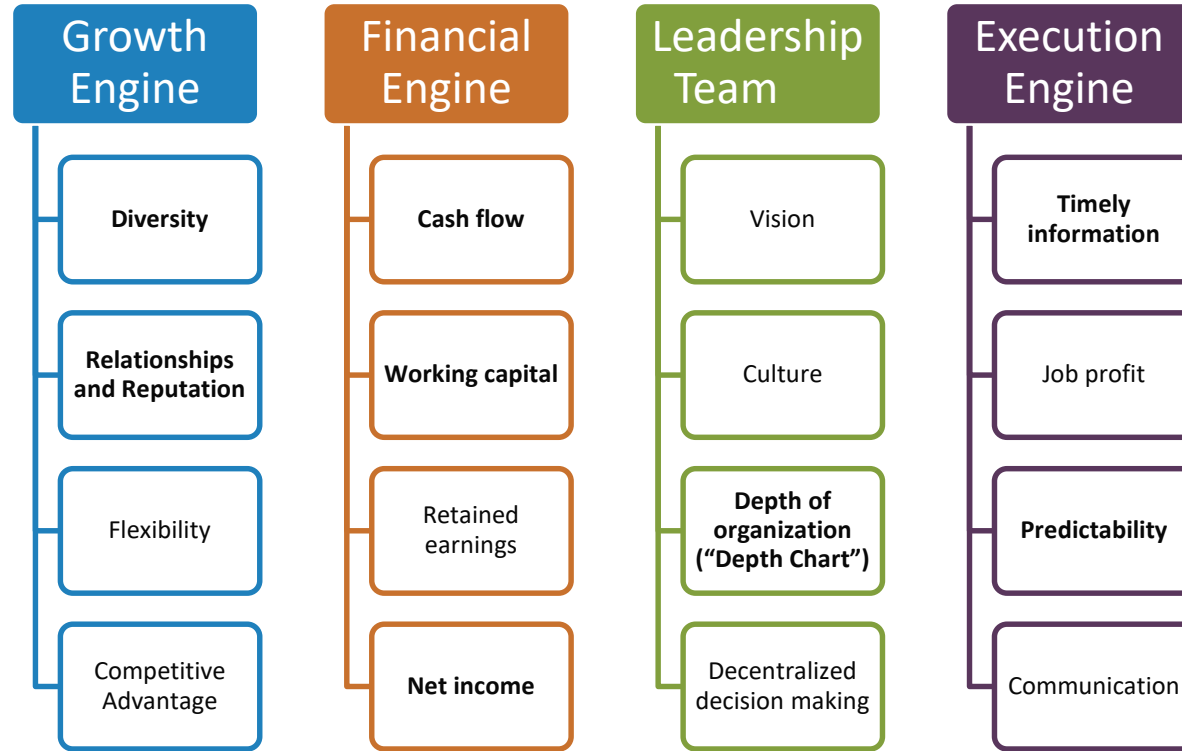


# The Value Triangle

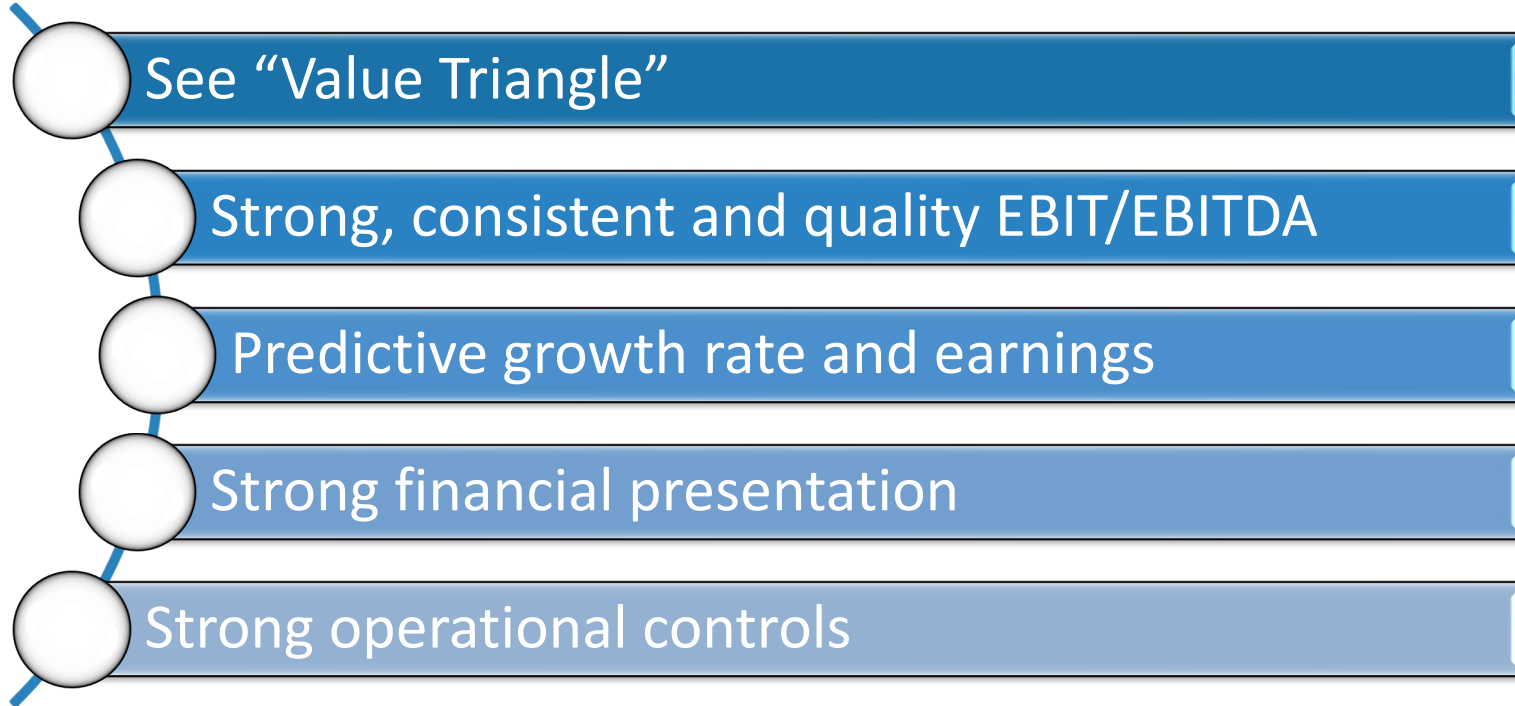


*Growing each of the four “engines” in balance leads to enterprise value and options for succession.*

# Value Triangle



# Enhancing Enterprise Value



# Enhancing Enterprise Value

- Management depth, experience and bench
- Non-compete agreement
- Maintain your equipment
- Minimize related party transactions
- Diversified customer base and service capabilities



# Enhancing Enterprise Value

- Monthly reporting capabilities
- Job and operating cash flow analysis
- FFTM = Forward Thinking Twelve Months
- TTM = Trailing Twelve Months
- Benchmarking of KPI's



# Building a Healthy, Sustainable Business

## *Construction Company Valuations*

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# Common Valuation Methods

- Net Asset (Cost) Approach
  - Replacement Value of Assets
- Market Approach
  - Public Company Comparable
  - Previous Transactions
- Income Approach
  - Future cash flows



## Thoughts...

- Valuation professionals have differing opinions
- Many center around income based approach
- Each approach provides value for comparison
- Consider when to use a given approach
- Stable earnings – Focus on Income Approach
- Inconsistent earnings – Focus on Asset Approach
- Market Approach not always realistic



## Thoughts...

- Do not need certified appraisal (valuation)
- Need to stress test multiple scenario's
- Should get certified appraisal if internal transaction
- Running “Monte Carlo” scenario's will help



# Succession Planning: Options and Considerations

## *Internal Succession Strategies*

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# Ownership Transfer Options

Internal Strategies	External Strategies
Management buyout	Competitor
Family transfer	Strategic Buyer
Employee Stock Ownership (ESOP)	Private Equity
Combination	Minority Investor



# Internal Strategies for Ownership Transfer

## Internal Strategies

Stock/Unit Redemptions

Owner to Owner Sales

Re-Org followed by Sale (S Corp)

Leveraged or Unleveraged ESOP

Combination of Above



## Stock/Unit Redemption Overview

- Corporation/LLC repurchases shares/units from owners
- May be followed by re-issuance of stock/units to new or existing owners
- May have negative cash flow impact on business
- Impact on financials of the business



# Redemption Logistics

- 1) Parties agree to a methodology for determining price
  - Often set by shareholder agreement, operating agreement, or separate buy/sell agreement
- 2) Exiting owner transfers stock/units to the business for cash or note receivable (installment sale???)
- 3) Company may reissue stock or units to new owners
  - Can be non-voting or preferred interest for LLC's or C-Corporations
- 4) If eligible, entity make basis adjustments for property, equipment, and goodwill (Partnerships & LLC's)



# Redemption Considerations (pros & cons)

Pros	Cons
Transactions stay between the owners and the company	Potential significant effect on the company's financials/cash flow
Partnerships & LLCs: Company eligible for step-up of assets allocable to repurchased units (and depreciation/amortization)	Corporations: Company not entitled to tax benefits for re-purchase of stock
Allows for succession over time with owners transitioning over a period of time	Requires significant management succession planning ahead of time to ensure continuity of operations/vision
Little complexity	Often lower value as opposed to external transactions (pro for remaining owners)



# Tax Considerations

- Seller
  - Capital gain/loss on sale of stock (long term is held > 1 year)
  - Capital gain/loss AND ordinary income on sale of partnership/LLC (HOT Assets!!!)
  - Installment sale treatment available, but not on ordinary income portion
- Purchaser
  - If Partnership/LLC units redeemed, basis adjustment available
    - ◇ Same effect as owner-to-owner, except benefit is spread among all shareholders rather than a single new owner



## Owner-to-Owner Sales Overview

- Exiting owner sells stock or LLC units directly existing owners or new owners/management
- Value typically determined by valuation, book value, formula in buy/sell agreement, or combination
- Little to no impact of the financials of the business
- Different tax consequences for Corporation v LLC
- Least complex of internal transfer options



# Owner-to-Owner Sale Logistics

- 1) Parties agree to a methodology for determining price
  - Any methodology acceptable as transaction is arms-length and outside the walls of the business
- 2) Exiting owner transfers stock/units to new owner for cash or note receivable (installment sale???)
- 3) Purchaser assumes all the rights to vote (or not vote), income, and distributions
- 4) If eligible, entity make basis adjustments for property, equipment, and goodwill (Partnerships & LLC's)



# Owner to Owner Considerations (pros & cons)

Pros	Cons
Little to no effect on the company financials	Exposes exiting owner to individual's ability to pay
Partnerships & LLCs: Purchaser eligible for step-up of assets allocable to them (and depreciation/amortization)	Corporations: Purchaser only has basis in their stock. No current benefit for appreciated assets until future sale
Allows for succession over time with owners transitioning over a period of time	Requires significant management succession planning ahead of time to ensure continuity of operations/vision
Low cost / little complexity	Often lower value as opposed to external transactions





# Tax Considerations

- Seller
  - Capital gain/loss on sale of stock (long term is held > 1 year)
  - Capital gain/loss AND ordinary income on sale of partnership/LLC (HOT Assets!!!)
  - Installment sale treatment available, but not on ordinary income portion
- Purchaser
  - Cost basis and holding period begin on purchase date; even with installment sales
  - If Partnership/LLC units purchased, basis adjustment available



# What's this about basis adjustments?!?

- Partnership/LLC owners are considered to own a piece of every asset/liability...they should get credit for it!!

Balance Sheet at Purchase Date		
	FMV	Tax Basis
Cash	1,500,000	1,500,000
A/R	1,200,000	1,200,000
Underbillings	500,000	500,000
PP&E (Tax Basis)	100,000	100,000
<b>Goodwill (Tax Basis)</b>	<b>1,000,000</b>	-
Total Assets	4,300,000	3,300,000
A/P	800,000	800,000
Overbillings	350,000	350,000
Other Liabilities	200,000	200,000
Total Liabilities	1,350,000	1,350,000
<b>Equity</b>	<b>2,950,000</b>	<b>1,950,000</b>
Total Liabilities & Equity	4,300,000	3,300,000

Basis Adjustment on Purchase	
1,475,000	Purchase of 50% interest
(975,000)	Tax Basis of 50% interest
500,000	Difference
↓	
500,000	Goodwill Amortized over 15 years

**Purchasing owner will get an extra \$33,333 of deduction allocated to them each year for 15 years**

## But what if I'm an S-Corp

- Most of the “pros” seem to be related to Partnership/LLC's
- No need to worry, a simple re-organization prior to a sale (internal or external buyer) can achieve favorable basis adjustment treatment

Two common examples are...



# Re-Organization prior to sale (option 1)

## Drop down to an LLC

- 1) S-Corp drops all assets/liabilities down to a newly formed LLC in exchange for a 100% interest
- 2) New owner purchases a portion of the new LLC from the S-Corp
- 3) New owner is entitled to a basis adjustment for their share of the assets inside the LLC
- 4) Old S-Corp can now redeem the exiting owner with the proceeds from the new owner

It looks a something like this...



# Drop down LLC Structure



- Acquirer get credit for the basis step-up
- Exiting owner get redeemed out for his share
- Makes entity attractive for a potential external event at a later date
- Some added complexity with existing contracts...

# Re-Organization prior to sale (option 1)

## “Type F” Reorganization

- Similar in function to a Drop down LLC structure
- Puts a holding company above the existing S-Corporation, immediately followed by a conversion of the old S-Corporation to an LLC (tax free under IRS code)
- From here, sell away just like in the previous examples





# ESOP

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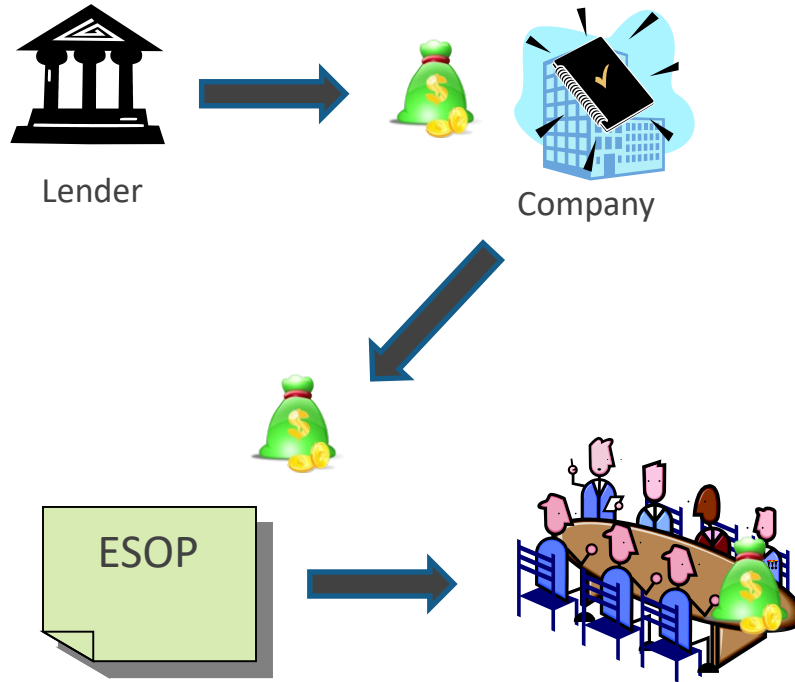
## ESOP – Overview

- One of my favorite financing options
- Not necessarily right for everyone
- Will not cover up operational shortfalls
- Surety considerations are critical
- Can use tax-deductible earnings to repurchase stock
- Creates a market for shareholder of closely held Co.
- Only way to create tax free business





# ESOP – Leveraged



1. Company sets up an ESOP Trust
2. Bank or SH lend \$ to the Company
3. Company lends \$ to ESOP Trust
4. ESOP buys SH's stock pays \$

## ESOP – Overview

- Defined contribution plan under IRS and ERISA
- Subject to compensation limits (25% of wages)
- Typically for those not subject to CBA
- “C Corporation” could qualify as tax-free to sellers
- “S Corporation” is where we will spend our time
- Non-Leveraged ESOP
- Leveraged ESOP



# Accounting for Leveraged ESOP

- Record loan on Company's books
- At time of stock purchase:
  - Debit to Unearned ESOP Shares
  - Credit to Notes Payable
  - Cash goes to Seller



# Accounting for Leveraged ESOP

- When cash is contributed to ESOP and debt is repaid
  - Debit to Contribution expense (FMV of shares)
  - Credit to Unearned ESOP Shares (Historical cost)
  - Difference to PIC or RE
- Model future repurchase obligation



# Succession Planning: Options and Considerations

## *External Succession Strategies*

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# Ownership Transfer Options

## External Strategies

Sale to Strategic Buyer

Competitor/3<sup>rd</sup> Party

Minority Investor

Private Equity



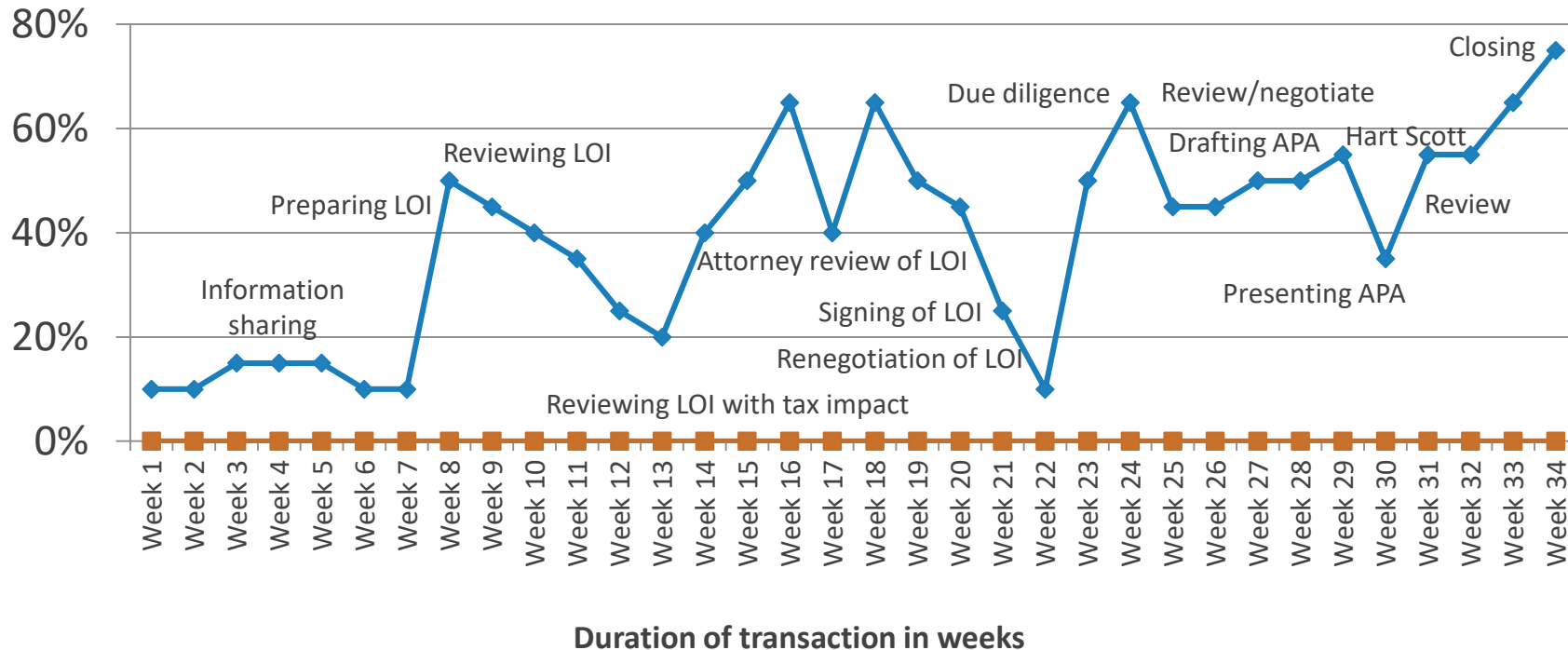
# Planning for the Sale

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# Planning for the Event

Success rate





# Planning for the Event

- First impressions are important
- Boy Scout philosophy...be prepared
- Come across as a well run organization
- Do your tax and structuring planning
- Have your corporate documents up to date
- Address value triangle drivers
- Present normalized financials with commentary
- Forecasted financial statements



# Recast Financial Information

## – Balance Sheet

- Start with real financials
- Adjust balance sheet
- Eliminate non operating assets
- Present balance sheet ratios
- Add multiple years for trends
- Explain all adjustments

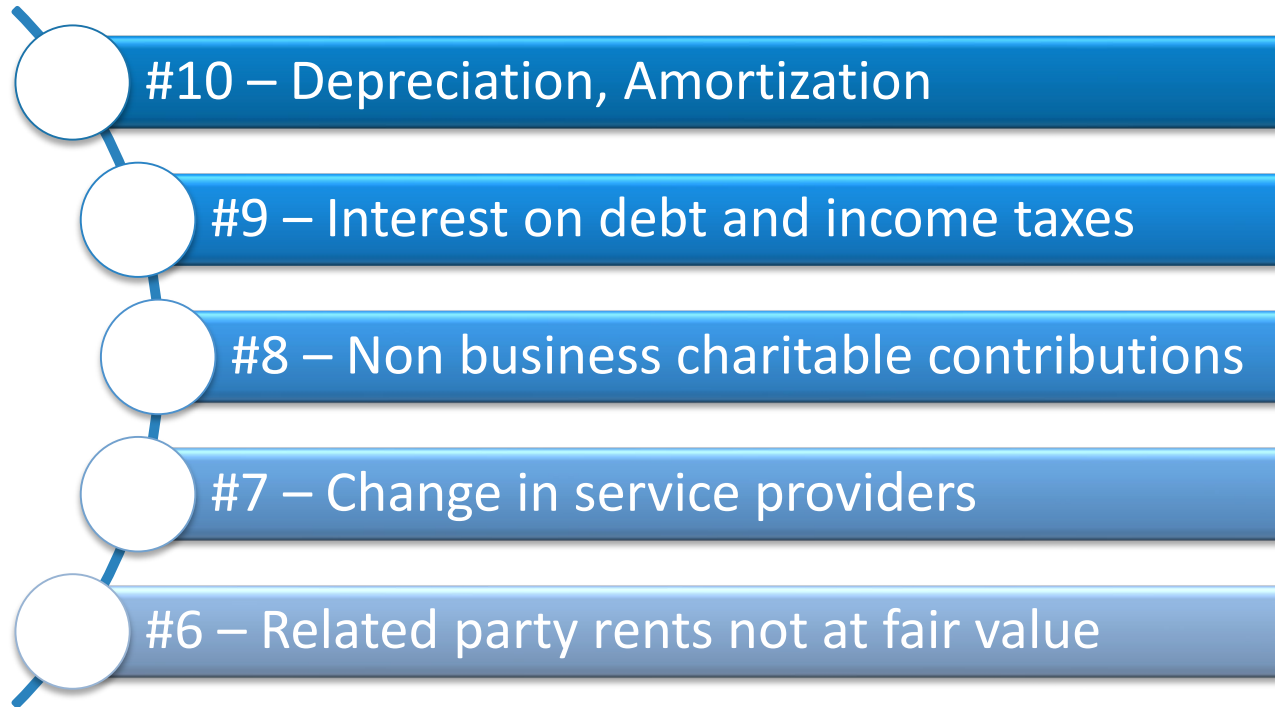
ABC Construction Contractors						
Dec-16						
September 30,	Audited 2016	Adj.	Ref #	Proforma B/S	2015	2014
Current						
Cash and cash equivalents	\$ 71,000			\$ 71,000	\$ 69,730	\$ 52,814
Contracts receivable	126,000			126,000	119,884	126,514
Supplies inventory	3,750			3,750	3,915	4,402
Overbillings	1,575			1,575	658	3,088
Prepaid expenses and other	1,500			1,500	18,090	13,284
Total current assets	203,825	-	-	203,825	212,297	200,102
PPE						
Equipment, carry value	28,000			28,000	25,962	25,039
Equipment FMV Adjust.	-	9,000		9,000		
Equipment, adjusted NBV	28,000	9,000	-	37,000	25,962	25,039
Other						
Note receivable - stockholder	1,500	(1,500)		-	6,400	6,400
Deferred income taxes	2,500	(2,500)		-		
Investments	18,000	(8,000)		10,000	5,447	5,229
Total other assets	22,000	(12,000)	-	10,000	11,847	11,629
Total assets	\$ 253,825	\$ (3,000)	\$ -	\$ 250,825	\$ 250,106	\$ 236,770
Current						
Accounts payable	86,000			86,000	73,666	95,790
Accrued liabilities	14,000			14,000	14,617	18,169
Overbillings	56,000			56,000	68,659	37,482
Income taxes payable	500			500	225	-
Total current liabilities	156,500	-	-	156,500	157,167	151,451
LTD						
Notes payable, net current	2,000			2,000	3,982	6,599
Deferred income taxes	1,769			1,769	4,727	2,608
Deferred compensation	5,500			5,500	6,273	5,871
Total long-term liabilities	9,269	-	-	9,269	14,982	15,078
Equity						
Common stock	12			12	12	12
Retained earnings	88,044	(3,000)		85,044	77,945	70,229
Total stockholders' equity	88,056	(3,000)	-	85,056	77,957	70,241
Total liabilities and stockholders' equity	\$ 253,825	\$ (3,000)	\$ -	\$ 250,825	\$ 250,106	\$ 236,770
Working Capital	47,325			47,325	55,130	48,651
Sales	\$ 356,333			\$ 333,825	\$ 336,850	\$ 341,124
Working Capital %	13.28%			14.18%	16.37%	14.26%

# Recast Financial Information – P & L

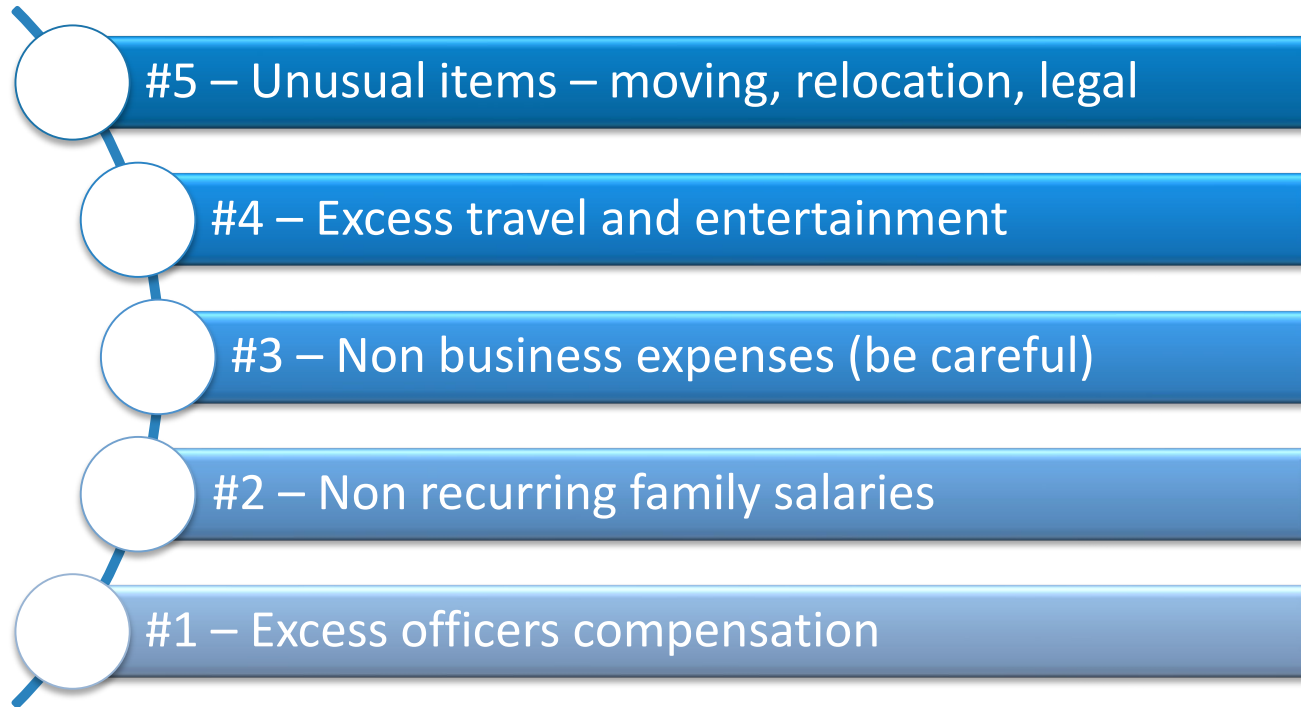
- Start with actual financials
- All adjustments on the bottom
- Calculate EBIT and EBITDA
- Make supportable adjustments
- Present cash flow
- Backlog

ABC Construction P&L 2014-2017(F)							
	Forecast		Actual		average		
December 31,	(\$ in 000's)	2017	2016	2015	2014	3 yr	10 yr
Contract revenues		\$ 425,000	\$ 319,571	\$ 268,158	\$ 544,932	\$ 377,554	\$ 409,666
Contract costs		372,000	254,820	218,074	495,151	322,682	368,493
Gross profit		53,000	64,751	50,084	49,781	54,872	41,173
%		12.5%	20.3%	18.7%	9.1%	14.5%	10.1%
Operating expense		35,000	29,227	27,348	27,822	28,132	23,270
Income from operations		18,000	35,524	22,736	21,959	26,740	17,903
Non sponsord JV's		1,000	(6,760)	(2,258)	4,630	(1,463)	2,221
Other income (expense)		300	225	429	(180)	158	857
Interest income (expense)		(200)	(300)	(246)	(303)	(283)	304
Net income before taxes		19,100	28,689	20,661	26,106	25,152	21,285
Income tax		1,000	5,525	701	448	2,225	4,119
Income before non-controlling		18,100	23,164	19,960	25,658	22,927	17,166
Non controlling interests				7,954	5,426	4,460	4,191
Net income - Per FS		\$ 18,100	\$ 23,164	\$ 12,006	\$ 20,232	\$ 18,467	\$ 12,975
Depreciation		8,500	5,925	3,155	7,814	5,631	4,803
Interest expense		200	300	465	581	449	644
Taxes		1,000	5,525	701	448	2,225	4,119
						-	-
EBITDA - net cash flow		\$ 27,800	\$ 34,914	\$ 16,327	\$ 29,075	\$ 26,772	\$ 22,540
						0	0
Adjustments		2017	2016	2015	2014	2015	2009
Executive expenses		1,500	2,000	2,163	1,969	2,044	1,840
Losses (income) inactive sponso		-		75	(610)	(178)	(54)
Losses (income) from inactive nc		-		3,384	(474)	970	291
Legal expenses - corporate dispi		700	430	1,372	2,654	1,485	853
Total		2,200	2,430	6,994	3,539	4,321	2,931
						0	0
Adjusted EBITDA		\$ 30,000	\$ 37,344	\$ 23,321	\$ 32,614	\$ 31,093	\$ 25,471
Capital Expenditures		\$ 10,500	\$ 11,342	\$ 17,293	\$ 3,822	\$ 10,819	\$ 7,247
Working Capital End of Year						\$ -	\$ -
Taxes (s corp at 35%0		\$ (7,335)	\$ (13,632)	\$ (4,903)	\$ (7,529)	\$ (8,688)	\$ (6,730)
Cash Flow		\$ 33,165	\$ 35,054	\$ 35,711	\$ 28,907	\$ 33,224	\$ 25,987
						0	0
Backlog as of December 31		\$ 410,000	\$ 935,987	\$ 398,850	\$ 415,229	\$ 583,355	\$ 532,805
Notes						\$ -	\$ -

# Top Ten List of EBITDA Adjustments

- 
- #10 – Depreciation, Amortization
  - #9 – Interest on debt and income taxes
  - #8 – Non business charitable contributions
  - #7 – Change in service providers
  - #6 – Related party rents not at fair value

# Top Ten List of EBITDA Adjustments

- 
- #5 – Unusual items – moving, relocation, legal
  - #4 – Excess travel and entertainment
  - #3 – Non business expenses (be careful)
  - #2 – Non recurring family salaries
  - #1 – Excess officers compensation

## Letter of Intent

- Done after confidentiality agreements
- Establish basic terms of agreements
- Knock out “deal breakers”
- Make sure structure is known
- Provides for time to negotiate
- Provide for return of information



## Due Diligence

- Hold to timeframe in LOI
- Fill data room completely
- Typically 30 - 45 days from completed data room
- Address difficult items up front (i.e. litigation)
- Watch for problems with working capital
- Quality of earnings
- Quality of financial records

# Finalizing and Signing

- Legal – devil in the details
- Last minute negotiations
- Corporate complications
- Hart Scott filings





# Signing and Close





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