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.
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

- Construction
- Manufacturing and distribution
- Trucking and transportation
- Agribusiness
- Cooperatives
- Real Estate
- Employee benefit plans
- Federal government
- Financial institutions
- Dealerships
- Health care
- Higher education
- Nonprofit
- State and local government
- Private clients
- Commercial services
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.
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
Why are we talking about succession?

Some Expert Estimations About Baby Boomers

60% of 15 million business owner's are baby boomers¹ (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.

Dealologic 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 11th 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

What is “business succession”?

Transfer of ownership of business entity

Transfer of control of a business entity

Transfer management of a business entity
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
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...

Concentrations

Government regulations

Adaptability

Workforce development ("Depth Chart")

Governance

Availability of capital
Growing each of the four “engines” in balance leads to enterprise value and options for succession.
Value Triangle

**Growth Engine**
- Diversity
- Relationships and Reputation
- Flexibility
- Competitive Advantage

**Financial Engine**
- Cash flow
- Working capital
- Retained earnings
- Net income

**Leadership Team**
- Vision
- Culture
- Depth of organization ("Depth Chart")
- Decentralized decision making

**Execution Engine**
- Timely information
- Job profit
- Predictability
- Communication
Enhancing Enterprise Value

- See “Value Triangle”
- Strong, consistent and quality EBIT/EBITDA
- Predictive growth rate and earnings
- Strong financial presentation
- Strong operational controls
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
- FTTM = Forward Thinking Twelve Months
- TTM = Trailing Twelve Months
- Benchmarking of KPI’s
Building a Healthy, Sustainable Business

Construction Company Valuations
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

Investment advisory services are offered through CliftonLarsonAllen Wealth Advisors, LLC, an SEC-registered investment advisor.
# Ownership Transfer Options

<table>
<thead>
<tr>
<th>Internal Strategies</th>
<th>External Strategies</th>
</tr>
</thead>
<tbody>
<tr>
<td>Management buyout</td>
<td>Competitor</td>
</tr>
<tr>
<td>Family transfer</td>
<td>Strategic Buyer</td>
</tr>
<tr>
<td>Employee Stock Ownership</td>
<td>Private Equity</td>
</tr>
<tr>
<td>(ESOP)</td>
<td>Minority Investor</td>
</tr>
<tr>
<td>Combination</td>
<td></td>
</tr>
</tbody>
</table>
# Internal Strategies for Ownership Transfer

<table>
<thead>
<tr>
<th>Internal Strategies</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stock/Unit Redemptions</td>
</tr>
<tr>
<td>Owner to Owner Sales</td>
</tr>
<tr>
<td>Re-Org followed by Sale (S Corp)</td>
</tr>
<tr>
<td>Leveraged or Unleveraged ESOP</td>
</tr>
<tr>
<td>Combination of Above</td>
</tr>
</tbody>
</table>
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)

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

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

<table>
<thead>
<tr>
<th></th>
<th>FMV</th>
<th>Tax Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>1,500,000</td>
<td>1,500,000</td>
</tr>
<tr>
<td>A/R</td>
<td>1,200,000</td>
<td>1,200,000</td>
</tr>
<tr>
<td>Underbillings</td>
<td>500,000</td>
<td>500,000</td>
</tr>
<tr>
<td>PP&amp;E (Tax Basis)</td>
<td>100,000</td>
<td>100,000</td>
</tr>
<tr>
<td><strong>Goodwill (Tax Basis)</strong></td>
<td><strong>1,000,000</strong></td>
<td>-</td>
</tr>
<tr>
<td>Total Assets</td>
<td>4,300,000</td>
<td>3,300,000</td>
</tr>
<tr>
<td>A/P</td>
<td>800,000</td>
<td>800,000</td>
</tr>
<tr>
<td>Overbillings</td>
<td>350,000</td>
<td>350,000</td>
</tr>
<tr>
<td>Other Liabilities</td>
<td>200,000</td>
<td>200,000</td>
</tr>
<tr>
<td>Total Liabilities</td>
<td>1,350,000</td>
<td>1,350,000</td>
</tr>
</tbody>
</table>

**Equity** 2,950,000 1,950,000

Total Liabilities & Equity 4,300,000 3,300,000

### Basis Adjustment on Purchase

<p>| | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1,475,000</td>
<td>Purchase of 50% interest</td>
<td></td>
</tr>
<tr>
<td>(975,000)</td>
<td>Tax Basis of 50% interest</td>
<td></td>
</tr>
<tr>
<td>500,000</td>
<td>Difference</td>
<td></td>
</tr>
</tbody>
</table>

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 – 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*
## Ownership Transfer Options

<table>
<thead>
<tr>
<th>External Strategies</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sale to Strategic Buyer</td>
</tr>
<tr>
<td>Competitor/3rd Party</td>
</tr>
<tr>
<td>Minority Investor</td>
</tr>
<tr>
<td>Private Equity</td>
</tr>
</tbody>
</table>
Planning for the Sale
Planning for the Event

Success rate

Duration of transaction in weeks

Week 1
Week 2
Week 3
Week 4
Week 5
Week 6
Week 7
Week 8
Week 9
Week 10
Week 11
Week 12
Week 13
Week 14
Week 15
Week 16
Week 17
Week 18
Week 19
Week 20
Week 21
Week 22
Week 23
Week 24
Week 25
Week 26
Week 27
Week 28
Week 29
Week 30
Week 31
Week 32
Week 33
Week 34

Success rate in weeks

0%
20%
40%
60%
80%

Information sharing
Preparing LOI
Reviewing LOI
Reviewing LOI with tax impact
Due diligence
Review/negotiate
Drafting APA
Hart Scott
Review
Presenting APA
Renegotiation of LOI
Attorney review of LOI
Signing of LOI
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
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
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