Succession planning in closely held construction businesses

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Closely held construction businesses face many challenges over the lifetime of the business. Maintaining adequate working capital; generating cash flow to pay bills and employees; holding on to talented employees; securing financing; and just performing the work that make the business thrive, are all among the issues they face. To many business owners these things are second nature. Why, because they have been doing them for so many years either as an employee or principle in their respective industries. The number one challenge these executives face is succession and continuity planning for the company and of upper management.

One primary reason why this is so important for construction businesses in particular is because more bonding companies and banks are pressing for continuity and succession plans to protect their interests. Why is business continuity so tough for contractors to handle? In my opinion there are two major factors. First the very people pressing for the plan (sureties and banks) are the most difficult to satisfy and convince that the plan will actually work. The structure of the "buyout" plan, will dictate how financial information is presented to credit grantors. The underwriting process is very "balance sheet" driven and the effect of a continuity plan on a balance sheet can potentially create an underwriting nightmare. All closely held businesses have this challenge, but a construction company has to involve two credit grantors as opposed to just the bank.

The second hurdle is common with every entrepreneurial business owner; they have a hard time letting go and imagining anyone else is capable of running their business. There are layers of other problems too especially when children are in the business. Business problems and family problems are difficult on their own; however, when they overlap the result can be devastating.

Few challenges demand more of a business owner. The stakes are high: lifelong hopes, dreams, ambitions, relationships and morality issues are all challenged. Young business owners (CEOs under the age of 50) that even think about this issue often harbor the dream that their children will one day take over the company and bring it to new heights while dad (or mom) ride off into the sunset of retirement. One thing they need to know before they continue this dream: fewer than 33% of businesses survive the second generation and less than 13% make it past the third. Sureties and banks are well aware of these statistics.

Many people ask why this happens. Simply speaking, the company is being run by an inexperienced and unqualified CEO because of the right of passage in a family-run business. While this is not always the cause of a second generation failure, in all likelihood it is a contributing factor.

Most family-run businesses have non-family key employees that contribute to the success of the company and construction firms are no different. Without these key people, the company could lose business or operate less efficiently. Even worse, the company could be imperiled should important people leave and take their knowledge to a competitor.

This scenario is probably one of the biggest mistakes made by CEOs when developing a succession

and continuity plan. They fail to include the people who helped build and grow the business in the succession process. Instead, they come into the office one morning and decide "Junior" is in charge and expect all employees to simply line up behind the new company leader. This can be a problem when you consider that some of the employees may have been at the company far longer and may have had a significant role in its success and growth and may not appreciate a new leader selected in this way.

This can lead to resentment and lack of respect for the successor whether they are qualified or not. Other thought processes of key employees when not brought into the succession loop are "will this guy ever retire and when he does where does it leave me?" If there is no communication with key people there are several likely outcomes, none of them good for the business: they will either retire when the owner does; take their knowledge, experience and contacts to a competitor; or perhaps worst of all, stay on but in a diminished capacity, not giving it their all.

In part one of this article, we looked at the challenges of succession planning. Part two presents the elements of a well-thought out, comprehensive succession plan.

Process for choosing a successor: Choosing a successor is the lynchpin of any good succession plan. The business owner should consult outside business counsel as well as key internal people. Outside counsel is well positioned to offer objective advice about management and succession challenges. Consulting with internal people serves to inform them of your plans and involves them in the process.

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William Fischer, CPA is a partner at GRASSI & CO. CPAs and
Success Consultants, Lake
Success, N.Y.

Leadership Plan: The leadership plan involves more than just the existing leader and successor, but all the other key constituents the CEO has contact with regularly. The successor should "shadow" the existing leader to become familiar with the business and how the CEO interacts and runs things. Changes to how a business conducts day-to-day operations should be a well thought out idea that includes all members of management.

Career Planning: The plan should also include the career paths of key project people and employees and how they fit into the succession and development plan. This is absolutely key so the firm has a clear plan for its key employees and so they see their continued place in the organization. Also, the management of the company needs to understand these aspects so it can be effectively communicated to the employees and related business community.

Continuous Improvement: The plan needs to be updated annually and should be "tweaked" as the succession process evolves. For example, the existing CEO may come to find that he has a particular management function that could be given to someone else in the organization because they are better suited to handle it.

At this point in the process, separation between the exiting CEO and the new CEO is important. The two leaders need to spend time away from one another and respect each other's evolving roles. The exiting CEO needs to grow comfortable not being in charge and the new CEO needs to begin to get used to doing things on his own.

There can be many pitfalls along the way as this process evolves. One of the most common is inadequate financial security for the retiring owner. Essentially, the combination of the buyout

money and retirement savings is often not enough to maintain the accustomed lifestyle. Another potential problem can develop if the wrong successor was selected or a conflict develops between the owner and the successor.

In terms of the actual mechanics of the transfer of ownership, the organization's top advisors should be consulted and the following options should be examined individually and in combination: stock redemption agreements; stock bonus plans; phantom stock plans; incentive stock options; and compensation plans; employee stock ownership plans (ESOPs); and parallel company/spin-offs.

The owner and successor need to approach the ownership transfer as financial partners. As the existing equity is drawn out by the old owners it needs to be replenished with new equity. This is usually a combination of future earnings retained by the business and periodic capital contributions by the next generation of equity owners. The mix is determined by the transfer options selected and here the company's accountant and attorney will play a key role. Without this carefully planned financial balance, the surety and bank may cut back overall available credit, thus potentially inhibiting growth.

In cases where the ownership will stay with the family, the outside professionals need to have extensive estate planning experience. Poorly structured transfer options could cost millions in estate taxes later, especially if the new leader is successful and grows the company and makes it even more profitable. The right balance of gifting and outright sales to the next generation can be very complex, especially if there are outside family members or in-laws obtaining ownership.

The transfer options need to be structured in a way that the old owners maintain financial control until they are satisfied that giving up the ownership and control has been earned and warranted.

These are perfect situations for incentive and phantom stock ownership plans in which the new owners vest in their ownership rights and benefits but can be canceled or bought out at the company's discretion should they find the chosen successors are not a good fit or worse, a family member gets divorced from a key employee involved in the buyout.

As a professional who has witnessed many succession planning failures and successes, I know that the rate of success goes up dramatically when the plan is well thought out and the participants involved make honest assessments of what made the business successful and what it will take for the next generation to achieve their goals. Those assessments are often eye-opening experiences to the old owner, but as long as the experience is embraced by everyone and top priority goes to the best interest of the business, it can be a productive, successful process and all parties involved will benefit.

William Fischer, CPA is a partner at GRASSI & CO. CPAs and Success Consultants, Lake Success, N.Y.