

Navigating Succession Planning

Options and Next Steps for Your Construction Company



CliftonLarsonAllen

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About CliftonLarsonAllen

- A professional services firm with three distinct business lines
 - Accounting and Consulting
 - Outsourcing
 - Wealth Advisory
- 3,600 employees
- Offices coast to coast
- 2,700+ construction clients
- 200 professionals and 50 principals dedicated to the construction industry



Speaker Introductions

- **Timothy J. Skelly, CPA, Managing Principal**

Tim is the managing principal of CLA's construction and real estate group and has been with the firm for more than 30 years. He spends a majority of his time serving general and specialty contractors, companies that service and supply the construction industry, as well as real estate related companies. Tim has significant experience with various acquisition, merger, and financing transactions as well as working with the tax, financial, and business planning aspects of privately-owned companies.

- **Brian P. Buwalda, CPA, Principal**

Brian is a principal in the firm's construction and real estate group and has more than 25 years of experience. He specializes in assisting privately-held businesses and their owners, including structuring and implementing plans for business succession. Brian also has significant experience with various acquisition, merger, and financing transactions ranging from hundreds of thousands of dollars to transactions valued at over \$1 billion.

Learning Objectives

- At the end of this session, you will be able to:
 - Understand options to transition your business to new management and owners
 - Learn how to strategize for a smooth transition of your company by retaining key employees and minimizing business interruptions
 - Identify next steps to evaluate or initiate the process for a successful succession plan



Topics

- Helping owners plan for their succession
- Concepts important to understanding valuation
- Impact on family and creditors

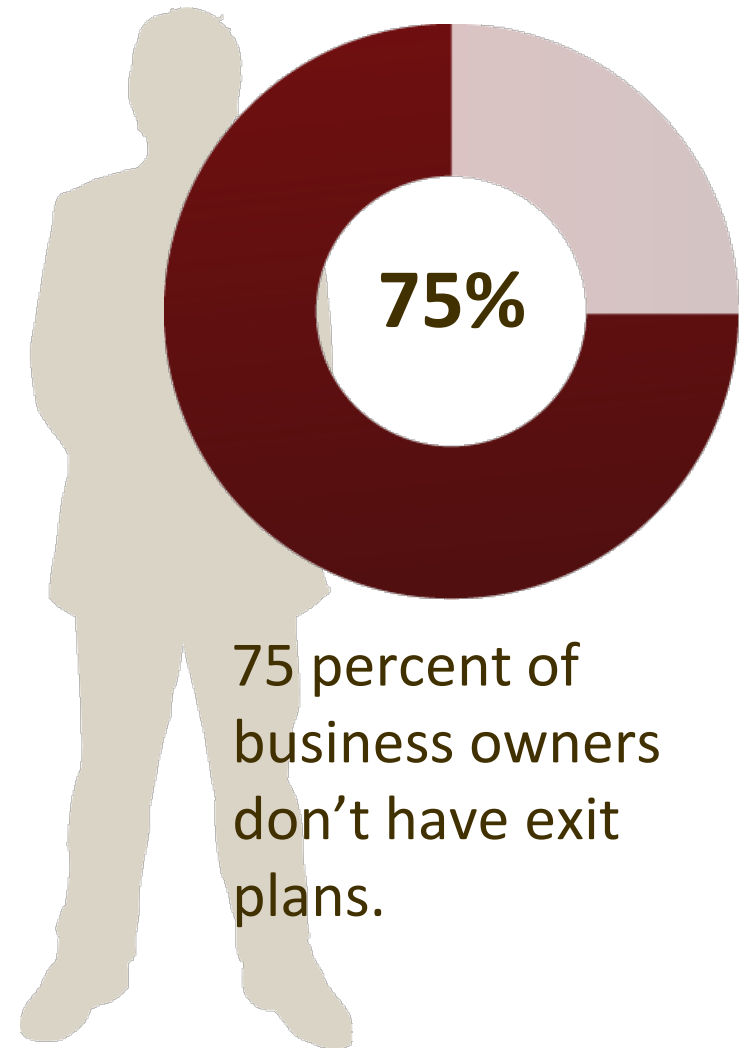
Why are we talking about succession?

Some Expert Estimations About Baby Boomers

Around \$11 trillion will be transferred from one generation to the next.

9 million of America's 15 million business owners were born in or before 1964.

Most business owners will wait until the 11th hour to do a succession plan or determine the value of their business.



Importance of Succession Plans

- The Company represents the majority of wealth or primary asset of most owners.
- Construction Companies are highly dependent on effectiveness of Owners - as Leaders - average age of owners \simeq 55*
- Sureties – concern over demographic tidal wave of aging baby boomer ownership generation in the Construction Industry!*
- < 50% Contractors have a formal management and ownership continuity plan in place*



- 80% of companies rate the quality of their succession plans as low*

*FMI 2011 Surety Survey/Special Report

Before we begin...

- Estate planning ≠ succession planning
- Retirement ≠ sale of the business
- Ownership ≠ management

Succession planning is about creating options and flexibility for business transition that align with your goals and dreams.

Helping Owners achieve their dreams . . . dreams are as unique as each of us



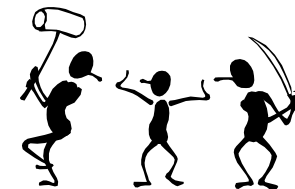
- Business
- Family
- Community
- Health
- Faith

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

Yogi Berra

Priorities of Many Owners' Succession Plan

- Avoid selling to third party
- Provide for welfare of Company and employees
- Incent key employees to remain with Company through an ownership stake
- Prepare next generation to carry on business – family and non-family
- Provide orderly transition in a cost and tax effective manner
- Maintain structure and transactions straightforward /simple
- Retain equity base necessary for bonding and banking credit capacity – Remove personal guaranties and indemnities
- Create lasting business legacy – continued growth and success of the business beyond active involvement of its Founders.



Challenges of Succession Planning

- Resistance, procrastination, avoidance
- Always something more urgent; focus on day-to-day threats and opportunities
- Focus on financial and tax matters – business operations and compliance
- Not in the ordinary course of business – once in a lifetime process
- 70% of family business transfers fail due to:
 - Lack of trust and communication between owners and/or family
 - Lack of development of the next generation of ownership/management. . . Leader(s)
 - ◇ Current generation entering a more complex business
 - ◇ Need for greater range of skills and capabilities than required by previous generation

*FMI 2011 Surety Survey/Special Report

Where Are You? Where Are You Going?

- Business lifecycles follow fairly predictable patterns
- Identify current and future challenges
- Sustainability: does the current leadership identify challenges and solutions in a timely and effective manner to impact value and create options for succession?



Translating to Enterprise Value

Environment:

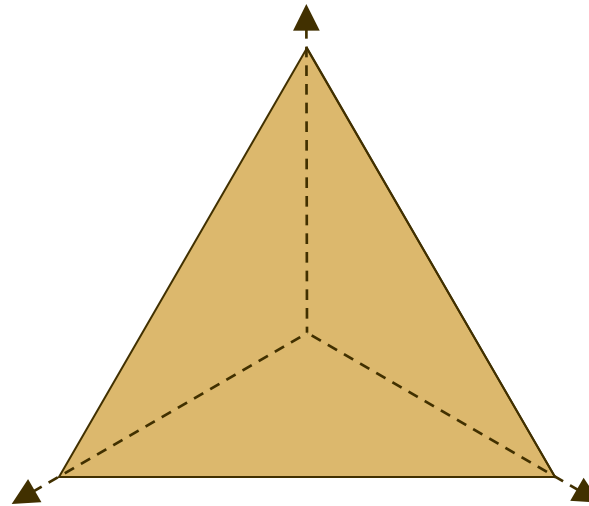
- Seller Motivation
- Access to Capital
- Economy

Financials

- Strong earnings/management
- Consistent earnings
- Working capital mgmt

Buyers

- Family
- Management
- Strategic Buyers
- Private Equity Groups



Markets & Customers

- Growing markets
- Concentrations and Specialization
- Key Resources/Capabilities
- Competitive Bid vs. Negotiations

Execution

- Management team
- Asset quality
- Information Systems

It is about more than just numbers...

Concentrations

*Market Demands
Consolidation*

*Workforce
development*

*Business
succession*

*Inflexible
operations*

*Availability
of capital*

Valuation of Operations

- Older Companies may have accumulated “excess” value
 - Equipment, real estate, other assets
 - Current operations may not generate necessary cash flow to support value and buy-out
- Plans to extract excess assets or value of Company?
 - Ramifications to Creditors?
 - Tax ramifications may be prohibitive
 - Distributions of assets out of S-Corporations – at FMV
 - Distributions out of C-Corporations - double taxation



Vision For Transition / Succession Plan

- No right or wrong way
- What does the owner desire?
- How to communicate your plans to those you trust
 - Ensure expectations are clear
 - Allow time for discussion, input and commitment by others
 - Demonstrate vision for ongoing success
- Allow for time and change – be flexible



Family Succession

- Treating all your children fairly – in/out of the business
- Providing for spouse in case “something happens”
- Decisions made now – that you can control and influence vs. letting others sort out
 - Lack of information or experience
 - Poor decisions by the wrong people
 - Fire sale to pay estate taxes
 - Decisions by committee
- Evaluate dynamics of change in control and critical decision making



Owners' Succession – Financial Conflicts

- Owners Needs
 - Personal Assets vs. On-Going Cash Flow & Liquidity Needs
 - Peripheral Operations, Hobbies, Incidentals?



Take Time To Plan. . .Anticipate

- Don't think to execute a Plan all at once in its entirety
 - Set interim goals/milestone that contribute to success of plan
- Owners continued role? Transfer of control?
- Owner/spouse long term financial plan-necessary to maintain lifestyle?
- Plan will likely change – circumstances change
- Non-financial desire of owners? Legacy, Employees, Community?



Surety and Bank Credit

- Managing partnerships between Surety, Bank and Contractor
- Credit signifies strength of contractor's financial plan
- Credit as a competitive differentiator in a field weakened by a 3 year recession
- What is your Company's bank and surety credit without the current Guarantor?





Topics

- Financing the transition
- Tax strategies
- Business structures

Financing

- Management Buy-Out Groups
 - Cash Resources?
 - Borrowing from Company
 - Borrowing from Sellers
 - Financing from Financial Institutions
- Who has the Risk Tolerance? Owners? Management?
- Be Realistic – Your Company finances the Purchase



Financing – Example 1

- *Facts: Company with two owners each owning 50% of business. Company enters into a stock redemption agreement with one of the owners to acquire 50% of the company.*
- Assume that the value of 50% of the company is \$750,000 and the company will use \$250,000 of cash and finances the balance.

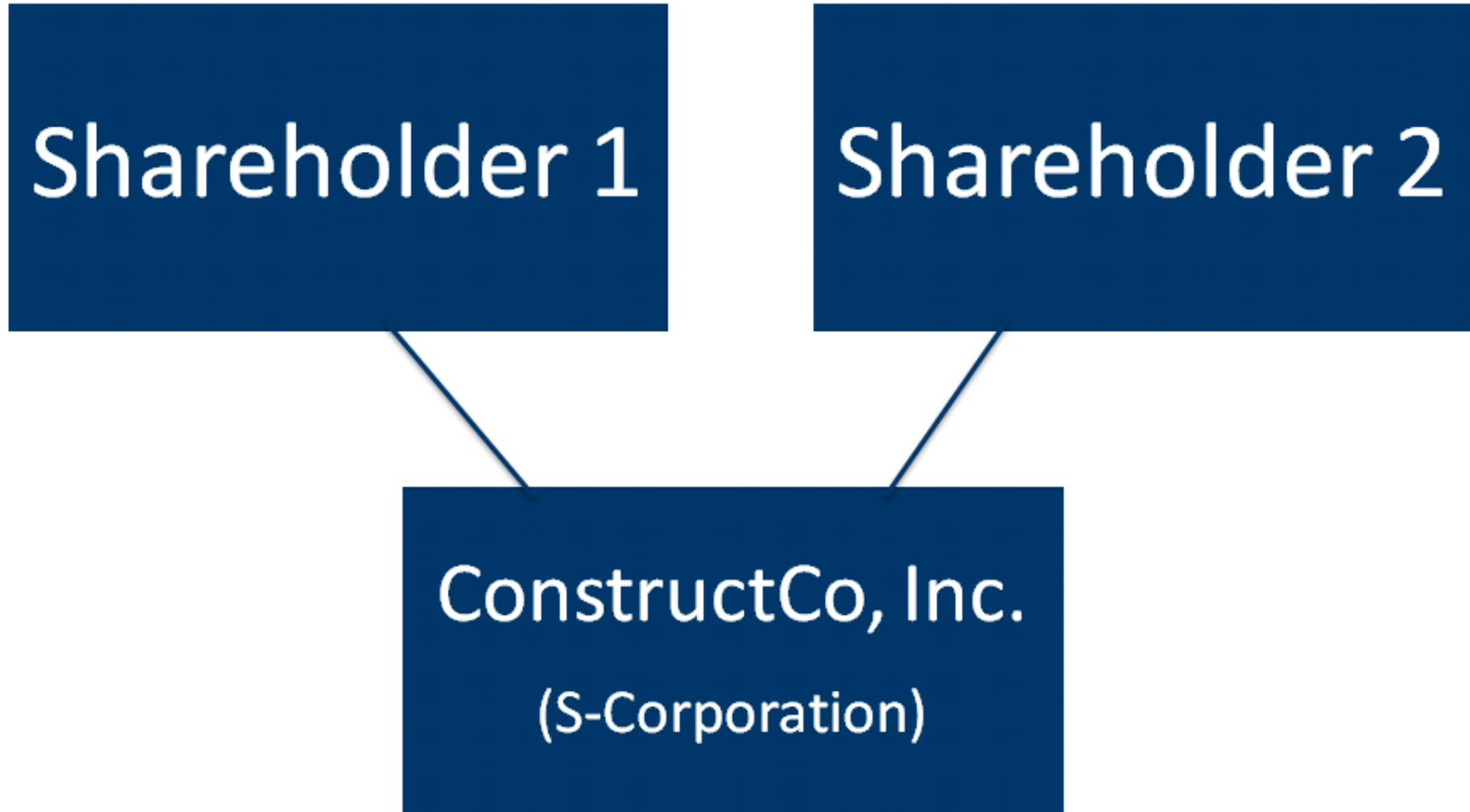
	(in 000's)		
	Before repurchase	Transaction	After repurchase
Current assets	500	(250)	250
Non-Current assets	1,000		1,000
Total assets	<u>1,500</u>	<u>(250)</u>	<u>1,250</u>
Current liabilities	250		250
Long-term liabilities	250	500	750
Equity	1,000	(750)	250
Total	<u>1,500</u>	<u>(250)</u>	<u>1,250</u>
W/C ratio	2.00		1.00
Debt/equity	0.50		4.00

Financing – Example 2

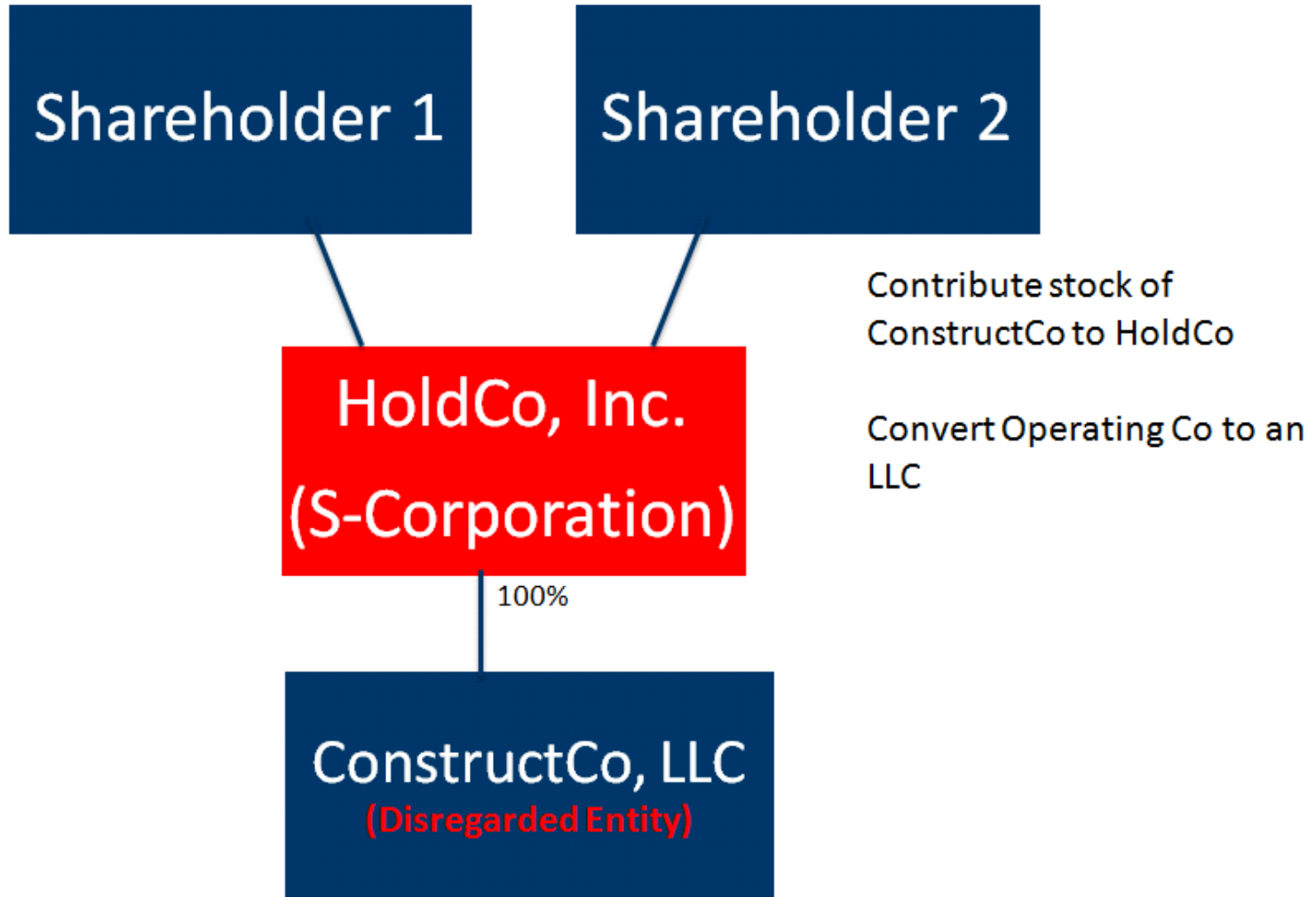
- *Facts: Same as previous example except instead of redemption agreement the two shareholders enter into a cross-purchase agreement whereby the exiting shareholder sells his stock for \$750,000 to the other shareholder under.*
- Furthermore, the company makes a distribution of cash after the transaction.

	(in 000's)		
	Before repurchase	Transaction	After repurchase
Current assets	500	(250)	250
Non-Current assets	1,000		1,000
Total assets	<u>1,500</u>	<u>(250)</u>	<u>1,250</u>
Current liabilities	250		250
Long-term liabilities	250		250
Equity	1,000	(250)	750
Total	<u>1,500</u>	<u>(250)</u>	<u>1,250</u>
W/C ratio	2.00		1.00
Debt/equity	0.50		0.67

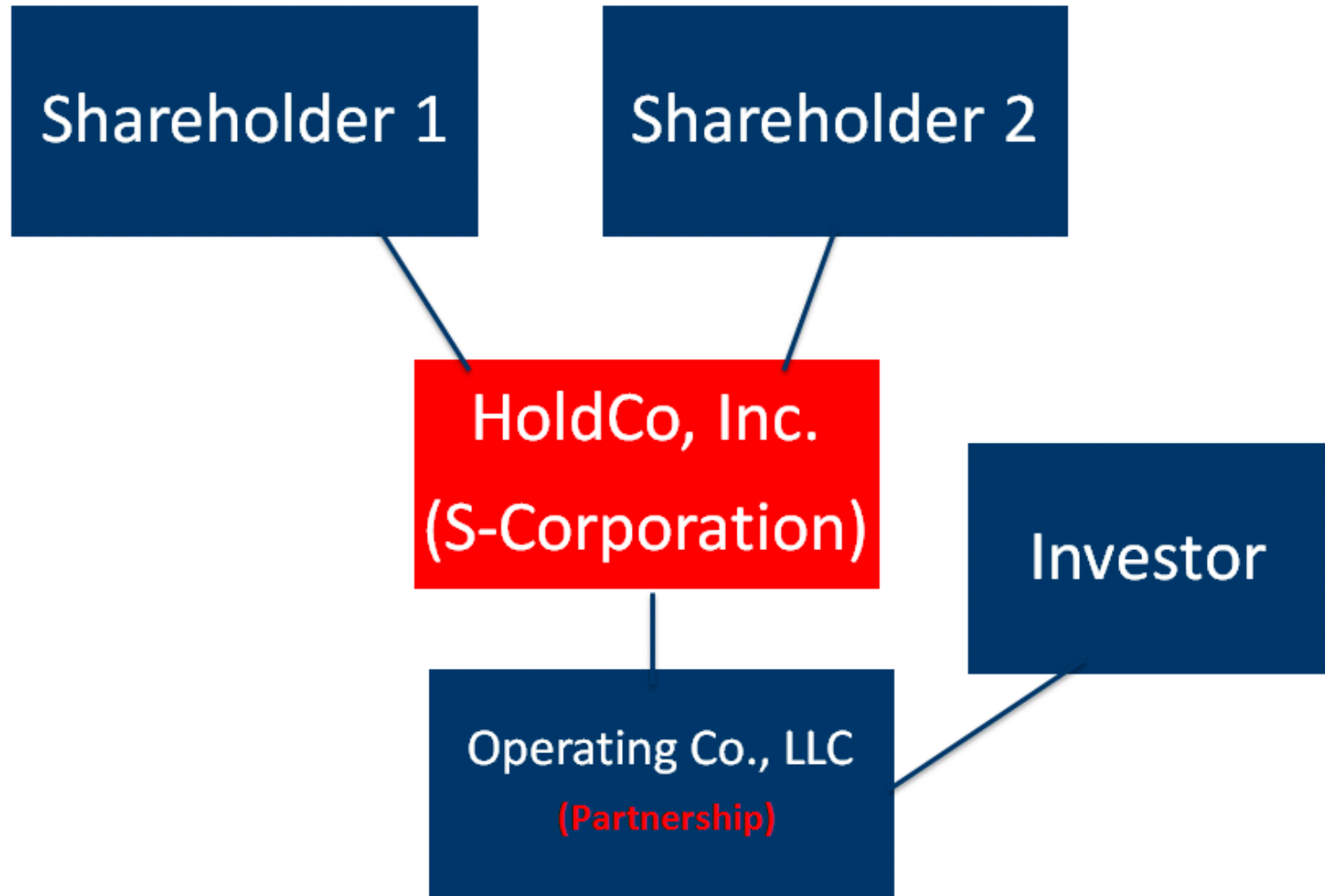
Financing – Example 3



Financing – Example 3 (continued)



Financing – Example 3 (continued)



Tax Consequences / Efficiencies to Succession

Estate and Gift Taxes

- 40% Federal rate, \$5.25 million estate/gift exemption
 - To increase to \$5.34 million in 2014
- Individual “portability” for unused exemptions; \$10.5M/Joint
 - Will be \$10.68 million in 2014
- Annual gifting exclusion of \$14,000
 - Husband/wife – gift-splitting can achieve \$28,000 (or \$56,000 to a couple)
- Techniques now to “freeze” asset values

Tax Strategies – Financially Effective Transfers

- Discounts on stock value – Provides flexibility in transfers, sales and gifting
 - Lack of control and marketability
 - Discounts in excess of 40%
 - Focus on <50% ownership and non-voting rights
 - IRS focus on eliminating discounts in family transactions



Tax Strategies...continued

- Grantor Retain Annuity Trusts (GRATs)
 - Provide methodology to transfer significant value at deeply discounted amounts
- Intentionally Defective Grantor Trusts (IDGTs)
 - Treated as a gift/sale for Estate Tax purposes, but not for Income Tax purposes
- Deferred Compensation Plans
 - Disassociate with stock transfers/gifts
 - Tax efficient to Corporation – tax deductible when paid vs. stock redemption
 - Secure owners/spouses financial and personal needs in defined manner over time



Business Structures

- Corporations may lack flexibility to effect most financially effective and efficient ownership transfer
 - C-Corporations – double taxation
 - S-Corporations – based on ownership and no special preference to any owner
- LLC's allow for greater flexibility and creative solutions



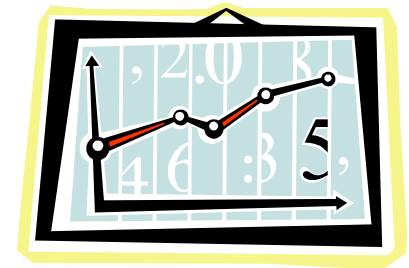
Business Structures - Continued

- Restructure operations with a “drop down” LLC
 - Drop entire operations into newly formed LLC – wholly owned by Inc.
 - Existing ownership continues to own Inc. and other non-essential / operating assets
 - Use of LLC as platform from which restructured LLC takes place
 - LLC preferred returns and disproportionate distributions effectively freezes value of old Corporation
 - Allows new ownership group to slowly build value through related management LLC



Overview/Summary

- Focus on developing Managers into Leaders
- Valuation considerations impact successor plans – Understand the concepts of valuation and impact on your Company and Plans
- Communicate plans with those you trust – soon and often
- Anticipate the impact succession plans have on surety and bank credit
- Realize there are tax strategies that favorably impact ownership transfer and succession plans
- Plan to integrate estate and personal financial planning
- Know that organization restructuring can:
 - Mitigate current tax impact to current owners
 - Allow successor management to begin to build financial strength and value



When/How will you be comfortable in relinquishing control?

Allow for time and anticipate change to effect your plan – be flexible



Questions?

Thank you



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