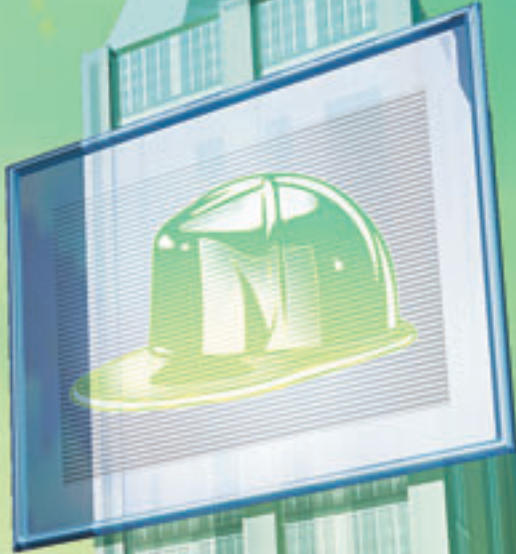

By Deirdre R. Schwiesow

CHOOSING GENERATION

NEXT

When it's time to pass the torch of leadership, will your firm **be ready?**

Losing one or more key principals, either through retirement or an unexpected death or disability, can be disastrous for an engineering firm if the company hasn't formalized an ownership transition plan. Fortunately, says Colvin Matheson, managing director of the Arlington, Va., company Matheson Financial Advisors Inc., "With the right planning, business succession can be managed quite well."



- WILLINGNESS
- LEADERSHIP SKILLS
- ABILITY
- SKILL SET

“Founding owners wear many hats. If you are the key person, you have to start—five to ten years before the transition—taking off those hats and letting other people wear them. You may have to look at the 30-something, high-potential people to find that entrepreneurial spirit.”

— SANDY BLAHA
BLAHA ASSOCIATES
PERFORMANCE CONSULTING



The different options for ownership transition depend on factors such as the size and makeup of your firm and how far in advance you are able to plan. However, almost any plan is better than no plan. “Most people are so involved in day-to-day activities and projects that they really forget about planning,” says Mike Lucki, Americas director of engineering and construction for Ernst & Young. Lucki adds that he’s seen companies face “horrendous challenges when leaders feel like they’re immortal and haven’t identified their successors.”

Generally speaking, there are two primary components to the business succession process: identifying and cultivating a

new leader or group of leaders, and executing a majority stock transfer. Lowell Getz, a Houston-based independent financial consultant to architectural and engineering firms, emphasizes “leadership and ownership of the firm go hand in hand. Early planning is really important—identifying the key individuals in the second tier that could move up to the first tier. You need to have a plan in place that allows these employees to buy in as soon as you identify them as future leaders.”

The Leadership Development Challenge

“Transitions falter because they don’t develop the next generation of leaders in time,” Matheson says. “It’s not enough to have good engineers. You have to go beyond technical capacity into marketing, finance and accounting, human resource management and so forth. [Maybe] 10 percent of the firm [has these leadership skills] and has the potential to grow the firm. So how are you going to motivate and keep those people?”

For Ernst & Young clients, Lucki says, part of the process involves looking at the key people within the company and evaluating their skill sets. “You need to find someone within the organization who understands the culture,” he says. “Plus you have to have people who are willing to invest their future net worth into the company. Usually, you’re financing the sale to your management team based on their future profits.” For midsize firms (\$20 million to \$50 million), he adds, “the opportunity to find the people internally to take the reins is very viable.” At smaller

companies, however, it becomes more difficult.

Grooming future leaders can be another problem. Sometimes principals “have trouble letting go, and then the individuals who have any ambition are going to leave, and the owner will be left with employees who can’t get work anywhere else,” Getz says. “Also, I find that some second-generation people are risk-averse and reluctant to step up to the plate. If the second generation is composed of non-entrepreneurs, then the owner has no choice but to look elsewhere.”

Sandy Blaha, president of Blaha Associates Performance Consulting in Denver, an architect/engineering leadership development and transition specialist, agrees that finding the best successor can be a challenge. “Founding owners wear many hats,” she says. “If you are the key person, you have to start—five to 10 years before the transition—taking off those hats and letting other people wear them. You may have to look at the 30-something, high-potential people to find that entrepreneurial spirit. Engineers can be labor decisions, so the day the key decision makers walk out, there has to be somebody who has enough confidence and support to take their place.”

Ownership Transition Alternatives

After identifying your goals and future leaders, you can decide what transition plan works best for your firm. “There really are only four options,” says Hugh Rice, chairman of IMI Corp., a management consultancy based



in Raleigh, N.C. Company owners can “shut the firm down and liquidate it, they can transfer the business to the family, they can transfer the business to employees or they can sell it to a third party.” Of these options, transferring the business to the employees is generally preferable, though Matheson notes that selling the company externally “can create opportunities for employees if it’s done right.”

But transferring ownership internally to employees has its challenges—particularly in the event of a tragedy. “There has to be an estate emergency clause in the event of the death of the owner—hopefully a policy that buys out that owner’s stock—so that the company can continue

“A lot of ownership transitions get thwarted because they don’t develop the next generation of leaders in time.”

—COLVIN MATHESON
MATHESON FINANCIAL
ADVISORS, INC.



to run without the family stepping in," Blaha explains.

A planned buyout over time, Rice says, "is more difficult, because you don't have life insurance to fund it, so it has to come from corporate funds." One option is an Employee Stock Ownership Plan (ESOP), a retirement plan that allows companies to use pretax dollars to buy out significant blocks of stock. Because ESOPs require a valuation consultant, they cost \$10,000 to \$15,000 per year to run (in addition to record-keeping costs and a setup fee of \$40,000-to \$60,000), and, therefore, are generally appropriate only for companies with more than 40 people. "If your firm is large enough to have an ESOP, I strongly urge that the ESOP only has a minority interest in the firm," Getz advises, so that "the movers and shakers have a majority interest."

However it's done, Rice says, "You want to get the larger percentage of the stock to [the future leaders], and a smaller percentage in the hands of the key technical people. Junior employees generally don't have the money to buy large chunks of stock, so we have to help them get the money through stock bonuses, or [enable them] to buy the stock at a discounted value."

In order to get the stock to the junior employees, Getz explains, "A firm has to be financially able to make the transfer, because basically the funds have to come from the firm itself. Even deferred compensation plans depend on the financial health of the firm. If you've delayed this process too long, you may need to arrange

a bank loan, with the stock as collateral."

The big issue when arranging a leveraged buyout is the competing interests of the buyers and sellers. "In a professional service firm, you have buyers who have been with the company for a long time and want to buy stock at a discounted price," Matheson explains. "In the meantime, you have founders who have reinvested in the business, so they want as high a return as possible. Often the attorneys get involved and write very onerous buy/sell agreements, which a prudent investor probably would not sign. Since the value of the business is based on the future cash flow, the owners need to ask themselves, 'What happens to the value of the firm if we lose our second tier because the price is too high?'"

Matheson notes that valuation of the firm is not just a matter of book value—"an engineering firm really has a lot of intangible value. So what's needed is a holistic perspective that encompasses the business and the human aspects of what you're trying to accomplish." And that circles back to the importance of identifying a future crop of broadly skilled leaders early on.

Ultimately, Getz says, "There needs to be trust between the buyers and the sellers. The sellers have to trust the second generation is going to perform like they said they would. And the second generation needs to trust that the leaders will hand over power. You can't do an effective transition if you don't have that trust." ■



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Langen, Inc.
May 2004

Financial advisor
to CGvL in
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HDR, Inc.

CCS Planning &
Engineering, Inc.*
October 2003

Financial advisor to
CCS in acquisition by
T.Y. Lin
International, Inc.

AgRotors, Inc.*
August 2003

Financial and valuation
advisor for the 100%
acquisition by the
AgRotors ESOP

TBE Holdings, Inc.*
February 2003

Financial and
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for the
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* Colvin Matheson initiated, managed, & provided valuation services for these clients while leading the financial advisory group of another consulting firm.

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