PASSING THE B

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As baby boomers continue to retire, ownership transition plans are more important than ever

By Stacy Collett

Thirty years ago, Jeff Asher joined KPFF Consulting Engineers in Agoura Hills, California, as a bright, promising structural engineer. From the get-go, Asher was nurtured, mentored and treated as a valued worker. Over the years, he acquired more responsibilities, became an integral part of the business and eventually acquired leadership and ownership responsibilities to grow the firm. >>

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Today, Asher is chairman of the KPFF board. He takes pride in the contributions he made that helped grow an 85-person firm into 1,000 employees, but he knows that a new generation of talent must eventually take the helm. In 2011, he voluntarily stepped down from his position as president to make way for new leadership and began the process of divesting his ownership in the firm—all part of KPFF's ownership transition plan.

"I can't say that every day is perfect, but I'm finding the right way to be productive and constructive," Asher says. "What really matters is that we see that the firm continues to be successful."

Why Now?

Many A/E firm leaders such as Asher are reaching that same pivotal professional moment. Baby boomers in particular are entering ages where transferring ownership of firms they helped grow is paramount. Industry experts believe, however, that a large percentage of midsize A/E firms have ownership profiles that don't effectively consider future ownership transition. Many firms are considered top-heavy with principals in their 50s and 60s who own a large majority of the firm's stock. There simply aren't enough 30- and 40-year-olds ready, willing or able to buy out these senior owners in a coordinated process that won't result in a decade long (or more) sell down.

Getting buy-in on an ownership transition plan is not always easy. Greed, ego and fear often keep senior owners from relinquishing power, experts say. They may be unwilling to share client relationships, knowledge and other sources of power in a professional practice, which prevents younger people from assuming real ownership and leadership of the firm. If there is no transition plan in place, younger employees might not be ready to assume leadership roles when owners decide to retire, or they can't afford to buy shares in the firm at the prices set by owners.

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A successful transition plan balances the interests of sellers, buyers and the business; but time is ticking, and the actions that owners take today will determine the fate of their firm. One of the major mistakes many firm leaders make is waiting too long, says Bill Mandel, a partner at law firm Fox Rothschild LLP and co-author of the book, *Essentials of Ownership Transition*. "It takes time for people to be developed and mentored" into leaders, he says.

Considering today's aging owner population, Mandel says it's more important than ever for A/E firms to have an ownership-transition plan. "If the firm wants to succeed in the future rather than just closing the doors when the owners retire, they have to plan for continuity."

But there are other benefits to having a transition plan. It can help firms accommodate growth by promoting more leaders to manage people. It can also help attract and retain talented staff by offering up a piece of the pie. This new generation also helps the firm keep in touch with the marketplace, Mandel says. "Younger people understand what younger clients want."

Timing is also important when it comes to cash flow, which allows firms to afford an internal transition plan, says Matt Fultz, vice president of Matheson Financial Advisors. Fultz recommends that owners begin planning 10 years ahead of a transition. "Business is cyclical. A number of firms sold or went through an ownership transition process prior to the last recession at values that were supported by pre-recession earnings, and when revenue and profits fell, those plans became unaffordable," he says. It takes three-to-five years of current level earnings, on average, to transition the ownership of the business. "That's why we like to have a longer runway," he says.

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The Method

Owners usually choose to transition either through a management buyout (MBO) plan, which allows for future growth from within the firm's ranks, or by merger or acquisition, which relinquishes control to an outside buyer.

Owners looking for a quick and lucrative return may choose acquisition because the firm's value can be as much as 30 to 50 percent higher than its value in an MBO, Mandel says. "But the reality is not all firms are sellable." Firms may be more likely to develop an ownership transition program than they are to sell to an outside party. The founders may get less money by selling to the leadership candidates in an MBO. "If things work out well, the firm prospers, and they can realize value through compensation."

An MBO-based ownership transition plan begins with establishing a commitment by owners to facilitate a transition. "That's not just ownership transition but a leadership and management transition as well," Asher says. "Then there's the process of really forcing yourself to live that commitment on a regular and ongoing basis. We view it as a cultural value."

In the midst of the economic downturn, many internal transition plans stalled, Fultz says. Values were down, financing was generally unavailable and owners were unsure of the future direction of the business, which made Employee Stock Ownership Plans (ESOP) appealing. An ESOP is an employee benefit plan where shares are held in a trust that vests in the company for the benefit of the employee participants. Today, even with the slow recovery of the last two years, many young engineers have not regained their buy-in risk appetite, so many firms continue to offer ESOPs.

"You're seeing more firms considering an ESOP than before," Fultz says. "If that level of commitment isn't there, but the company wants to remain privately held and not sell to the third party, then an ESOP is an effective tool to do so. [However] it's not right for every firm."

For instance, if a company is not employee-focused, then there is a risk that the value of an ESOP won't be realized, Fultz says. Firms are more likely to find ESOP success if they're "essentially running the business like an employee-focused firm, and it's part of your culture." An ESOP does not, however, help identify and groom future leaders, he adds. Fultz says some firms do add an ESOP as part of a combination of strategies.

30% to 50% higher

A firm's value in an acquisition vs. a management buyout

Identifying Leaders

One of the first steps in any MBO transition plan is to identify the next generation of leaders. How do you discover those diamonds in the rough and then keep the pool of talent coming to continue the process?

Founders often have a good idea of their future leaders, but many use outside consultants to vet candidates. "It's done in a non-threatening way," usually by pointing out that "the firm is going to be doing some strategic planning and we want your views on the firm," Mandel says.

Surprisingly, most founders aren't afraid to pick someone who's been there a very short time if they're very impressed with that person. "I don't recommend rewarding somebody with ownership just because they've been there for a very long time, especially if they're not owner material," Mandel says. "Reward them another way."

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GLENN BELL
SIMPSON GUMPERTZ & HEGER

Vetted candidates usually receive a terms sheet that lays out exactly what they would receive as an owner. This paper usually includes their base compensation and explanation of the owners' bonus pool, which is typically based on firm profits and individual performance.

"I strongly recommend they also get a client development budget to go out and recruit potential clients," Mandel says. "It could be just $2,500 a year, but they've got to use it." The bottom line: "The better you perform, the more you're going to get," he says.

Buy-in also has to be affordable for young leaders. "Most of these buyers aren't sitting on large amounts of cash, so they're going to rely on compensation they've earned through their employment with the company," Fultz says. "For instance, instead of just salary and bonus, it's salary, bonus and some distribution of firm profit."

Be Flexible

Over the years, plans should remain flexible to accommodate changes in business climate, economy and ownership makeup.

About 10 years ago, engineering firm Simpson Gumpertz & Heger recognized that a large portion of company shares would be coming up for sale as the firm's baby-boomer owners neared retirement. "At that time we had a share sell-down agreement that stretched over five years, but we extended that five years early to 10 years to spread that transfer out, so there wasn't an impractical concentration of shares coming on the market too soon," says CEO Glenn Bell, who has been with the firm for 40 years and the CEO for 22 years. Baby-boomer owners turn over 3 to 5 percent of ownership of the firm each year. "It's smooth, sellers and buyers can plan for it, and it makes the whole transition very practical."

When it comes to ownership transition plans. "Resistance is normal—it just takes a lot of work and a joint commitment to making it happen," Asher says. "Err on the side of making a plan sooner rather than later. There's always an excuse to not move forward, but that's destructive if you're interested in perpetuating the firm." ■

Stacy Collett is a business and technology writer based in Chicago, Illinois.