My Key Employees Want Stock...What Do I Do Now?

William G. Hill

FMI Corporation

5151 Glenwood Avenue
Raleigh, NC 27622
Tel: 919.787.8400
Fax: 919.785.9320

55 Madison Street
Suite 410
Denver, CO 80206
Tel: 303.377.4740
Fax: 303.377.3535

5301 West Cypress
Suite 201
Tampa, FL 33607
Tel: 813.636.1364
Fax: 813.636.9601

www.fminet.com

Extending stock ownership to key employees is a decision that most business owners face at one time or another. The following are some important considerations to examine before moving forward.

It is a familiar scene. A key employee comes into your office and informs you that he is being actively recruited by a competitor. The money is about the same, but the other firm is offering stock. You are well aware that this employee has sought ownership in your organization for quite some time but, for a variety of reasons, you have resisted moving forward. What should you do?

This scenario, or something similar, occurs in closely held, private organizations all too frequently. Often, owners react rashly, doing something that they regret down the road. This is why FMI counsels owners to examine their long-term strategic plans before taking any action; anything you do now will likely have far-reaching consequences. For example, once you offer an employee stock, you have the potential to turn the organization's reward system upside down. Employees want to know how they can become shareholders and an owner should be able to objectively answer the question. The following are some questions to consider:

- Why is stock ownership important to this employee? What are the employee's long-term employment goals and is this employee key to the company's future?
- Are there other employee-retention programs that can be put into place for this employee?
- When do you want to exit your business and how (external sale or internal transfer)?

Depending upon the situation, you may find these questions difficult to answer. Also, you and your key employee may be reluctant to discuss this in an open and honest manner. If this is the case, then you may want to consider hiring an outside consultant who can view the situation objectively.

Once a dialog has begun, do not be surprised if one of the key reasons the employee desires stock is because he wants more "say" in the business. This frequently occurs in privately held, owner managed companies because the distinction between ownership and management is not always clear. Simply put, the employee may think that in order to have any influence in the direction of the business, they must have a share in ownership.

This is an erroneous conclusion, however. In properly run organizations, the role of an owner should be quite distinct from that of a manager. For example, I have an "ownership" share in Ford Motor Company but I cannot go sit down in the executive offices of Ford and tell the company how to manufacture their trucks. A construction organization should be no different. To further clarify this point, let us look at the various functions that fall under the role of an owner as well as those that fall under the role of a manager:

Functions that fall under the "Owner" Role

- Decisions about where to employ capital
- Securing management talent to engage capital
- Establishing strategic goals and the accountability of management personnel as well as determining management's reward for success
- Conducting a periodic review of investment performance and deciding when to extract capital and deploy elsewhere.

Functions that fall under the "Manager" Role

- Establishing an action plan to achieve goals
- Creating processes, procedures, and structure for business execution
- Securing human and physical assets necessary for the business
- Tracking business performance and reporting routinely to shareholders.

In reality, the "say" power in a business should exist in the management role. By teaching this simple and appropriate distinction, they already have a "say" in the business.

Some employees are interested in stock ownership because they would like to share in the long-term financial rewards of the company. This is a good scenario for three reasons. One, the employee truly understands the concept of ownership. Two, this indicates that the employee wants to stay with the organization for the long-term. And three, the employee's goals are aligned with those of current shareholders.

Another key question owners must answer in this situation is when and how they want to eventually exit their business. If you are within 15 years of your projected retirement date, it is not too early to start considering whether to seek an external sale or make an internal transfer of ownership to management or family. On average, it takes seven to 12 years to sell 100% of the stock in a closely held construction company, assuming it is normally capitalized and has average industry profitability. Therefore, the planning horizon for internal transition needs to be long.

If your goal is to exit the business via an external sale, you should be especially cautious about extending stock ownership. Down the road you may not want to inform your key employees that you are in discussions to sell the company, but if they are shareholders, you might not have that choice. Furthermore, your fellow shareholders may not want to sell the company, which could further complicate matters.

Finally, if you decide to extend stock, you will need to consider how much stock you want to extend. There are no steadfast rules here; however, it is important that the amount of stock be "meaningful." For example, extending 1% ownership in a company with shareholders' equity of $1million will mean that the employee has the equivalent of $10K of ownership value. This may not be a powerful motivator in the long run. Conversely, if you extend 25% ownership in the same $1 million equity company, you may not be able to afford it. You also need to make sure that you have sufficient "extra" stock in the event that you want to extend it to other employees at some future point.

You will also need to consider how you want to extend the stock to employees. A variety of methods can be used, including issuing new stock in the form of a stock bonus, selling some of your shares, or by using stock options. The most important aspect is that employees must pay for at least a portion of the stock out of their own resources. Simply "giving" stock without some sacrifice in return will diminish the implied value of ownership and consequently the stock may lose some effectiveness as a retention tool.

Once you have examined these key questions and issues you should be able to determine whether you want to extend ownership.

Will Hill is a senior consultant with the FMI Mergers and Acquisitions Group. He can be reached at 303-398-7237 or whill@fminet.com.

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