Succession management and ownership transfer are critical topics in today’s engineering and construction (E&C) industry. As with all business sectors across North America, the baby-boom generation is exiting the E&C industry at an accelerated rate.

Company leaders need to ask themselves the questions: Who’s going to lead and manage my firm? Who’s going to take over ownership? Do I have the right people in the right seats? These are just a few of the many questions that industry participants should be addressing to perpetuate their businesses into the next generation.

What’s unique about our industry is that over 99% of the firms are privately owned. For most of these companies, the option to transition from one generation of leaders and owners to the next is rather limited. Many of these firms must turn to their internal workforces to transition leadership and ownership over time (through some form of internal ownership transfer, for example). The hard reality is that only a small percentage of construction firms are salable to a third party at a reasonably acceptable price and terms. Because the sale option is not on the table for the majority of E&C firms, we have to look more carefully at internal transfers and succession—a prospect that’s not always easy to tackle when owners assume that their firms are worth more than their employees can afford to pay.

We encounter companies with ownership and leadership transition challenges daily. So, for this Quarterly issue, we decided to share some of our best thinking around these topics and provide key insights into the most common industry challenges and opportunities. It's time to raise the conversation that we’re having as an industry on this subject since most companies are already behind in their planning and transition processes.
The firms that are most successful transitioning into the next generation—be it the first generation transitioning to the second or a multigenerational handing over the reins—are the ones that take a proactive approach to the issue. These firms also have a very clear idea of where they’re going as an organization, and they’re very proactive about developing the leadership and management teams that they need to get them across the finish line (and beyond).

Time works against you when it comes to transitioning ownership and leadership of a privately held engineering or construction firm, with 10 years being the optimal start-to-finish completion period for a successful ownership transfer. So whether you run a small trade contracting firm or a billion-dollar, multidivisional family business, time is your enemy. By taking the time to develop robust leadership, effective management programs and an ownership transition process that works for everyone, E&C firms will be well-braced for success for years to come.

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At its core, succession is a deeply emotional process for leaders. For seasoned executives, it often requires reflection and insight into one’s career journey and legacy.

Perhaps not surprisingly, given the weight of the process, leaders avoid this necessary introspection, in favor of the more tangible decisions needed to transfer a business to the next generation. For example, leaders often dive into identifying and executing on equity transfer techniques, buy/sell agreements and organizational structure changes while neglecting a critical part of succession needed to guide the organization to lasting success beyond transactions: a continuity mindset.

We define a continuity mindset as “a framework of thinking that informs and guides the many critical decision points in a transition.” This article sheds light on the importance of developing and utilizing a continuity mindset in today’s business environment, where succession is often approached hastily or completely overlooked.

The Common Mindset
Through our research and work with E&C firms, we often observe senior leaders thinking more deeply about succession when the process coincides with specific milestones. For example, most senior leaders start reflecting about succession when they are considering transferring ownership and transitioning into retirement. Transferring ownership generally means that owners choose among three options:

1. Sell the company to internal members (employees or family members)
2. Liquidate the business
3. Seek merger or acquisition options
Since it can be challenging to liquidate and still yield rewarding financial benefits, E&C leaders generally feel that selling internally or using mergers and acquisitions is the more desirable choice. The viability of these choices also depends on the quality of the organization’s current and future leadership.

Like most talent-related decisions in the E&C industry, succession decisions are often based on instinct and tend to be highly emotional, especially when leaders hope to pass the business along to a family member or trusted partner. These emotional factors can cloud the use of facts and data to pick the right successor to lead the business into the future. As a result, companies will often promote people before they are ready, pick the wrong successor, or lose talent due to perceptions of a poorly handled succession management process. All of these hurdles can be avoided through the use of a well-thought-out, fact-based approach to succession, and one that incorporates the continuity mindset into the equation.

In most situations, a bench of star performers or high potentials will fall short on the succession plan. That’s because, while these candidates may represent top talent, they may not be aligned with the skills and competencies needed to lead the company to success in the future. Furthermore, winning the battle for talent means having the right people in the right place and at the right time in the first place, not simply having “lots of great talent.” To overcome this perception, organizations must fine-tune their talent strategy for key positions and prioritize succession management efforts by building the bench for those specific roles, since they will serve as important business differentiators.

Succession is often viewed as simply picking a successor for the top leader (the CEO or president); the focus is usually superficial and emphasizes mostly replacement. However, good succession goes beyond putting a new leader in place. It also includes the conservation of a company’s culture and values, the identification and development of future leaders for all key roles, and a smooth ownership transition. This type of transition is key to a company’s success and requires a well-thought-out process to ensure that all of the pieces are in sync.

The effective organization makes succession decisions based on facts and data, focuses its attention on strategically important positions, and takes a holistic and proactive approach when looking at the organization’s succession requirements. Embracing a continuity mindset will help prepare the organization for effective succession management and ownership transfer.

The Continuity Mindset

Embracing the continuity mindset means establishing the necessary groundwork to prepare the organization for effective succession, including both leadership transitions and ownership transfer. It incorporates both data-and fact-based decisions that serve the company’s long-term interests, even when those decisions are immediately unpopular or misunderstood. This goes as far as setting the leader transition in motion and seeing it through to the successful integration of individuals in their new roles, including the preservation of values and culture. These steps must be carefully orchestrated and then revisited whenever the strategy changes. Ultimately, individuals who possess continuity mindsets see leadership and ownership of a firm as a privilege and an ongoing responsibility to steward the organization for future generations.

Clarity of Intent Is Critical

Our decades of experience guiding engineering and construction (E&C) clients through transitions have shown us that leader clarity of intent is crucial. Complete clarity of vision around the future company (e.g., the intent to maximize wealth) will drive a much more coherent and unified transition than an owner who speaks of continuity (but is unwilling to act from a continuity mindset because his or her focus is on something else). Effective leaders do not take continuity lightly and recognize that following that path is a conscious choice that takes place with a full understanding of the requisite courage, humility and long-term focus.
FMI’s Peak Succession approach (see Exhibit 1) is built on a continuity mindset approach, which, on top of picking a successor, incorporates factors such as ownership transfer, preservation of the company’s culture and values, strategic identification of critical positions to replace, and fact-based selection and development of successors. In this approach, leaders must move away from gut instinct, intentionally create a wider pool of talent to meet tomorrow’s challenges, and view succession as a system and organizationwide process versus a one-time reactionary decision.

**Continuity Mindset in Action**

There are several steps that companies can take on the path to good succession planning that incorporate a continuity mindset. They are:

*Think Strategic Roles, Not High Performers*

After establishing a clear vision for where the organization is going (part of essential groundwork), the succession process begins with the identification of strategic positions. This allows companies to focus on identifying every role that has a major impact on the company’s strategy, rather than just looking at those roles facing imminent need for replacement. At this step, taking a continuity mindset means looking at the positions, not the people. When thinking about a business’s strategic positions, the primary focus should be on the roles that directly impact strategy and not necessarily on the company’s current star players. Take Joe, a current CEO, for example. Due to retire in three years, Joe has successfully made the company into a leading, national player, but he lacks international experience in an era where the company’s new strategy includes major international development. While replacing Joe, we need to tailor the future CEO role to the new strategy and ensure that we hire for strategic fit. Instead of looking at the succession process as cloning Joe, for example, the company needs to look at the broader skill set required for the new CEO role in this global context.
In these situations, executives typically pay attention to high performers (A players) who come to mind when they think about getting something done. While those individuals may seem like the obvious choice for today, they may not produce the optimal company results in the long term. Focusing on the latter helps organizations maintain objectivity and keeps the focus on what roles will contribute most to future strategy (instead of who’s performing well right now). After all, the envisioned future of the company should bring new challenges that may require a different set of skills. That’s what business is all about, right?

Now it’s important to note that this process also requires a shift of focus—from A Players to A positions—to identify roles that are critical for organizational success and that need a succession plan.¹ This means identifying the roles that are key to driving and executing the strategy, and then identifying the individuals who are good fits for those positions. Of course, your A players might be the best candidates for these A positions, but the role identification should come first. (It is possible that given a shift in the competitive environment or changes in technology, looking outside the organization might provide a candidate who better supports a role of the future.)

**Take the Time to Identify “A” Positions**

There are two main criteria that differentiate A positions:²

1. **They have a direct impact on strategy**: A positions have a direct impact on the company’s ability to execute one or more of its strategic goals. These positions create value and contribute directly to an area that is a distinctive competitive advantage for a company. This implies that a company has clarity over its strategic capabilities—a measure that may incorporate various data points. In an organization that has customer satisfaction as a strategic differentiator, for example, these metrics can be used to identify which roles have direct impact in performance variability:

   - Existing customer satisfaction
   - On-time completion
   - Within-budget completion
   - Speed to resolution of customer problem
   - Performance in executing problem escalation processes
   - Annual recurring revenue
   - Net promoter score (percentage of clients recommending the business)

2. **They present great performance variability**: Along with having a direct impact on strategy, A positions typically present the potential for great variability in performance. For example, if a position is responsible for securing new clients, the potential for variability of performance is high. A person who performs above average can generate five to 10 times more revenue than a person whose performance is below average. Furthermore, these positions can also destroy value (i.e., losing client relationships in favor of competitors).

**Clarifying “A” Positions**

Once you’ve identified your firm’s strategic positions, you’ll want to develop a Peak Profile for each of those roles. Peak Profiles include role requirements (what you do), technical skills (what you need to know) and competencies (how you do it). While creating these profiles might seem intuitive and something easily developed by HR functions, E&C leaders tend to overestimate the importance of technical skills and background needed and underestimate the need for managerial, lead-

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ership and people skills required by key roles. The truth is, both are crucial, and technical experts moving into leadership roles rarely transition smoothly in absence of adequately developed people skills. The establishment of a Peak Profile plays a critical role in rigorously assessing and developing the pipeline of potential successors for strategic positions.

### Criteria for Great Competencies:

- They align with organizational values
- They align with your vision for the future and your strategies for success
- They differentiate an average performer from a star player
- They should be concise and focused

Once competencies are established, the organization can make more objective and informed talent decisions, including:

1. Hiring individuals for A positions
2. Promotion choices for A positions
3. Readying individuals to transition into A positions by way of advanced executive development

### Evaluating an Individual’s Potential for an “A Position”

While many organizations use the gut instinct approach for successor selection decisions (see our recent article, “Finding the Right Leader: How to Disrupt Your Leader Selection Process”), the use of a structured approach is far more valuable for assessing candidates fairly and reliably. Assessment tools such as structured interviews and validated assessment instruments (e.g., The Hogan Battery, Pinsight Leader Simulation) are job-related and more accurate when it comes to capturing the level of individual proficiency competencies. Since competencies were identified for the Peak Profile as the key ingredients for success in a strategic position, assessment of these competencies is a useful predictor of leader performance.

### Readying Your Successor and a Broader Bench for “A Positions”

Once individuals have been assessed and their potential for a future strategic role established, the next step is to provide structured developmental activities. The activities will equip identified successors for their future roles; they will advance individual development and accelerate future leaders. Specific tactics for development in the context of succession are referenced in the Quarterly article, “The Growth Mindset: Developing Your Successors With Intention, Purpose and Personal Focus.”
Start Embracing a Continuity Mindset Today

Embracing a continuity mindset and engaging in a systematic succession management approach allow organizations to minimize the likelihood of the wrong individual being put in place at the wrong time. When positions that drive strategy are identified early on, and when the competencies for success in those roles are clearly defined, the organization will be well-positioned to develop and select the best-suited individuals for the job.

Effective leaders with a continuity mindset understand that for the organization to succeed, they must make hard choices that may be unpopular in the short term. Succession management and ownership transfer for a long-term win requires courage, humility and a long-term focus. This broad and proactive approach to succession management ensures that the right people will be ready at the right time to support effective transition, whether due to planned retirement or unexpected crisis. This systematic succession approach will make the greatest impact on the market. Having the best talent in the most strategic positions—and the bench strength to fill those key roles when the time comes—drives winning organizations.

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When companies adopt growth mindsets, those organizations are more readily able to identify and grow leadership potential in their employees.

A true asset in today's tight labor market, the growth mindset helps companies gain strategic advantage, win the war for talent, develop people who are both innovative and collaborative, and ultimately thrive in competitive business markets.

Largely reactive and nonintentional by nature, the engineering and construction (E&C) approach to leadership development is in clear need of a radical transformation. Leading organizations in our industry are beginning to use a more rigorous and systemic approach to leadership development, realizing the benefits of disciplined leadership development.

This pivot from fluid and reactionary leadership development to one that's both intentional and strategic parallels the industry's approach to safety nearly 25 years ago. Those organizations that applied structured processes, treating safety as a differentiating strategy and addressing it in a way that touched all levels of the organization, could reduce incidents and claims.

“The vast majority of leadership programs are set curricula delivered through classroom-taught, rationally based, individual-focused methods. Participants are taken out of their day-to-day workplaces to be inspired by expert faculty, work on case studies, receive personal feedback and take away the latest leadership thinking (and badges for their résumés),” writes Harvard Business Review's Deborah Rowland in “Why Leadership Development Isn’t Developing Leaders.” “Yet study after study, including my own, tells us the qualities that leaders in today's world need are intuitive, dynamic, collaborative and grounded in here-and-now emotional intelligence.”

In today's E&C industry, implementing a rigorous leadership development process will ultimately accelerate an organization's path to success. In this article, we'll outline the problems companies face when cultivating the next generation of leaders (versus how the industry has traditionally faced leadership development), and, conversely, how most effectively to manage them (i.e., how to think differently about leadership development to achieve strategic advantage).
We Just “Figured It Out”

When our industry considers leadership development, we often hear seasoned executives say that, when they transitioned into new roles, they “just figured it out” back when everything was “sink or swim.” While this may have been a baptism by fire, of sorts, with those executives learning fast, the same individuals are hesitant to throw future leaders into the deep end for these good reasons:

1. Putting people into challenging roles prematurely can create real risk for the business. At senior leadership levels, “developmental growing pains” can translate to real bottom-line impact to the organization.
2. Leaders may feel that relinquishing control and transferring power are emotionally challenging.
3. The pace of the business is greater than ever before, and there is simply not enough time for trial and error to be the sole foundational element of learning and growth.

To prepare future leaders to take the reins of one’s organization, current executives must apply leadership development methods that meet today’s standards while also addressing tomorrow’s needs.

Deep-sixing the “Sink or Swim” Mindset

Traditional leadership development often lacks a clear intentionality. More often than not, when an employee is promoted to a new role, he or she simply takes on the responsibilities in a “sink or swim” type of scenario. While there are many positive attributes associated with on-the-job training (OJT), utilizing this approach as the sole—or primary—learning method has many drawbacks, especially for acquiring leadership knowledge and skills.

For example, we have all witnessed junior employees who acquired poor technical skills and knowledge due to limited initial support and formal onboarding. We have also seen how, in absence of intentionality, successors can’t adequately gain critical leadership skills. At best, this approach slows down the successor’s ability to pick up on these skills. At worst, it results in poor leadership behaviors that can impact a company’s legacy, culture and bottom line. To avoid these traps, organizations should follow the three-step process described below and shown in Exhibit 1.

A Case of Successor Development:

**The Leader:** Newly promoted VP of operations

**The Context:** The organization was in the middle of a comprehensive acquisition strategy that required a greater aptitude on the part of its VP of operations.

**The Leadership Development Approach:** Leadership development was launched internally to accelerate the VP into his new role. The individual was told to attend classes on public speaking, time management and writing effectively as foundational steps for development.

**The Big Miss:** Though the training provided some value for the individual and expanded his knowledge (due to the individual’s lack of a formal education in business), these learning initiatives missed the immediate needs of the candidate and provided very little return on investment (ROI). Given the comprehensive acquisition strategy, the VP really needed to develop greater financial acumen, a deeper understanding of the business model of the combined organizations, and a means by which to remove costs from the business without negatively affecting schedule or quality of projects that were under contract. A clear link between corporate strategy and the required competencies of this key leader was imperative. In fact, in our view, more timely development in these key areas would have prepared the leader to address the immediate needs of his position.
Step 1: Make It Intentional
While most executives suggest that tomorrow's leaders aren't ready to take on tomorrow's challenges—and agree that this presents a strategic issue—very few actually lead and sponsor this process. Moreover, in the context of executive succession, this support must come from the company's leading executives (i.e., CEO, owner, president). This top-down approach ensures that the entire organization is onboard with the charge, and that it's not just being orchestrated at the individual department or manager level. Fundamentally, current executives must acknowledge their strategic roles in leader and successor development and implement processes that intentionally support the development of future generations. Moving away from on-the-job training as the sole learning mechanism, for example, ensures that leadership development is accelerated and reduces the likelihood of leadership misfire. Methods could include executive coaching, competency-based executive workshops, strategic mentoring relationships, clear action and stretch assignments or rotational assignments. Whatever method chosen, it is critical that development is implemented with intent.

Step 2: Make It Purposeful
To prepare leaders for the future, organizations must develop successors based on where leaders need to go to address the business's near- and long-term needs. Ignore this step and you'll quickly find your company stagnating or, even worse, moving backwards down the food chain. Leaders who address their business's strategic needs make calculated bets on the ROI of leadership development and ensure that time, man-hours and financial resources will create impactful competencies. For example, if an organization that's expecting a long-term strategy wants to grow geographically, it may be critical for the associated operations leader to develop competencies that are aligned with that strategy (i.e., building strategic relationships, learning new markets quickly, identifying potential new regional talent or building new teams).

Step 3: Make It Personal
If the 2000s were all about individualization, then the 2010s are all about personalization and customization. Here are two ways that companies can develop leaders in a very personalized manner:

Put challenges in front of top candidates. To prepare future leaders, managers should focus on creating opportunities in the workplace to learn more about the business, try new skills and practice leading differently. One way to do this is by assigning “stretch” projects. For instance, if an employee is identified for an executive position, but if he or she has poor negotiating skills, then let that person take the lead, even if that employee doesn't normally handle negotiations for his or her team. Or if that feels like too much, allow him or her to assist. Your leader will be much quicker to grasp the concept of negotiation in its context when it is personal.

Create a “holistic” experience. Executives must understand the entirety of the organization, how it operates and the nuances of its culture. Great executives in our industry can speak to the strategic opportunities and challenges in functional departments and on different teams. We often hear executives concerned that their future generation lacks this holistic perspective of the organization and how it operates. The problem is that most future leaders lack the ability to experience other elements of the business in a hands-on fashion. By exposing your future executives to other areas of the business—via rotational assignments or participation on cross-functional projects and teams—your likelihood of preparing a more well-rounded executive will increase exponentially.

Getting Into the Growth Mindset
When developing leaders, many companies utilize a traditional approach that lacks strategic focus and alignment with personal needs. Leaders have differing personalities, natural abilities, skill sets and underlying competencies as well as varying values, goals and views about how the world works. Positions that make up an organization's structure, similarly, vary in specific requirements of knowledge, experience and capabilities.
As Melissa Daimler pointed out in Harvard Business Review’s “Why Leadership Development Has to Happen on the Job,” “Organizational learning has to become less about the kind of learning done in a training session or online tutorial and more about continuous learning on the job. That means creating a work environment that supports and encourages learning, one that’s less about individuals learning new skills on their own, and more about using their environment to learn and learning from one another.”

Not surprisingly, the most effective approaches to development are highly personalized and specific to both the position and the individual. Too often, development plans lack clarity and focus as to what specific competencies need development, and this can have real impact on organizations’ health. To best accelerate business performance, focus on linking strategy with personalized development plans, based on a true gap assessment of key competencies required by individuals who are assuming key positions.

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How to effectively recognize and address the major, underlying shifts associated with ownership transfer and succession management in the E&C environment.

To be most effective, succession planning requires foundational groundwork that includes preparing the organization for effective leadership transitions and ownership transfer, focusing on change readiness, clarifying a vision for the future, and creating roles that drive organizational success and market differentiation.

In many cases, those leaders who rally around the “transactional” side of succession management (and the ownership transfer itself) overlook the need for the large, fundamental shifts that come along with such big organizational changes. Each shift requires effective change management and must be addressed to ensure the highest chance of success. Here are four primary shifts that companies typically experience when a current leader hands over the reins:

**The transition of the current leader out of his or her role**
When the owner or CEO is moving out and moving on, the organization must brace itself for myriad change issues. First, that individual may have been the initiator of business strategy and the key character in driving implementation of a particular vision. However, when the current leader is planning to transition out, the organization must reassess its vision for the future. It is possible that with changes in the external environment, government regulation, labor availability or new technology, big picture plans will need to be revisited. Strategy may change, for example, and effective communication about that strategy transition will be necessary to build support from employees, customers, suppliers, investors and the community. When an owner or CEO is moving out, there are also changes in relationships. Those who have invested their lives in building an organization have established effective relationships that bridge the professional and the personal. Keep this in mind as you prepare for the eventual transition and the subsequent impacts.
New leader = new competencies
The competencies required of the next CEO may be different, which means that you will not be looking for a clone of the current leader. Leadership skill sets and style may change to fit the revised vision for the future of the organization. Setting effective expectations for the new leader's role will help to build readiness for that person while also generating a more supportive environment where his or her new plans can be embraced and implemented. When a new leader steps in, he or she is ready to make a mark. With a beloved leader moving out, it will take time for the “replacement” to build the same depth of relationships in just a short time. If the replacement hails from outside the organization, there are organizational memory nuggets and culture nuances that the individual will need to learn. To promote success, ensure that the incoming leader is celebrated and embraced for the distinct competencies that he or she brings to the role, and that the existing leader makes space for the newcomer. Having a well-loved exiting leader endorse the incoming person and emphasize the need for change will help prime the organization for change readiness.

Individuals, teams and culture adapting to a new leader
When a new leader comes in and plans to implement a new strategy for business success, he or she may be changing “the way things are done around here.” Such shifts mean that individuals and teams may be pushed to focus on a new set of priorities. If the successor arrived through internal promotion, for instance, there may be initial reluctance to visualize the new leader fully ensconced in the new role. As such, it may take time to transition away from legacy role issues unless there are clear handoff arrangements made.

An organization that’s resistant to change
If you aren’t intentional about managing change, a number of negative impacts will be felt across the organization. For example, if the individual leaving a role decides to stick around and not let the successor really experience the full domain of the role, then the transition may be rocky. Other challenges include:

- The individual entering the role may not be aware of all the elements in his/her role that could shift (e.g., new relationships to form, new processes to address, new way of life to adjust to).
- Employees who are unaware of the need to make a shift in the competencies at the head of the organization may not embrace the shift, instead focusing negatively on the new leader’s approach and style.
- The organization may resist the new leader’s ideas. Individuals may continue to go around the new leader and go to the old leader if the latter doesn’t encourage a shift.
- Those who had thought they were in line for a key role may be distressed about being passed over.

Six Ways to Overcome Transition Obstacles
The good news is that by understanding resistance, understanding loss, acting with intentionality around change, building a change mindset and taking other steps to ensure an effective transition, E&C companies can overcome these issues and move onto their next chapters.

Here are six ways to make this happen:

1. Understand resistance: Organizations typically see resistance when they make major changes. Examples of resistance that we notice in FMI client organizations around succession management include:

   **At the organizational level:**
   - Resistance to changing the organization’s strategy. The existing business strategy led to the success of the organization; maintain it, don't mess with it.
   - Resistance to changing the structure and roles in the organization; the existing leadership roles should simply be refilled, not re-evaluated.
At the functional level:
- Resistance to leveraging the power of a board of directors; it will interfere in our business and tell us what to do.

At the group level:
- Resistance to sharing ideas that don't fit with the status quo; to be viewed as committed to the organization, people are expected to share only ideas that the group will support.

At the individual level:
- Resistance to hiring leaders with a different set of competencies; replacement leaders should be just like the current leaders.
- Understanding where resistance is likely to come from will help you face those obstacles head-on, share information about the real benefits of specific changes, and manage change readiness.

2. Understand loss: When you begin to talk about or implement an organizational change as part of ownership transfer and succession management (OTSM), people pay attention to the things they will lose. Some of the actual or perceived losses we hear about at FMI include:
  - Turf
  - Status
  - Resources
  - Autonomy
  - Security
  - Relationships
Since these shifts are felt as losses, people grieve in a way that parallels stages of personal loss, albeit on a different level. They may be in denial about the change, get angry, try to engage in bargaining, feel depressed or move more quickly to acceptance. Understanding what individuals stand to lose will help you to plan for and potentially remedy those losses and to manage change readiness.

3. Act with intentionality around change: By increasing intentionality about change at all levels, you can help ensure a successful transition. Organizations can leverage what they know about change to support ownership transfer and succession management. Success rates on organizational change initiatives are low and do not appear to be improving. Succession management and ownership transfer can involve tremendous change, and having your organization respond positively is crucial. Setting your organization up for responsiveness requires assessing and priming organizational change readiness.

4. Tell people why the change is occurring: Help your organization understand why you are making succession management or ownership transfer plans. A few of the recent change drivers that you can discuss include:
  - The competitive environment—Organizations that are embracing new technologies are seeing efficiencies that drive success; there is pressure to keep up, and leaders need to have the competencies to operate in a changing competitive environment.
  - Economic issues—Low unemployment rates mean that there are available jobs in other industries; unless we build career paths within the organization, we may not retain “high-potential” individuals in the organization or industry.
  - Political changes—Under a new administration, there is the high potential for government policy shifts that may affect work and workforce planning.

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Globalization—Global-minded businesses are seeing a need to diversify their workforce to meet the needs of a diverse customer base.

Demographic shifts—With millennials now making up the majority of the U.S. labor force, organizations are feeling pushed to change their culture to work effectively across a range of demographics.

Social change—Increased awareness of women’s rights issues in society means that male-dominated industries are now being pushed to confront any inequality in opportunity.

Ethical dilemmas—As family businesses look to shift ownership when the founder is nearing retirement, they are looking for a succession management and ownership transfer plan that appropriately balances the needs of different stakeholders (family members, owners, investors, employees, customers, the community).

Fully understanding why you need to make changes will help your organization articulate the need for change. Doing so will help in the “unfreezing” of the organization, an important step in preparing for change. Research shows that clear communication on transformation objectives is effective in engaging employees in the organization’s transformation.

5. Build a change mindset: Have a change readiness mindset that places embracing change at the top of your organization’s priority list. To build a climate that supports a culture of embracing change, a combination of tactics might be implemented, including:
   - Visible formal statements on the organization’s philosophy around embracing change.
   - Leaders paying attention to and giving credit for embracing and driving change.
   - Performance evaluation and promotion criteria that reinforce the organization’s value of a change-readiness mindset and change-implementation success.
   - Recruitment materials and selection processes that reflect the organization’s value of a change-readiness mindset.
   - Orientation processes that establish a change-readiness mindset and development activities that reinforce that mindset.

When an organization’s culture embraces change, employees are better-equipped to respond positively and the focus can move to the question, “How are we prepared to deal with change?”

6. Frame the change: Be explicit and clear about the change before it happens, during the transition itself and after it is complete. Appropriate change framing through effective organizational communication and support structures will build support and, with that, readiness for change. Research has shown that one characteristic of successful change efforts is that leadership communicated clearly about the change.

It’s not only communication of the change—but also the stakeholder buy-in regarding the change—that drives success. As such, the communication strategy should involve key stakeholders to map out key messaging, a timeline of activities to cascade the changes, and the establishment of avenues for employees and other involved parties to share their opinions. This allows the organization to be clear about the changes and its plans for implementation, and reinforces the willingness by the organization to hear feedback from employees and others who might be affected. Involvement also helps, so make sure you’ve thought through how you will retain key talent, especially where individuals have been looked over for promotion. And remember, human resources should be strategic partners and not an afterthought.

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Navigating a Clear Path to Successful Ownership and Management Transition

By Hugh Rice

While there are no cookie-cutter solutions for ownership transfer, there are some viable strategies to consider when it’s time to successfully hand over your company’s ownership and management to the next generation.

Ownership transfer is no easy task for engineering and construction (E&C) firms that know they should be thinking about the next generation of ownership, but that don’t always have the time or motivation to start getting a plan of action down on paper. And while there is no “one-size-fits-all” answer to this industrywide issue, there are some viable strategies to consider when it’s time to successfully hand over your company’s ownership to the next generation.

If your company hasn’t thought about ownership transfer in a while or considered it without doing anything about it, you are certainly not alone. According to FMI’s most recent industry research, only 22% of the owners surveyed have a formal plan to transition ownership of the business (Exhibit 1).

Family-run firms are particularly vulnerable to ownership transfer and succession management challenges. According to the Family Business Institute, 88% of current family business owners believe the same family or families will control their business in five years; yet actual succession statistics undermine this belief. According to the Family Firm Institute, for example, just 30% of family businesses survive into the second generation, 12% are still viable into the third generation, and only about 3% of all family businesses operate into the fourth generation or beyond.

For continuity planning purposes, the following components are formally in place in my business.

<table>
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<td>Ownership transfer plan</td>
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<td>21%</td>
</tr>
</tbody>
</table>

Source: 2017 FMI NRCI and CIRT industry surveys, Q1.

1 Preliminary results of FMI’s 2017 OTMS study. These are based on responses from FMI’s NRCI and CIRT surveys for Q1. Final statistics will be published in the second quarter of 2017.
“There is a disconnect between the optimistic belief of today’s family business owners and the reality of the massive failure of family companies to survive through the generations,” the Family Business Institute points out. “Research indicates that failures can essentially be traced to one factor: an unfortunate lack of family business succession planning.”

The need for good ownership transfer and succession management goes beyond just ensuring that there’s someone prepared to take over the reins when the current owner retires. According to Software Advice, which develops software that companies use for recruiting, succession planning also plays a critical role in successful talent management and organizational growth. In a recent survey, for example, the firm found that:

- 62% percent of employees would be “significantly more engaged” at work if their company had a succession plan.
- 94% percent of employers say having a succession plan positively impacts their employees’ engagement levels.
- Over 90% of younger workers (age 18 to 34) say that working at a company with a clear succession plan would “improve” their level of engagement.
- 79% of employers surveyed note they have succession plans in place for midlevel manager positions.

With these dynamics in play, it is increasingly important for owners to start planning early and focus on the long-term development of the next generation of leaders. In this article, we explore the issue of ownership transfer and succession management as it relates to E&G firms and introduce a number of strategies that your company can start using today to prepare for the future.

**Handing Over the Reins**

At its core, succession planning involves the handover of ownership and control of a firm to new management. In most cases, this entails:

- Transferring ownership to family members
- Selling the business to a third party
- Selling the business to key employees/ESOP
- Liquidating the business voluntarily—if the other options do not work

If you don’t think your own firm is in the position to start thinking about one or more of these options, think again. FMI estimates that about 50% of construction firms will have a significant change in ownership in the next 10 years. Based on this estimate, the question becomes: When and how will these transfers take place? And with less than half of today’s firms believing that they have capable, strong managers who could run the company in their absence—and even fewer having a formal transition plan in place—when will firms start thinking about this very important topic?

The harsh reality is that only a small percentage of construction firms are salable to a third party at a so-called “reasonable” price. Because the sale option is not on the table for the majority of firms in our industry, we have to look more carefully at internal transfers and succession—a prospect that’s not always easy to tackle when owners often assume that their firm is worth more than the employees can afford to pay. A good example of this would be a sole company owner who is currently in his or her late 60s. One morning that person wakes up and says, “Well, I think it’s time for me to get out and take my money off the table and turn this business over to someone else.” Unfortunately, selling your company to your employees doesn’t happen overnight. In our experience, such transactions typically take five to 10 years, since employees do not usually have the necessary financial resources to buy out the owner at short notice.
The challenges don’t end there. Here are other key considerations to take into account when developing an ownership transfer initiative:

**Succession is both a money issue and a people issue.** As construction firms consider their business transition options, there are two sides of the equation to evaluate: money and people. Both sides have to be taken into consideration if the business is to survive from one generation to the next. I’ve spent much of my career focused on the financial issues related to ownership transfer, which in most cases is the easier part. The people side is more complex. Consider this: The construction business is very much an entrepreneurially driven, risk-oriented business that requires a certain personality type to succeed. It’s often challenging to find those people, and we frequently hear company leaders say, “We’ve got one really strong leader, but that person’s retiring, so we’re going to replace that person with five or six other people.” This kind of transition can be challenging because it always takes a strong leader to make things work. Committees cannot manage businesses.

**Your second lieutenant probably isn’t the best choice.** Even though he or she may have helped shepherd your company through good and bad times over the last few decades, that right-hand person doesn’t necessarily have the instincts needed to lead the company into the future and take it to new levels. Besides, that individual may not even want to be in that top job. Knowing this, we often encourage people to move down a generation into the 30-something age group to find their successors. This goes against the common sentiment that people in their 30s lack the experience to lead. The reality is that someone with 10 years of the right kind of experience in construction—a very difficult business—is often well-equipped to take over.

**Bonding and banking issues can present major stumbling blocks.** In our industry, bonding and banking both present significant hurdles for any firm looking to transition to a new generation of ownership. Put simply, the bonding companies and the banks are not going to provide you with credit unless the company has a meaningful equity. If you start taking equity out, your bonding and banking credit levels decrease. So it becomes an issue of how to get your money out and maintain adequate financial capacity. In short, you have to be able to make enough money to replenish the funds that you’re taking out. That’s a tough pill for some people to swallow.

**Selling the business to your employees takes longer than you think.** Transferring ownership is a long process and entails myriad legal, accounting, tax, insurance and business planning issues. A firm that plans to sell stock to its employees over a 10-year period, for example, will probably start by selling just 10% of that stock (meaning, the owner still benefits from 90% of the firm’s growth). By the end of the 10-year period, the employees own the company entirely. This type of slow buyout is necessary to allow the business to fund the buyout through profits. The business effectively funds its own transition.

**The cycle of ownership transitions happens every 25-30 years for every business.** Every construction firm in America that’s not publicly traded goes through ownership transitions. This transition process is currently being fueled by the high level of baby-boomer retirements. As a result, more people are trying to figure out how to exit their companies and leave those entities intact and on a growth path as they move into retirement. This isn’t any easy task for firms—particularly those 95% or so that aren’t candidates for sale to a third party. This can be difficult to accept, particularly for someone who has spent 30 to 40 years of his or her life creating and building the business. Successfully transitioning the business from one generation to the next is a never-ending process.
No Silver Bullet

When it comes to ownership transfer, there is no clear-cut guide to the question, “How can I successfully transfer my company to a new owner or owners?” In fact, ownership transfer is a lot like a chess game in that it involves a lot of moving parts and some very focused concentration to navigate successfully. It’s not simply a financial or tax problem nor is it an organizational or family problem. It’s also not just a bonding and banking problem. It’s a combination of all of these elements, and that’s why there is no cookie-cutter solution that applies to all construction firms. Each entity is different, and making all pieces fit together is an extremely important step that’s contingent upon the company’s individual nuances, traits and the goals of the current and future owners.

To construction firms seeking the best possible ownership transfer solution for their individual situations, the best approach is to consider the pros and cons of all options that lie before them. The final answer will depend on the individual circumstances, the preferences of current and future owners, and what approach “feels right.” By taking the time to understand your company’s current situation and your objectives, and assessing the options and planning well in advance, you’ll be well-positioned to handle the transition when the time comes to do so.

Hugh Rice is a senior chairman with FMI. Because of his expertise and experience in dealing with strategy and ownership issues in the construction industry, Hugh is frequently asked to speak before groups of international scope. He may be reached via email at hrice@fminet.com.
How to Use Phantom Stock to Assist With Ownership Transition and Retention

By Sal DiFonzo

Exploring phantom stock issuance as a viable ownership transfer strategy.

The Engineering and Construction (E&C) industry is comprised predominantly of privately held and family-run companies. Because of this, owners may not have an interest in selling actual shares to nonfamily members, or they may not have identified the next generation of ownership yet. And while FMI’s industry research indicates that the majority of owners over age 50 plan to retire in the next 10 years, fewer than half of those owners have taken any action to prepare for the inevitable transition. Owners should allow 10 years for a comfortable transition period; but for those who wait too long, death becomes the mandatory and inevitable ownership transition plan.

In this article, we’ll explore the use of “phantom stock” as an effective tool to fill the gap or provide a retention vehicle for those who will not become true equity partners. In a previous article, “Looking to the Future: How E&C Firms Can Leverage Long–Term Incentive Plans,” we provided an overview of this strategy. But now we’ll delve into more detail on how to use phantom stock to assist with ownership transition and retention.

What Is Phantom Stock?

Phantom stock is not real stock in the official sense. Its price can link to an actual share price, and the company may pay discretionary dividends on the shares; but phantom shares are not voting shares. Some of FMI’s Canadian clients call it “ghost stock,” while compensation professionals refer to it as synthetic equity or phantom stock units. Broadly, phantom stock is a form of long-term incentive compensation plan also known as a non-qualified deferred compensation plan. Such plans may be subject to the Employee Retirement and Income Security Act of 1974 (ERISA) if they include sufficient income deferral provisions so as to constitute a “pension plan” under that statute.

Privately held companies of all industry types utilize long-term incentive plans 53% of the time (see Exhibit 1) whereas only 28% of E&C companies utilize long-term incentive plans, according to FMI’s Incentive Compensation Effectiveness Study. Among all privately held companies, phantom equity plans represent 19% of long-term incentive plans (see Exhibit 1). Family-owned companies utilize phantom equity at a higher rate of 29% when they have long-term incentive plans (see Exhibit 2). FMI’s compensation surveys show that E&C companies utilize phantom stock plans less than 20% of the time.
How Does Phantom Stock Work?
In its simplest form, phantom stock finds a company granting a senior manager or key employee a number of shares at a given value. The value on the day that the stock is granted could be based on one of these valuation methods:

- **Book value divided by the number of shares.** This method works best for contractors that retain earnings and grow book value for the purpose of assuming larger jobs in the future.

- **Multiple of company cash flow.** The cash flow method is typically a multiple of EBITDA plus cash on hand multiplied by an assumed market multiple (e.g., EBITDA x 4). Contractors who strip all cash out of the business at the end of the year in the form of distributions or capital expenditures use this method.

- **Outside valuation.** Ordering an outside business appraisal every year is the most expensive option, but ESOP (Employee Stock Ownership Program) companies must do this, so the overlap for valuing phantom shares is convenient.
Once the grant date value is determined, the benefit of a phantom share award is that the value will hopefully grow over time along with the company's book value or cash flow. For example, a senior manager may receive 1,000 shares valued at $50 per share for a total award of $50,000 in 2017. After five years, those shares may be worth $75 each for a total appreciated award of $75,000. See Exhibit 3 for another illustration of phantom share appreciation over time.

**Vesting**

Phantom shareholders “vest” or become full owners of the phantom shares at some point in the future, pursuant to the terms of a formal plan document or award agreement. A typical time frame is three to five years, but any time frame is possible. There are variations on the vesting and payout structure where shares could vest in five years but could not be liquidated or cashed out until a certain age after vesting or a specified time frame after vesting. Either the plan document or the participant could specify the liquidation period after vesting. In many cases, participants will hold phantom shares for longer time periods when the return on equity is high.

After a plan participant’s phantom shares vest, the plan document often will define when the shares may be converted to cash. Internal Revenue Service (IRS) rules also allow for participants to choose when they receive funds as long as they are in compliance with Internal Revenue Code Section 409A. These regulations require a participant to make an election for cash-out either before December 31 in advance of the plan year for which an award may be granted (cash-out can occur at vest or any time after) or 12 months prior to the vesting of the shares (minimum of five-year wait period from vest).

**Accounting Treatment**

Phantom stock generally follows the same accounting rules as all non-qualified deferred compensation plans in that companies must take a book expense as the award accrues. For example, a $50,000 award would result in an expense charge divided evenly over the vesting period. In year one of five, the expense would be $10,000. Year two would be $10,000, adjusted by the increase or decrease in the share price.

The cumulative expense is carried on the balance sheet as a liability for the entire award. The liability is “marked to market” or changes each year, depending on the value of the phantom shares. It is important to note that this is an unfunded liability, with future obligations paid out of operating income in the year that the participant receives the cashed-out award. At award payout, the company takes its tax deduction, and the liability on the balance sheet is reduced. Participants are taxed
at ordinary income tax rates at time of vesting (not at award payout). Unfortunately, there is no reduced capital gains tax rate on the appreciation of phantom shares; it is all considered earned income.

Why Use Phantom Stock?
Nothing aligns the senior management team's interest with owner interests better than real stock. Building a long-term incentive plan based on performance shares, where the number of shares earned is tied to performance outcomes, is usually the preferred design approach. However, there are several situations that may prevent an owner from utilizing real stock as an ownership transition or retention tool, such as:

- The family owns all the shares, there are heirs who are already working in the business, and there is no interest in widening ownership outside of the family.
- The family owns all the shares, and the sole person working in the business owns all the shares. There are no heirs, but due to prior decisions that previous generations made, family members with no working interest in the business own the balance of shares and will not relinquish ownership. FMI recommends that only individuals with a working interest in the business be shareholders. Siblings, spouses, ex-spouses and other noninterested parties certainly enjoy collecting annual distributions, but their ownership is purely from a capital perspective. A good buy-sell agreement would state that only employee-owners receive shares and that there is a mandatory sell age (at which time the shares must be sold either to employees or back to the company treasury).
- The owner has not identified a successor. The owner needs time to assess whether existing management team members are qualified to become the next generation of owner. Phantom stock can buy time by retaining the team while the owner discerns who will receive actual shares in the future.
- Private equity owns the company. The number of shares that the private equity enterprise gives the management team may be limited, or shares may only be in the form of stock options.

Advantages and Disadvantages of Phantom Stock

Here are several reasons to use phantom stock:

- Aligns interest of management team with owners to increase the share price.
- Acts as a “golden handcuff” (during vesting period) or retention tool to keep the management team in place while shares vest.
- Can pay a distribution or dividend, and not necessarily at the same rate as real shares.
- Is a performance measure for determining award and can directly relate to strategy (e.g., increase book value, return on assets) or directly tie to owner interests (e.g., return on equity).
- Has flexible design rules around award amount, vesting period, vesting age, vesting tenure, payout period and eligibility.
- Nonvoting phantom shares do not affect the owners’ decision-making authority.
- Plan designs often include a “fail-safe” or minimum level of profit requirement in order for the company to make awards.

Here are several reasons not to use phantom stock:

- Real equity is available, and owner(s) are willing to sell some of their shares or otherwise dilute their ownership.
- A deferred cash program is less complex.
- The company’s current ownership does not anticipate growing the value of the business or does not think it will be profitable in future years.
- Participants may be responsible for income taxes at time of vesting.
- The stock price may decrease, thus magnifying issues within the business.
Concerning the last reason, even a decreased value phantom share still has retention value. Contrast this with stock appreciation rights (SARs), where only the increase in share value is available to the participant. Share prices below the strike price essentially make stock appreciation rights worthless, and, therefore, they would have no retention value versus phantom shares.

**Conclusion: Aligning Management Interests With Ownership Interests**

Phantom stock is a highly effective retention tool in that it aligns management interest with ownership interests. This tool supports the ownership transition process by giving the owner time to execute a plan to select, retain and evaluate candidates. For non-owner recipients, phantom shares send a message that the participant is still a valued contributor to the company.

Great flexibility in program design also makes phantom stock attractive. For example, the program could allow a five-year vesting period whereby the owner could issue real shares to future owners and phantom shares to management team members that they would like to retain. During this period, the owner would establish management team performance measures that align with both the business strategy and with the owner's best interests in growing the profitability, value or size of the business.

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Sal DiFonzo (CCP, CBP, CSCP) is the managing director of FMI Compensation—one of FMI’s business units focused on industry benchmark surveys and compensation consulting services. Work with clients includes assessment, design and implementation in the areas of company incentives, executive compensation, sales compensation and base pay strategies. He can be reached at sdifonzo@fminet.com.
Third-Party Sale or Internal Buyout? How to Make the Best Choice for Your Firm

By Landon Funsten

Key considerations that come into play when pursuing a third-party sale versus an internal buyout.

There comes a time in every business owner's life when the tough questions about succession, ownership transfer and/or liquidation must be addressed. Many times, these topics aren't broached until the inevitable happens: A key retirement is eminent, someone wants to pursue other interests or business ventures, or, unfortunately, a company leader passes away.

According to FMI's most recent industry research, only 22% of the owners surveyed have a formal plan to transition themselves out of managing the business (Exhibit 1). These are staggering statistics, given the fact that more than 70% of survey respondents will need to replace most critical company positions in the next three to 10 years (Exhibit 2).

<table>
<thead>
<tr>
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<th>EXHIBIT 2</th>
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<tr>
<td>My organization will need successors to replace most critical position in:</td>
<td></td>
</tr>
<tr>
<td>Less than 1 Year</td>
<td>2%</td>
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<tr>
<td>1 to 2 Years</td>
<td>17%</td>
</tr>
<tr>
<td>3 to 5 Years</td>
<td>37%</td>
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<td>5 to 10 Years</td>
<td>35%</td>
</tr>
<tr>
<td>More than 10 Year</td>
<td>9%</td>
</tr>
</tbody>
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1 Preliminary results of FMI’s 2017 OTMS study. These are based on responses from FMI’s NRCI and CIRT surveys for Q1. Final statistics will be published in the second quarter of 2017.
Most owners who are nearing retirement age—and who haven’t begun to plan—acknowledge the fact that they need to get the process underway. This is a positive sign, but in many cases, the immediacy of the problem is reinforced by several comments FMI received from owners, such as:

“It takes a long time.”

“Two third-generation members are still in college, and their competence/ability to run the business has yet to be determined. Several nonfamily managers are interested in taking over, which needs to be transitioned in the very near future.”

“We have had many discussions on the subject and have some of the pieces in place to structure a formal succession plan. We need to take the final step to decide on a specific course of action and implement it.”

As E&C firms continue to distance themselves from the Great Recession, owners are increasingly grappling with an issue that they have put on the backburner, namely: Now that transitioning my business is financially viable, what’s the best way to do it? And specifically, does it make more sense to sell to my key employees and/or family members, or should the company be sold to a third party? Further, what are the relative benefits and drawbacks of each alternative?

We explore these and other issues related to company sales and buyouts in this article, and help you make the best possible choice for your own firm.

**Assessing Your Firm’s Salability**

For years, FMI has surveyed the industry to assess how contractors exit their businesses. By far, the most common methodology is an internal sale to key employees and/or family members. Our latest research shows that the majority (82%) of industry firms plan to initiate an internal transaction (sell to employees or family members or give to family members), only 8% of respondents plan to sell to a third party, and 11% are uncertain about their ownership transfer plans at this point (Exhibit 3). Moreover, many of these third-party sales are structured to simply allow the seller to complete its backlog and monetize its balance sheets, yielding no “goodwill.”

For those companies that expect to sell to a third party, there are substantial risks involved with achieving this transition objective. In FMI’s experience, for example, very few of the 8% expecting to sell to a third party will find buyers ready and willing to purchase the company at an attractive valuation when the current owner is ready to sell. And when this happens, the potential seller that doesn’t have a backup plan can quickly find himself/herself forced to liquidate.

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**EXHIBIT 3**

Ownership Transfer Plans

<table>
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<tr>
<th>Option</th>
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<td>Sell to employees</td>
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<td>Gift to family members</td>
<td>17%</td>
</tr>
<tr>
<td>Sell to family members</td>
<td>13%</td>
</tr>
<tr>
<td>Uncertain at this point</td>
<td>11%</td>
</tr>
<tr>
<td>Sell to a third party</td>
<td>8%</td>
</tr>
<tr>
<td>Liquidate</td>
<td>0%</td>
</tr>
</tbody>
</table>

Source: 2017 FMI NRCI and CIRT industry surveys, Q1.
Attracting Third-Party Interest

An unfortunate truism of the E&C industry is that most firms simply aren’t salable to a third party for much more than net asset value. Low barriers to entry, hypercyclicality, seemingly bottomless liabilities, thin margins, the local nature of the business and other issues conspire to chase away buyers. As a result, most contractors choose to pursue an internal transaction as a default decision.

But that doesn’t mean finding a buyer is impossible. For example, your firm could attract third-party interest if it had several of the following attributes:

- **A defensible market niche.** By carving out a profitable niche, companies can make themselves more attractive in the eyes of a buyer who sees construction as a largely commoditized industry.
- **Participation in an attractive industry sector,** such as industrial, utility or health care. Pick an industry sector that’s growing and find a way to service it better than anyone else can.
- **Size** (depending on the type of work— at least $20 million) **and breadth** (multiple offices or lines of business). The bigger, the better when it comes to company size and diversity of product and/or business lines.
- **Top-quartile financial performance.** In most cases, investors and buyers want companies that are at the top of their game and not financial laggards.
- **A service/maintenance business.** Companies that can build ongoing business (versus just “one-and-done” projects) with multiyear revenue streams will be much more attractive in the eyes of the buyer.
- **Working directly with owners as opposed to having GCs and CMs as clients.** The closer you can get to the decision-makers and the money, the better chances that your company will be hired for future work, be paid on time, control schedule and quality, and be able to negotiate profitable projects in the future.
- **Deep management team.** Buyers will be most attracted to companies that have well-rounded and deep management teams that go beyond just a single owner or family-dominated “inner circle.”

It’s important to point out that recent buyer demand for E&C firms has been considerable and that this demand is anticipated to continue to increase in 2017 (and beyond). While this makes more firms attractive targets, a third-party sale at a compelling value is likely to remain elusive for most industry firms.

The Legacy Component

Assuming that your firm is salable, the second most common reason that firms opt to sell internally is the whole issue of legacy. One of the biggest concerns potential sellers have relative to a third-party sale is a potential transformation of the culture and ethos that the company has developed during its existence. This concern is compounded by the fact that, according to years of FMI surveys, the majority of E&C firms consider themselves to be family-owned.

Examples abound of industry buyers falling prey to the “conquering army” syndrome subsequent to an acquisition and destroying the culture of companies that they acquire, whether those actions are intentional or not. If perpetuation of the company’s legacy and culture is a paramount objective, selling to a third party is usually not the optimal outcome.

After-tax Proceeds

One of the most common and perpetual misperceptions of transitioning ownership in an E&C firm is that to optimize proceeds from a sale, a third-party sale is the only plausible alternative. This premise is demonstrably untrue for virtually all industry firms. In fact, FMI has found that industry firms that are sold typically sell for four to five times sustainable EBITDA. Certainly, there are many examples of firms that have been acquired for substantially higher (and lower) multiples, but this range has held up for the majority of firms for many years.
Contrast this metric with the structure of most internal buyouts, and you’ll find myriad variations on the theme. However, most entail taking the profit stream that the current owner(s) stick in their pocket and, instead, funneling these profits to the next generation of leaders who, in turn, buy stock from the current owners. Increasingly large increments of stock are sold (generally at book value) until the transaction is consummated. For an industry firm that has normal profitability and a typical capital structure, this process could take anywhere from eight to 12 years to cycle out of 100% of ownership.

Now consider the difference between the internal transaction and a third-party sale. Under the former, the seller participates in the relative share of the company’s income stream, sells its stock and continues to collect W-2 income and various other perks. Clearly, if a seller’s objective is strictly financial, the after-tax proceeds an internal sale generates are the optimal solution.

The Clock Never Stops Ticking

The unexpected good news about an internal transaction is its financial outcome. The bad news is that it takes time. As mentioned earlier, it will take eight to 12 years to fully cycle out of your ownership (and that’s assuming that you have a next generation of leaders that you can confidently sell the business to).

The fallacy and misconception that simply starting an internal sale and transition will somehow allow the owner to back away from the business, take more time off and ride off into the golden years of retirement are widespread in the industry. Unfortunately, this rarely happens in real life. In fact, E&C owners need to reconcile themselves to the fact that they will likely have to increase their time commitment to the business, often during nights and weekends.

And, assuming that there is a competent next generation of leaders in the business (a big if!), it will take considerable time, effort and energy to ensure that the new guard can competently run the business without the current management team. Transferring client relationships, providing financial training, developing leaders, fostering strategic thinking and so forth will consume vast amounts of time. And don’t forget that we’re not all cut out to be business owners, and that there is the considerable risk that the next generation of leaders is simply incapable of running the business.

What’s Your Personal Risk?

When considering an internal sale versus one involving a third party, personal risk also comes into play. Clearly, a third-party sale monetizes your interest in your business and eliminates virtually all of your future personal risk. However, with an internal transaction, you will have the following ongoing personal exposures:

- Possibility that the next generation won’t work out and is incapable of running the business. At best, you may have to find a new team; at worst, it could destroy your company. Keep this in mind as you make this very important decision.
- Exposure to another catastrophic downturn such as the Great Recession. Many potential sellers are still crawling out of this hole and definitely don’t want to go back into it anytime soon.
- You will likely have to continue to indemnify the bank and bonding company for the short to intermediate term. If you’re trying to make a clean break and head off into retirement, this could thwart your plans—at least for the short term.

Clearly, there are several critical considerations an owner needs to evaluate before choosing the appropriate avenue to pursue. A great place to start is to itemize and delineate your personal objectives for your transition and consider them relative to the key factors cited above. Using the advice outlined in this article, you can cull through your options, eliminate any that don’t align well with you and/or your firm’s future goals and plans, and come up with a workable solution to an age-old issue that a high percentage of E&C firms are dealing with right now.
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Much has been written about the aging baby-boom segment of the population.

Surprisingly, despite well-documented statistics on the aging workforce, preliminary results of FMI’s 2017 ownership transfer and management succession for your business (OTMS) industry research\(^1\) indicate that only 22% of contractors have a formal plan for transitioning themselves out of their businesses.

This situation, combined with the importance of management quality, makes succession planning critical to the future success of a construction business. During such transitions it is vital to have the surety provider’s support and confidence in the contractor’s financial strength, technical execution capabilities, and management quality and character. While it may come as a surprise to some financial purists, quality of management is one of the most important factors when determining the appropriate level of surety support to a contractor.

Financial Perspective

FMI’s preliminary research on OTMS\(^2\) also shows that 82% of contractors would prefer to transfer or sell ownership of their companies to employees and/or family upon exiting their businesses. In these circumstances, several alternatives exist for supporting the ownership transfer.

One of the cleanest yet least achievable approaches would be to treat the related party (or parties) as an external third party and to then sell ownership interest to that same third party, leaving the financial position of the underlying going concern unaffected by the transaction. The usual obstacle here, of course, is the lack of external funds to support the transaction. For this reason, related party transfers are usually facilitated using other methods.

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\(^1\) Preliminary results of FMI’s 2017 OTMS study. These are based on responses from FMI’s NRCI and CIRT surveys for Q1. Final statistics will be published in the second quarter of 2017.

\(^2\) Ibid
More common related party scenarios include:

- Traditional external financing to support the company's buyout.
- Injection of capital for a finite period by an alternative financing method such as private equity.
- Ownership transfer through an existing or new Employee Stock Ownership Trust.

Given the legal and tax implications of each option, the relative merits are best addressed by transaction specialists. Suffice it to say, there is a potential for significant impact on the capitalization, liquidity and cash flow of the underlying organization for which ownership is being transferred.

Critical to the ongoing success of a construction company, surety support could potentially be affected by the financial impact of the ownership transfer. To determine an appropriate level of support for a contractor, the surety market uses key factors like capitalization and liquidity relative to the existing and expected work program. The increased debt associated with financing the purchase transaction can often be reasonably serviced by the company's ongoing cash flow. The extra debt burden can add an element of risk to the new organization through reduced cash and working capital available to support ongoing work programs.

In many cases, surety capacity is supported not only by the company's financial resources but also by the personal indemnification of the primary stakeholder(s). The absence or reduction of continued additional support is a factor that could potentially impact the surety's level and form of support.

With that said, many insightful sureties have moved away from a purely formulaic approach to determining support. Accordingly, one should not conclude that an ownership transfer will create a crisis of confidence for the surety provider, but should recognize the value of early, frequent and ongoing communication with the surety as a transaction is being considered.

Leadership Transition

As noted earlier, the financial aspects of a transaction are not the only factors determining surety support of an ownership transition. Equally important, if not more so, is confirmation that the new leadership team has the capabilities and a mindset that is consistent with the previous, successful management team.

A surety's assessment of management capabilities is more art than science, as nearly all sureties recognize that the contractor, rather than the surety underwriter, is the true expert in the construction business. As a result, the surety's assessment is based primarily on overall comfort with the management team's attitude towards financial and operational risk; a realistic attitude towards technical capabilities; and consistent transparency and responsible engagement with owners, subcontractors and service providers. Of course, a track record of successful project execution is the foundation of the management assessment.

Because we provide surety support to many leading construction companies nationwide, we observe consistent key practices that are implemented by many best-in-class customers. Such practices are used to test and confirm the skills and competencies of contractors' future leadership teams while also preparing future leaders for larger roles, often as part of an ownership or leadership transition.

Here are some of the most common key practices we see:

- **Full commitment to succession planning** – Top companies of all sizes view succession planning as part of their core responsibilities rather than as periodic events. Once top candidates for future leadership roles are identified, the leading contractors spend considerable time developing the capabilities of their high-potential candidates.
- **Ongoing evaluation** – Rather than identifying candidates for a “just in case” checklist, top organizations assess potential and performance on a continual basis when evaluating the readiness of leadership candidates. Further, rather than relying on performance in an employee’s current role, additional “bolt-on” responsibilities are given to stretch a future leadership candidate and determine his or her ability to operate at the next level. In this regard, a safety net is usually provided in order to limit the tuition cost of the education!

- **Transparency** – The pros and cons of transparency with succession plans are often debated. Full transparency can lead to the unintended consequence of resentment from less successful leaders, while limited transparency can result in mistrust within the organization. While there are merits to each argument, our observation is that top contractors tend to have a high level of transparency with leadership succession plans within their organizations. In addition to the internal transparency, the top companies also share their plans early and regularly with their service providers to ensure support for future changes.

- **Planning with no immediate event on the horizon** – Leading companies have made succession planning and leadership development an essential part of their core business activities. This approach results in an “always ready” environment that can make future planned or unplanned succession events less daunting and risky when the time comes.

- **Depth of planning** – When speaking of succession, we often hear people refer to the top jobs within an organization. Leading contractors go beyond senior management jobs when looking at their succession plans and then commit to an ongoing plan to identify and develop talent for positions that are well below the executive level. Over time, these companies have found that the process ultimately results in an extremely strong commitment to the organization’s success, as staff members feel they are part of a well-developed and strategically aligned plan for future growth and continuity.

- **Attracting and retaining talent** – Along with providing clear benefits in preparation for eventual management or ownership transitions, embedding succession planning into a contractor’s culture can help attract and retain staff in today’s highly competitive labor market. An absolute priority for attracting new talent is an environment of frequent feedback and well-developed career plans. A strong succession-planning culture facilitates the environment demanded by the new workers entering the workforce and the future leadership pool.

**Reach Out and Be Proactive**

Like many industries, construction faces the challenge of attracting new talent in order to ensure a sufficient and qualified workforce in both the C-suite and in the field. With this trend, the issue of succession at all levels should continue to take on a greater level of importance for the successful contractor. Consistent surety capacity for the construction company is vital to the success of construction companies throughout the succession planning process. Contractors should actively engage with their surety provider to help assure that capacity will be available to support the organization’s strategic plans.

Top contractors are ahead of the curve in making succession planning part of their core management and leadership activities, and those organizations will continue to win the war for talent in a tight labor market. These same organizations should also be prepared to handle planned and unplanned management and ownership transitions as they arise.

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Leaders tend to respond differently when given the opportunity to lead innovative processes. Some leaders feel an overwhelming sense of excitement for the challenge ahead and the chance to make a significant impact on their businesses. Others get a deep pit in their stomach full of doubt and fear for what lies ahead.

Interestingly, both types of leaders are venturing into unknown territory where their leadership skills will be tested in new ways. The journey of leading innovation can be exhilarating, exhausting and challenging for every leader regardless if you're a novice or a well-seasoned innovation leader. It's part of the beauty of leading innovation—you never know what to expect, and the outcomes are likely going to be different than your original intentions.

As we continue our series, “Leading Innovation: Insights From Industry Executives,” we focus on the lessons learned in leading organizations through innovation and disruption, which Russ Becker (APi Group), Tom Scarangello (Thornton Tomasetti) and Atul Khanzode (DPR Construction) shared with us during an intimate, one-day “think forum.” This article summarizes these executives' insights and offers practical industry examples.

Lessons Learned in Leading Organizations Through Innovation and Disruption

One of the best benefits of being a successor to your business is the chance to learn from your predecessors. FMI’s Center for Strategic Leadership (CSL) notes that the most effective leaders glean wisdom from the various mentors and leaders in the industry by asking questions and learning from those experiences. Fortunately, Tom, Russ and Atul are all at perfect points in their careers to be able to share their knowledge and experiences in leading innovation with other future leaders in our industry.
Here are the key lessons learned from our think forum:

- Challenging assumptions with a curious mind can crack open the innovation egg.
- It's easy to chase the wrong opportunities when your vision and innovation strategy are unclear.
- Understand each stakeholder deeply because each one values and invests in innovation differently.
- Technology is outpacing us, and how we organize ourselves as humans is either a limiter or an accelerator.

1. Challenging Assumptions With a Curious Mind Can Crack Open the Innovation Egg

It's one thing to be interested in something, and it's a completely different thing to be genuinely curious about it. These leaders demonstrated a sincere curiosity about the various trends they were witnessing in their businesses, the industry and in terms of innovation in general. This natural curiosity helped Russ, Tom and Atul see opportunities and trends before most of their peers did. To incentivize its leadership team and employees, and to encourage them to challenge each other's thinking, Thornton Tomasetti regularly awards current and future engineers with innovation and technology awards. The awards are simply to evoke an innovative and idea-sharing culture across the organization while keeping each other curious about what's possible in the industry. The group's curiosity didn't turn on or off at specific times of the day either—it was a constant mindset and approach for all of their interactions and conversations. FMI witnessed this curiosity firsthand throughout our day together, and we noted that they were teaching each other as much as they were learning from each other. By pausing to consider what others were saying, challenging each other's observations via questioning, and digging deeper into nuggets of thought-provoking data, the conversation spiraled into many unforeseen and fascinating areas. The natural intellectual curiosity, drive for constant improvement, unquenchable thirst for finding the edge in a highly competitive market, and the desire to build winning cultures are just a few of the behaviors and characteristics we witnessed in Atul, Russ and Tom. The curiosity simply does not stop.

We also discussed the fact that many assumptions emerge during the innovation process. Assumptions came in all shapes and sizes for these leaders, but the most common were related to the innovation itself, the process to test/implement it or the people who were involved in the process. They acknowledged that challenging assumptions with a curious mindset helped them see each perspective in a new light that oftentimes cracked open the innovation egg for their organizations. Russ, for example, knew that he wanted to build a culture of leaders who could change the way the industry grows and operates in the future. Rather than dictating what the “right” leadership approach would be for each company within the APi Group, Inc., Russ first got to know each company and each culture for who it is. He explored its nuances and collectively created an approach to leadership that would fit each company like a puzzle piece. This curious approach to building a leadership culture broke APi Group’s innovation egg in a way that has led to notable growth trajectories and strategic successes internally and externally. As we mentioned in the first article in the series, bringing together people with different experiences and business perspectives helps spur innovative ideas. As a leader, approaching those conversations with an inquisitive mind and a willingness to challenge one another's assumptions enriches the process tenfold.

The key lesson learned: Listen to your naysayers and your champions; don’t discount them. Learn from them. Be curious about what they are saying. Every person brings a different and valuable perspective to the innovation process. Challenging them and yourself will surprise you.

2. It's Easy to Chase the Wrong Opportunities When Your Vision and Innovation Strategy Are Unclear

Opportunities can present themselves differently, depending on what type of day you’re having as a leader. Emotional swings, internal company dynamics, industry shifts and numerous other factors have taught these leaders to lean on their organizational visions and strategies before chasing new, innovative opportunities. Building this foundation upfront serves as a guiding light through different scenarios of growth, innovation and transition across APi Group,
Thornton Tomasetti and DPR Construction. A common dilemma these leaders face is figuring out which ideas to invest in and implement versus which ones to decline. Through trial and error over the years, the consensus of the group is that you need to deeply understand your vision and be crystal clear on the innovation strategy you are aiming to achieve before considering new opportunities.

Clarity around company purpose and values helps these innovation leaders keep the bigger picture in perspective when striving to achieve their vision and innovation strategy. Oftentimes, a vision requires significant innovative shifts in an organization’s operations, leadership, products and services, and market approach. So which shifts are the right ones? Without understanding what customers you want to work with and why, it’s easy to pursue opportunities that seem wise at the time but that wind up missing the mark significantly. These are painful mistakes to make, but each leader has learned from them and adjusted his decision-making process moving forward.

The key lesson learned: Combining your company’s purpose, values, vision and innovation strategy can act as a sieve that filters out the wrong opportunities and brings in the right opportunities for your company. Just because one opportunity is right for one company doesn’t mean it’s right for your company. For example, an E&C firm may identify a potential opportunity in a new vertical (say, the construction of healthcare facilities) one day, but upon further examination may realize that the resources, time and human capital needed to fully explore and leverage this opportunity may not pay off in the long run. On the other side of town, however, a similar firm may be both successfully identifying and leveraging a similar opportunity.

3. Understand Each Stakeholder Deeply Because Each One Values and Invests in Innovation Differently

In a surprising conversation shift, we discussed how differently stakeholders in the industry view innovation and invest in it accordingly. These leaders talked about how communicating the value of innovative ideas for projects requires a different approach with an owner than with a contractor or an insurance company. Tom mentioned that Thornton Tomasetti spends a lot of its time with owners, explaining its new tactics to engineering to help them understand why it is designing a project in a new way and the short- and long-term benefits for the owner. Atul commented on the fact that each stakeholder in an integrated project delivery (IPD) system values new, innovative ideas and approaches differently. Some viewpoints are complete opposites, but when leaders come together and discuss those viewpoints, the creative ideas begin to flow much more easily. The entire IPD team can begin to buy into new methods together rather than trying to catch up to each other in silos. It’s a win-win-win for everyone involved.

This was a fun conversation for FMI to participate in since we work with all areas of the industry—owners, architects, engineers, contractors, insurance companies, building manufacturers, etc. And while we hear their differing perspectives on topics, we rarely get to hear their perspectives on each other related to innovation. Everyone agreed that if any stakeholder can see the risk of trying something new, but also understand the benefits, then he or she is usually willing to give it a try. How you approach those conversations is what matters the most.

The key lesson learned: Influencing and implementing innovation requires a customized, intentional and patient communication strategy. A one-size-fits-all with all stakeholders does not work. You have to understand where they are coming from in terms of risk and help them understand the benefits of the innovation before you can expect them to buy into your ideas. Listen to their feedback and make adjustments. Innovation is a give-and-take for all parties involved.

4. Technology Is Outpacing Us, and How We Organize Ourselves as Humans Is Either a Limiter or an Accelerator

There was a strong consensus in the room around this topic. Technological capability has surpassed our ability as humans to leverage it. It’s outpacing us! Russ, Tom, Atul and FMI all shared stories of how technology had signifi-
significantly shifted the way projects were being designed and built. We are all seeing it, and it’s not going to turn backwards. Atul brought up the fact that the way we organize ourselves throughout a project life cycle is either a limiter or an accelerator—it’s not just about technology any longer. As you can imagine, this sparked a lively conversation in the room. In the past, leading innovation meant finding the right talent to come up with great ideas and then implementing those ideas using technology. Now that technology has leapfrogged over the human side of the business, innovation leaders recognize that technology is determining the way we staff projects.

For example, smart buildings are in high demand right now, and industry leaders have seen this coming for some time. They’ve learned that the information about a building and what’s happening inside of it has become more valuable than the building itself. The data we are getting from these buildings is being consumed by more people than just the building owners, so the design and project delivery methodology now involves many more stakeholders. Learning and understanding what we want the building to accomplish from a data standpoint significantly shifts the way we lead those projects and influence stakeholders. The chasm between the progressive technology adaptors and the traditional players is widening. Leaders who can align their organizations and cultures to keep up with the technologies and flex accordingly will win in this market.

The key lesson learned: Leading innovation today requires an appreciation for, and fluency in, new technologies. Building and leading cultures that embrace technology and recognize that it’s something to keep up with, not be scared of, are flourishing in this new market.

The Next Step
Part One of this series described the traits of innovation leaders based on Russ, Tom, Atul and FMI’s experiences. In Part Two, we heard their lessons learned in leading innovation. These lessons are easily adaptable for current and future leaders who are embarking on new innovation horizons.

We will continue this journey in Part Three of this series, where we will outline how the influence of culture, talent and leadership has shaped the way Russ, Tom and Atul have led innovation and disruption in our industry.

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About FMI

For over 60 years, FMI has been the leading management consulting and investment banking firm dedicated exclusively to engineering and construction, infrastructure and the built environment.

FMI serves all sectors of the industry as a trusted advisor. More than six decades of context, connections and insights lead to transformational outcomes for clients and the industry.

Sector Expertise

- A/E and Environmental
- General Contractors/CM
- Heavy Civil
- Industrial
- Specialty Trades
- Utility T&D
- Cleantech and Energy Services
- Construction Materials
- Building Products
- Oil and Gas
- Private Equity
- Owners

FMI Client Highlights

- 73% of the ENR Top 400 Contractors
- 65% of the ENR Top 200 Specialty Contractors
- 57% of the ENR Top 100 Design Firms
- 56% of the ENR Top 200 Environmental Firms
- 58% of the ENR Top 100 CM for Fee Firms
† FMI Capital Advisors, Inc., is the investment banking subsidiary of FMI Corporation, which has been exclusively serving the E&C industry for over 60 years.