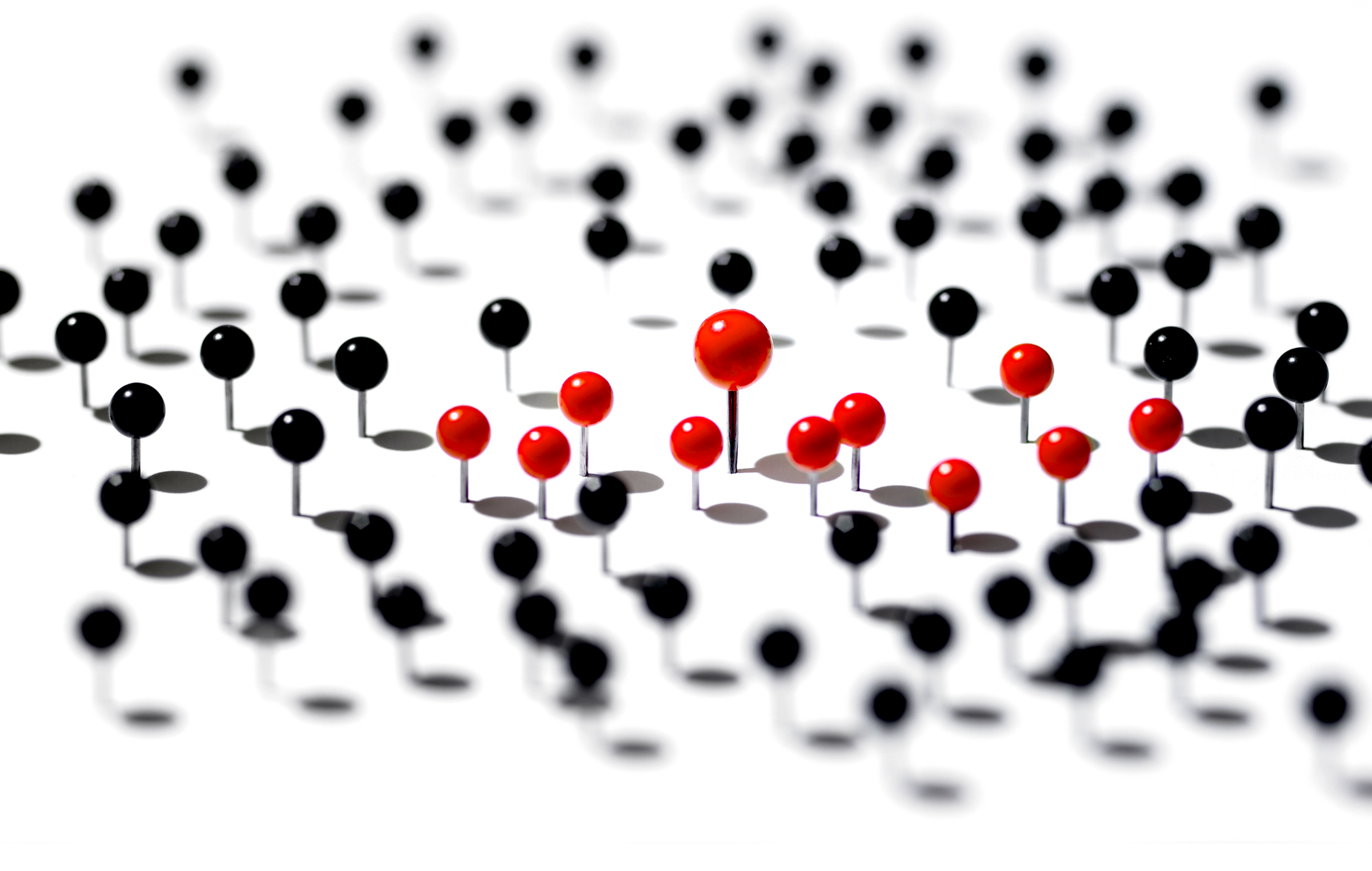
FMI QUARTERLY
ISSUE THREE
2017

Positioning to Win From the Inside Out



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Positioning to Win From the Inside Out

By Chris Daum, CEO of FMI Corporation

As we move along in 2017, construction spending is robust and the near-term outlook for the industry remains positive.

We find ourselves in one of the longest sustained economic expansions in the history of the U.S. engineering and construction industry. As such, we think it is a good time to focus on a few strategic items that executives often overlook, but, if acted upon, can make a positive impact on a firm's performance regardless of market conditions.

One such organizational discipline is to proactively engage the company's board of directors in the firm's strategic plan. Through its active involvement in setting the organization's strategic direction, the board can help shape and refine a company's strategic plan and share ownership of it. In this Quarterly edition, our subject matter experts share six practical steps for leveraging and engaging boards more effectively on strategy and provide a framework for high-performing boards to consider.

Another often overlooked tool in the context of corporate performance is the practice of strategic divestitures, or the sale of a division or a subsidiary that's no longer performing well or no longer essential to the organization's strategy. Our authors illustrate how divestitures often lead to more strategic focus and increased shareholder returns over time and provide insights on "how the best divest."

Or consider this: In our trillion-dollar industry, industry participants price and bid between $3 trillion and $4 trillion worth of work each year. That's because contractor "hit rates" average between 25 and 30%. As a result, many contractors fall into the trap of "chasing more to win more," which costs the industry millions of dollars of unproductive time each year. To minimize this loss, we discuss ways leaders can make smarter and more disciplined choices about customer and project selection.

Finally, we have long observed that contractors don't starve to death; they die from gluttony. They get too much work, too fast, with inadequate resources, and then get into financial trouble and run out of cash. When markets are strong and companies are taking on more work with fewer resources, it's essential that firms remain disciplined in all areas of the business and not overextend themselves beyond their capacity to execute well. As the industry continues to adapt to new labor market trends and competitive pressures, the companies that have solid internal processes and structures in place will continue to prosper in the current up market and be better able to withstand the next industry downturn.

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How to Avoid Wasting Millions of Dollars Chasing Down Business

By Cynthia Paul

Getting smart about your go-to-market strategy, picking the right customers and pre-positioning yourself for the win will help set up your company to gain profitable market share without breaking the bank.

In the construction industry, millions of dollars are spent chasing projects that are never won. This costly and time-consuming process can leave some contractors feeling as if the system is rigged against them. It's in the client's best interest to have competition bidding on a project. For some clients that means one or two highly qualified construction teams. For others that number might rise to three to seven contractors. It all depends on how well the owner has prequalified contractors before a request for proposal (RFP) hits the streets.

There are usually differences between how the owner and the contractor look at the project pursuit process. From the owner's perspective, multiple teams chasing the project can bring innovative ideas, ensure a more competitive price, and give the owner more options for project partners. This helps the owner understand the differences between competing teams and ultimately leads to more informed decision-making. If the owner is sophisticated and a serial builder, for example, he or she will likely know what to look for. If not, having multiple contractors pursue the project provides the owner with a broad spectrum of options and insights for delivering a successful project.

Contractors view the process very differently. It can seem like an unnecessary step in the process, a beauty contest where appearance matters more than substance, or simply a way to get the ultimate project price down. Too often, the project pursuit process drains the contractor's time, energy and capital.

Ideally, a contractor seeks a one-on-one relationship with the owner, helping the owner frame the project needs and then winning the work, because the contractor has demonstrated its value in the process. The final step involves agreeing on contract terms and cost.

Chasing 10 projects to win two, three or five of them is challenging at best. Today there is over $1 trillion in construction work in the pipeline. Using rough numbers, if the average hit rate (i.e., success rate chasing work) is 30%, that means the industry must chase $3.3 trillion of work to win every project in the pipeline. The cost of chasing work is significant, and both owners and contractors must find a better way to collaborate with one another to improve the project bidding/award process.

Market Forces Are Impacting the Industry

It's a buyer's market right now, but that is changing (or has already changed) in some geographic markets around the country. Not all local markets have grown equally in the last five years. Many major cities on the East and West coasts have enjoyed significant growth, while many markets in the middle of the country have remained very competitive.

One major industry driver right now is the higher number of contractors available versus projects to build. That sets up a system of contractors competing for projects. In geographic markets or market segments where that dynamic is different, contractors typically enjoy better profit margins and can more easily win new work.

A lack of qualified talent, both in the field and office, is encouraging contractors to be more selective about which projects to pursue. It has also led contractors to raise their prices. Many contractors today are one or two major projects from stripping their bench of key project talent.

Clients do not see the world the same way. They want contractors to bring the team that will build the project as promised. The challenge is that if you have that team available now, you might not by the time the owner makes a decision. Most contractors find themselves needing to present the same team on more than one project at a time. It makes sense that some customers want the strongest team available to work on their project, and some even specify the people by name. The question becomes, can that contractor charge a bit more for guaranteeing that team for the project. The answer goes back to supply and demand: When the supply of top talent is low and demand remains high, prices should go up.

The same can be said for innovative ideas that are brought forth during the project's proposal and presentation stages. Naturally, the customer wants the best ideas for building its project; it just makes sense. For the contractor, however, investing the time and talent to generate and implement highly innovative ideas on one specific project can be very costly.

There are only so many business development, preconstruction, estimating and operations hours available to invest in project pursuits. As a result, not all projects being chased get the level of attention that they deserve. Contractors must make smarter strategic choices regarding which customers and projects to pursue.

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The Real Impact of Hit Rates

Small changes in hit rates (i.e., rate of winning a project) have dramatic impacts on contractors. Exhibit 1 shows the impact of changing hit rates for a company from 30% to 20% and 40%, respectively. If the company wants to end up with $350 million in work, and at a 30% hit rate, it would have to actively pursue $1.167 billion in work. If the hit rate drops to 20%, that number goes from $1.167 billion to $1.75 billion, or almost a 50% increase in the number of projects needed to pursue.

Exhibit 1. The Real Impact of Hit Rates

	Scenario One	Scenario Two	Scenario Three
Revenue Wanted	$350,000,000	$350,000,000	$350,000,000
Hit Rate	30%	20%	40%
Projects That Are Needed to Be Pursued	$1,166,666,667	$1,750,000,000	$875,000,000

Finding that much quality work to chase is daunting enough. Finding the time to estimate the project, bringing in innovative ideas and committing your best team are downright overwhelming.

If the hit rate can be improved to 40% (which is a pretty high bar for most contractors in the private or public arenas), then the company would only have to chase $875 million in work, or about 75% of what is needed for a 30% hit rate.

Hit rates can create the pressure to "chase more to win more." It is easy to get trapped on that hamster wheel, running faster and faster just to win sufficient work to keep the company busy.

Getting Off the Hamster Wheel

Winning profitable work starts long before you pursue a client or a project. Here is a quick list of things you can do to help get off the hamster wheel:

1. **Get your strategy straight.** It all starts with strategy—what slices of the market do you want to target, who are the right customers, what services do they need, and how do these offerings set you apart from the competition? No one chases the complete commercial or institutional markets anymore; contractors chase market slices. You might want to target community colleges that are expanding their campuses, for example, or if you do well with big concrete work, you may want to focus on commercial projects that will require parking garages.

2. **Base your decisions on facts.** Get smart about which market segments are growing, which are cooling off, and which have already peaked. This is not to say you can only chase growing market segments; but it does alter the strategy needed to bust in and win market share.

FMI uses a "4C model" to illustrate the context of profitable growth (see Exhibit 2). Start with the business "climate" that you are operating in (e.g., demographics, per capita income, government regulations, research and development, economic cycles, etc.), and then dig into the changes, expectations and needs of "customers." Since they are the ones who will be buying your services, find out what criteria they use to select contractors. Ask them about the "competition" (the third C in the model); find out what competitors are good at and where there are opportunities to improve.

The last C in the model is your "company" and what you are truly good at, simply OK at, and where you might lag behind the best contractors in the market.

Exhibit 2. FMI's 4C Strategy Model

The 4 Cs come together to create the context behind crafting your go-to-market strategy. Simply put, that strategy identifies which market slice you will pursue, the right customers to get in front of, your ideal projects (i.e., sweet spot) and your market differentiation.

3. **Build a compelling story.** You don't have to be 100% differentiated from your competition. The key is identifying things you currently do (or could expand upon) that would create more value for your customers. If you simply match the competition that is already in the market slice, expect heavy price competition from entrenched contractors.

   You need a story that explains to customers why you are the right choice for their project. Back up your story with proof that you really can deliver that additional value and guess what? Customers will listen.

4. **Build your go-to-market strategy.** This strategy will help you define which customers to target and connect with before an RFP hits the street. This is when they will be the most open to meeting with you and talking to you. You need to get in early and deep to create an advantage to win their project. Exhibit 3 shows several key elements of a go-to-market strategy.

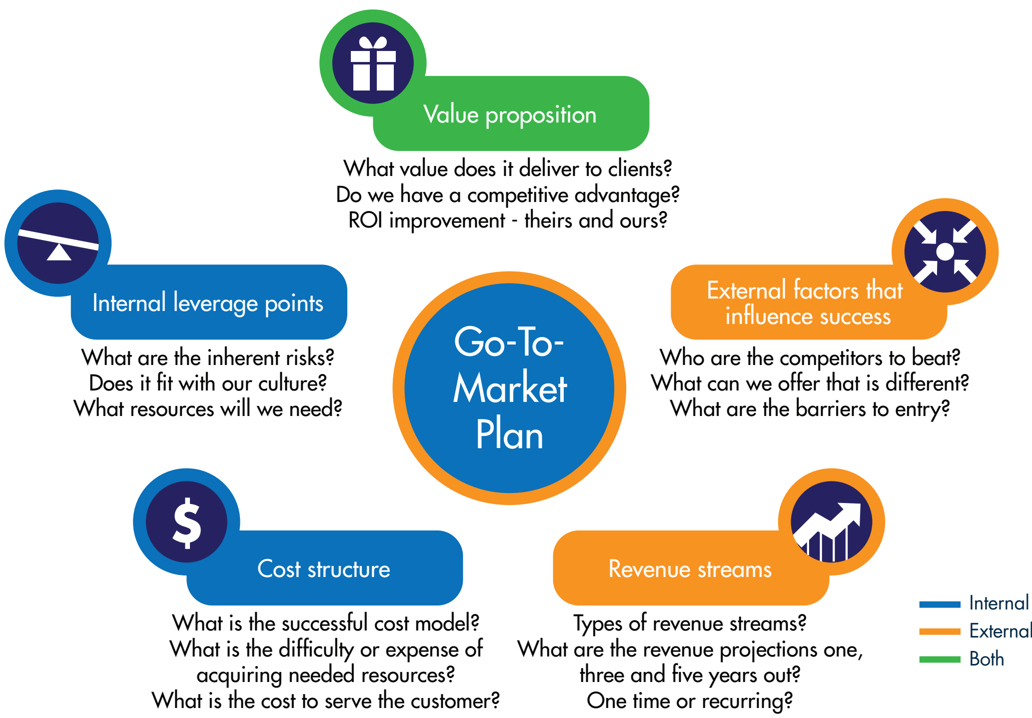
   Remember, it's in the customer's best interest to have multiple contractors chasing a project. You don't just want to be a number in the game. Find ways to stand out and add value for your customer, and build your strategy to win around that value proposition.

5. **Think like the customer.** What is the same, and what is different from the customer's other projects? What is the project's business purpose? Who are the key end users that need to be included in the decision? What is something the customer has struggled to get other contractors to fully focus on?

Find out what the customer wants and why it is so important. What value do you bring that the competition does not? Value, by definition, is something that a person is willing to spend a little bit extra to obtain. See if you can find something the customer values that your organization can deliver better than anybody else.

6. **Put your time where your strategy is.** Build in organizational capacity that's centered on a key focus, such as spending time with customers in advance. Everyone is busy today, so even when you do a good job of targeting specific customers, a lot of other things will be vying for your attention. The tactical things we all get caught up in take time away from the strategic moves that are needed to put ourselves in a winning position.

Exhibit 3. Key Elements of a Go-To-Market Plan



Why throw millions of dollars out the window trying to win bids and customers? Chasing work is a necessary but expensive proposition for contractors, but the firms that get smart about their strategies are generally the most successful and profitable. Getting smart about your go-to-market strategy, picking the right customers and pre-positioning yourself for the win will help set up your company to gain profitable market share without breaking the bank.

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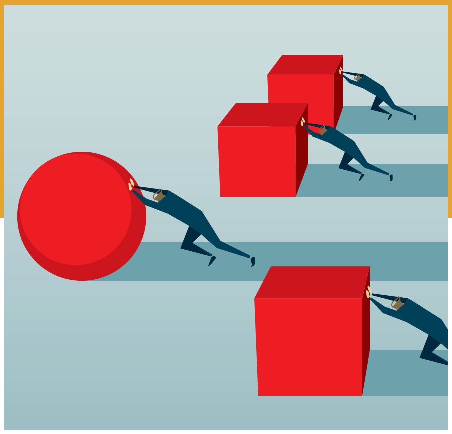


How Your Board Can Propel Organizational Strategy

By Michael Mangum, Lauren Ramsay and Emily Livorsi

How to leverage the power of your board of directors to propel strategy and enhance company growth.

In a recent study of contracting firms, over 70% of industry leaders acknowledge that they have a strategic plan in place that has been fully communicated to the rest of the organization. Despite their prevalence, the quality of such plans can be highly variable. In addition, many firms lack the organizational discipline and accountability necessary to execute the plan, further diminishing its efficacy. Yet we know that organizational health is a function of the depth, quality and execution of its strategies, and not whether an organization has merely "checked the box" of developing the strategic plan.

Similarly, most businesses have a board of directors in place since the law requires all for-profit and nonprofit corporations to utilize a board. However, relatively few businesses utilize their boards for anything more than legal compliance. This leads us to a key question: Can a board of directors play a catalytic role in supporting the successful creation and implementation of strategy?

This article summarizes the common challenges industry organizations face when developing and utilizing boards for strategic planning, how boards can be more effectively developed, and, finally, when maximized, how boards can engage with management to improve strategy.

Common Challenges

Multiple industry factors contribute to the underutilization and relative underdevelopment of boards—hence diminishing their influence on an organization's strategy. The factors include:

- **Common Challenge #1:** The CEO/majority owner chooses to utilize a board to simply fulfill its minimum statutory legal requirements.

  Likely result: The board never officially meets and is composed of "insiders"—either employees or family members—who merely approve meeting minutes to catalog in the corporate records and provide no input to the strategic planning process.

- **Common Challenge #2:** The CEO is concerned that inviting a board to advise on strategic plans will result in his or her losing organizational control and influence.

  Likely result: The board is used primarily to rubber-stamp the strategic plan that is presented by management (rather than offering deep insight, questioning or value).

- **Common Challenge #3:** The CEO and leadership team are emotionally attached to a set of strategic initiatives and not open to feedback, questioning and potential modification.

  Likely result: Leadership shares only carefully chosen content and presents that content to the board in an overly orchestrated fashion that limits the board's depth of engagement.

- **Common Challenge #4:** Board membership is limited to internal directors who also serve as employees of the business. In this scenario, the board strongly resembles a subcommittee of the organization's leadership team.

  Likely result: A lack of external perspective results in little additional value when weighing in on a strategic plan. In this case, the directors lack motivation to ask the hard questions necessary to enhance strategy.

- **Common Challenge #5:** The board digresses into operational issues (especially when dominated by internal directors) rather than focusing at the strategic level.

  Likely result: The board meeting is consumed by "deep dive" tactical concerns, frequently devolving into micromanagement and second-guessing of managerial decisions.

These problems are likely to surface when senior leadership and board members lack a fundamental understanding of how fully developed boards can truly accelerate strategy.

Six Ways to Leverage Your Board to Boost Organizational Strategy

To improve the impact of organizational strategy, firms can start with the following six practical steps to leverage and engage their boards more effectively:

1. **Set up the expectation that strategic planning must include meaningful input from the board. For many organizations, this represents a significant cultural and procedural shift in strategic planning.**

   To put a strong strategic plan in place, senior leaders must embrace strategic collaborative engagement so that the focus will be on the right issues—those that directly support achievement of the organizational vision and a plan that is influenced by diverse perspectives. Chip Andrews, former chairman of FMI, notes, "The No. 1 thing I am looking for is for the board to own strategy… [a great] board takes the strategic recommendations, the strategic analysis that the executive team does, it questions, it debates, it considers and eventually owns that strategy."

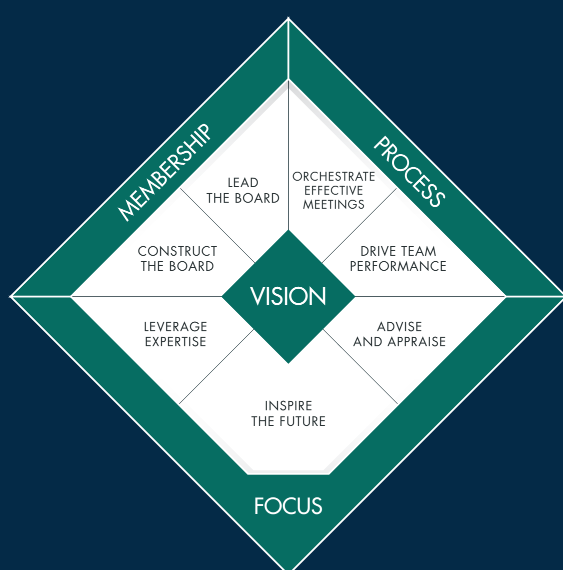
   This process may be uncomfortable for CEOs who seek to be celebrated for their successes, but a true leader is open to feedback and willing to commit to a participative, dynamic, strategy-centered engagement with the board. To get a board involved in the strategy conversation, set expectations for both the directors and the organizational leadership regarding this direction. For board members, this means clear directions around strategy involvement in the onboarding process and reinforcement during any subsequent training. In addition, meetings must be managed in a way that carves out time to dive deep into strategy.

2. **Synthesize data from a variety of sources relative to market dynamics, buyer behavior, competitor analysis and external trends in pursuit of the optimal strategy approach.** Board members need to think critically about strategy and, specifically, about what information sources are utilized to develop their underlying assumptions and conclusions. To what extent does management tap into external resources? Does the research involve accessing publicly available information only, or is it original research to more deeply understand key markets, construction services buyers and/or influencers? Or, alternately, does the business's senior leadership rely primarily upon on its collective experiences and anecdotal knowledge of the market to craft the strategic plan?

Improving a Board's Effectiveness

A board of directors can, and should, be deeply involved in strategy. By focusing on the organization's strategic direction, the board has an opportunity to drive and refine a company's strategy. And yet, to offer real value in this process, the board must have the appropriate focus. Related to strategy, FMI has found that high-performing boards, alternately called "Peak Boards," primarily focus in the key areas shown in the following Exhibit:

Exhibit 1. FMI's Peak Boards Model



Source: Model is based on in-depth industry research.

A board culture that promotes learning and development will support the insightful analysis of trends and issues facing the firm. Establishing and reinforcing this culture is key. A growth-oriented culture welcomes new and potentially conflicting ideas, while a more insular culture feels threatened over the prospect of a different way of viewing the marketplace.

3. **Encourage board diversity to bring new perspectives, ask questions and debate.** We know that outside directors working actively together to influence the company generate great value for the business. One board-related study found that in family-held businesses, directors external to the organization created higher shareholder value as well as greater EBITDA. Conversely, companies where the founding family overwhelmed outside directors achieved significantly lower returns.

   Creating a balanced board that includes both external and internal members, and one that brings together expertise from different sectors, will support the breadth and depth of debate through integrating different perspectives. Andrews notes on board membership, "I'm looking for diversity." Strategic plan quality is a function of diverse perspectives and critical debate. Thus, the more diverse the board, the better-equipped it is to add real value to an organization's strategic plans.

   A diverse Peak Board will include directors of many "shapes and sizes." While some may have spent a career in the engineering and construction industry, others may be outsiders who bring a fresh (and very different) perspective. To wit, I (Michael Mangum) serve on a board of directors of a company far removed from construction. However, my expertise in early-stage board development plus family business generational transitions provides unique perspectives to help a firm living through both challenges for the first time.

   To learn more about board composition, read FMI's earlier article, "Four Fundamentals of Highly Effective Boards."

4. **Ask hard questions and bring a "what are we missing?" mentality to the boardroom.** Hugh Rice, senior chairman at FMI, says the main role of outside directors is to "force people to think about things they do not normally think about." The board—and especially outside directors—is uniquely positioned to challenge convictions, business proposals and strategic plans, and should bring diverse perspectives and expertise to do so effectively. One recent industry CEO recalls an interaction with his board of directors early on in his executive tenure:

   > I recall pitching an acquisition idea to my board. At the time I was thrilled by the potential of a new venture, investing in an innovative technology start-up with tremendous upside. My intuition, careful study of the organization and years of following small tech start-ups told me this would be a fantastic investment. One of my outside directors immediately fired a series of questions at me. The first was whether our management team had considered doing this as a separate legal entity (versus inside the legacy construction company). Sheepishly, I admitted we did not consider that option. After the board meeting, our plan was reshaped; a new limited liability company was later formed that separated the start-up from the legacy business. This drastically reduced the operational and financial risks in pursuing

this new venture. With this approach, we protected shareholder value and created potential to attract external capital. In this instance, a single, hard question from an outside director changed the course of two businesses for the better.

The board that tackles the hard questions shines a light on executive blind spots. Whether asking hard questions about potential opportunities (i.e., new ventures or geographic expansion) or challenging the feasibility of a strategy, a Peak Board ultimately increases the likelihood of a CEO and management team being well-informed in their decision-making and improves the odds of success.

5. **Establish and monitor performance metrics that are consistent with strategic direction.**
   Peak Boards ensure that progress metrics are measured and tracked appropriately when strategies are in place. For example, an organization that wants to differentiate itself in the market through customer satisfaction should be considering these metrics:

   - Existing customer satisfaction
   - On-time and/or within-budget project completion
   - Communication and engagement by staff
   - Speed of resolution of customer-related problems
   - Client lifetime value
   - Percent of annual client “spend” captured
   - Year-on-year revenue growth of existing clients
   - New client acquisition
   - Net promoter score
   - Social media efficacy (e.g., Twitter, LinkedIn, Facebook)

   Using these metrics, leadership can, and should, actively inform boards on strategic priority progress.

6. **Make strategic matters the core of the agenda.**
   While it is easy for the board to become mired in operational details, it must also be able to step back and maintain its focus on strategic monitoring of the company. To maintain strategic engagement, consider the cadence of board meetings as well as the agendas for those meetings. Annual review is not often enough. Ensure that strategy issues are consistently raised, and that there is time for deep discussion as well as ample follow-up. A great board spends 60% of its meeting time on matters directly related to the strategy of the business; any lower than that points to a board drifting into the realm of management. Board committees are often used to keep things moving on targeted strategy initiatives between meetings of the full board.

Collaborative Engagement

A Peak Board is expected to collaboratively engage with the company on a full range of strategy issues. Board members synthesize a broad array of data, leverage the breadth and depth of the team for meaningful debate, and ask hard questions of the company leadership to assess whether wise choices are made.

A high-performing board develops measures of strategic success and keeps strategy at the forefront of its agenda, thus transforming a company for the better. And a business that keeps its board deeply involved in strategy will likely accelerate that transformation and ultimately support the business in achieving its strategic objectives.

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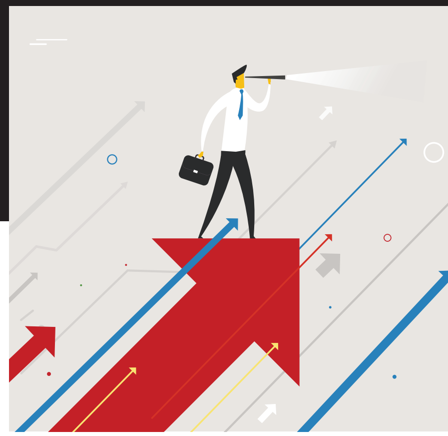


Four Ways to Take Your Client Relationships to the Next Level

By Stephen Boughton

Customer loyalty is more than repeat business. Now is the time to recalibrate your client focus and achieve new levels of customer loyalty.

Sitting here in the third quarter of 2017, within a few months of the 10-year anniversary of the Great Recession, we are in a buoyant construction market. It is not just the major metropolitans that are "on fire." The resurgence of activity across the nation is providing ample opportunities to any attentive contractor.

With this backdrop, the day-to-day focus is on grabbing market share and building a team that can execute on our commitments—certainly no easy task. So does this mean we can take our foot off the "strategic gas pedal"? After all, where can we find the time to think about the future when we are in the heat of today's battle?

The truth is, leading organizations never stop thinking long term; they constantly challenge how they position to win, deliver value and succeed in their marketplaces. A lot has been written on this subject. Authors Michael Treacy and Fred Wiersma, in their book "The Discipline of Market Leaders," describe three generic competitive strategies or value disciplines: operational excellence, customer intimacy and product leadership. Let's think about how we can apply these principles in our industry.

Jack of All Trades, Master of None

With operational excellence, customer intimacy and product leadership all on the menu, the natural (optimistic) tendency is to declare an intent to win on all three, and all the time. While this intent is honorable, companies that do this usually come up short. The result is a jack of all trades, master of none. There are many examples of companies, both inside and outside of the industry, which have become leaders by being more focused, not less.

So where to focus? Product leadership means bringing customers leading-edge products and services that consistently enhance the customer's use or application of the product, in turn making competitors' goods obsolete. In our industry, it is increasingly difficult to stand out in this regard. Contract methods, delivery systems, procurement practices, means and methods, and so forth are easy to replicate once one competitor discovers a first-mover advantage. However, this should not preclude us from exploring innovations that could set us apart.

What about operational excellence? Some might even call this discipline "table stakes." After all, if we cannot provide our clients with reliable service, at a competitive price, delivered efficiently with minimal headaches, then why are we even in business? In reality, we encounter companies daily that struggle to deliver operational excellence. The body of evidence is strong on this topic; too few contractors create the robust systems, tools and processes necessary to deliver on their promises. Look at how long it takes to punch out a project and how many items linger well after substantial completion.

That leaves us with customer intimacy. This is the good, old-fashioned "segment, target and position" approach, which is often taken for granted. The more we can understand our client base and then tailor offerings to match exactly the demands of those niches, the more successful we will become.

Companies that excel in this discipline understand how to balance detailed client knowledge with operational flexibility to respond to client needs.

Don't Confuse Repeat Business With Customer Loyalty

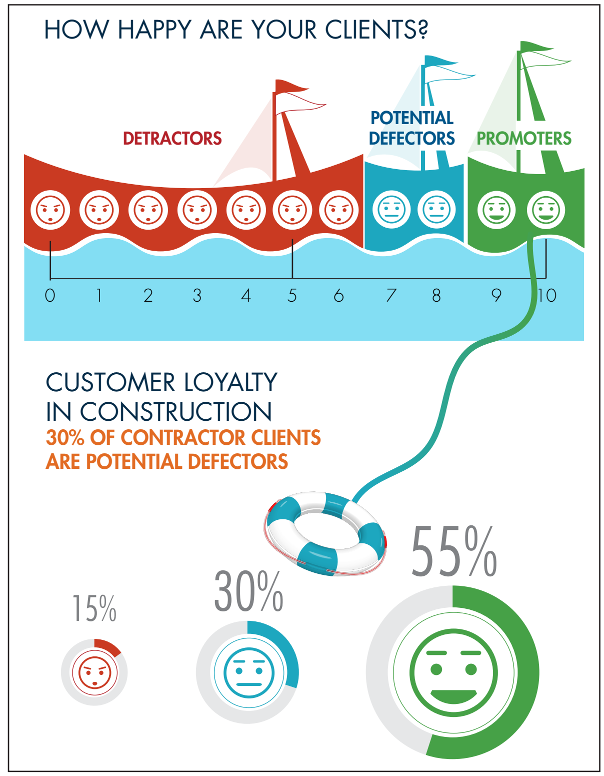
Working with contractors around the country, we often hear that "80% of our business comes from repeat clients." At first glance, this statistic would imply a strong level of customer commitment and loyalty. But we need to challenge ourselves below the headline by asking:

- Do those clients come back to us because we are their No. 1 choice?
- Or are we simply fulfilling their need to spread some work beyond their preferred contractors?
- Is it a capacity issue?
- Do they see us as a lower-quality option, able to satisfy their needs on a "C" project?

This all may sound a bit negative, but we must be prepared to challenge conventional thinking at a time when industry capacity is stretched. My colleague Jay Bowman recently wrote about the importance of understanding your Net Promoter Score in the article "Three Ways to Keep Your Clients From Defecting to the Competition." Jay underscored the importance of truly understanding how your client base feels about you, stating, "From FMI's research, 30% of contractor clients could drop them at a moment's notice," as shown in Exhibit 1.

Losing those clients can be devastating, so how do you achieve customer intimacy, and how do you know when you get there? For starters, customer intimacy is something you earn through a commitment of your time, talent and treasure. Many companies pay lip service to this principle with throwaway statements like "Client service is our No. 1 goal," or "The client comes first." Posting such statements on the lunchroom wall does not constitute commitment. The solution lies in your management of the relationship, understanding and ability to meet the clients' greater needs.

Exhibit 1. Customer Loyalty in Construction.



Data Source: FMI Research Services
Statistics are based on more than 5,000 contractor-client responses.

Four Strategies for Building Deeper Client Relationships

Client and work acquisition are team sports. Not everyone in your company has the responsibility of targeting and winning new customers, but everyone is responsible for making sure customers get the outcomes they hired your company to achieve, and with the least possible hassle. These comments are likely intuitive to most, if not all, of our readers. However, the application of these ideas is what sets contractors apart. An email from the desk of your company president, declaring "Everyone has a role to play in business development," won't cut it.

To achieve new levels of customer loyalty, conduct a concerted review of all your business development (work acquisition) activities through the integrated chain, namely marketing, sales and customer service. There are opportunities to earn customer loyalty in each of these areas. The real win comes when you can demonstrate an integrated approach where there is virtually no line of separation. In other words, clients perceive a "one-to-one" relationship at each stage regardless of which company representative they encounter. Do this by:

1. **Increasing the number of client touchpoints.** Customers are organizations (public, private, for profit, not for profit) made up of individuals who can choose to either hire you or someone else. Some customers have the authority to say yes, but many more can say no. We need to increase the range and frequency of touchpoints to ensure we fully understand clients' needs and filter them back to our organizations.

2. **Ensuring executive involvement.** Too many executives gravitate to the operational side of the business. It is the area they have likely grown up in, and so they feel comfortable in those roles. Widening the focus beyond the immediate needs of the projects and building the right teams to run the day-to-day operations allow you to get out in front of developing one-to-one relationships and learn about your client's business. This translates into better knowledge of future opportunities and a chance to differentiate your company.

3. **Developing a client-service culture.** Companies with a strong, client-centric culture have greater success rolling out positive relationship behaviors to frontline employees and reaching those who can truly impact a client's experience. Do you have a cadre of superintendents who will see a client from across the job site and run toward him or her, seeking feedback, providing observations and getting ahead of problems? Or do they run the other way in the hope they are not seen?

   Cultural shifts do not happen overnight, nor do they happen by chance. Creating the right culture requires an investment in your people. Ask yourself questions like: Are we hiring the right people, and are they armed with the right tools, training and questions? Are they encouraged to get closer to the clients—not just during a project but also in between projects? Think of the cumulative impact you can achieve with 10 project managers regularly interfacing with just five key clients on an ongoing basis.

4. **Rewarding employees.** Our industry is built on hard work and going beyond the call of duty, but how often are these cornerstones taken for granted by associates? Highly engaged employees who exhibit the right behaviors at any level should be rewarded accordingly. Formal or informal incentive programs and bonuses not only motivate employees but also get them more in tune with the company approach. Customer intimacy relies on increasing employee knowledge at every touchpoint.

Time, Focus and Effort

Customer intimacy is a discipline and must be much more than a marketing slogan to make an impact. True customer intimacy can only be earned by aligning all functions and layers of the organization around the needs of the individual customer. By promoting lifetime customer value and developing strategies to increase customer intimacy levels with a business, companies can position themselves to win in today's highly competitive market—a mission that requires time, focus and organizational effort.

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FMI QUARTERLY
ISSUE THREE
2017

Taking Your Leaders to the Next Level With Coordinated Coaching

By Tom Alafat and Emily Livorsi

How Cadre Coaching can help address not only individual developmental needs but also a shared set of organizational objectives.

Over the last few decades, the number of companies using executive coaching has grown significantly. Currently, there are nearly 20,000 professional coaches who have active clients in North America, thus illustrating both a demand for coaching among executives and a realization of the value that these professionals provide.

Here at FMI, we've seen a substantial rise in architecture/engineering/construction (AEC) industry organizations that rely on coaching to help them rapidly accelerate the development of their people. In an industry where talent is a scarce commodity, organizations that invest deeply in their people through the highly personalized coaching experience have identified it as a true differentiator.

In this article, we explore the use of executive coaching in AEC firms, discuss the challenges that leaders encounter when working with coaches, and detail FMI's successful Cadre Coaching approach.

The Seven Limitations of Coaching

Coaching's impact on a business can vary greatly according to the company, the time and effort it puts into it, and the individuals involved in the process. When these stars don't align properly, the following challenges can occur:

1. **Coaching Comes With Minimal Barriers to Entry.** While coaching credentials are becoming increasingly popular for executive coaches, there remains a limited barrier to entry, meaning anyone can be a coach or call himself or herself a coach, regardless of training, industry expertise or certifications. The International Coach Federation (ICF) is the most recognized organization for coaching certification. Sophisticated buyers will ask about where the coach received his or her training and whether he or she is ICF-certified.

2. **Most Coaches Lack Industry Expertise.** While some coaches may have specialized niches, few coaches dive deep in industries and instead pride themselves as being broader leadership experts. While basic leadership principles may apply across industries, a lack of intimate industry exposure and experience can result in misguided support or minimal confidence in a coach's knowledge and reputation.

3. **Many Coaches Operate Autonomously.** While this may work in smaller organizations, many coaches lack the necessary network and/or resources to address the many facets of the construction environment. One FMI coach recently worked on talent development skills with a CEO from a $500 million specialty contracting firm. During the coaching engagement, the CEO disclosed his issues with field productivity. With careful questioning and industry experience, the coach identified a field leadership issue and connected the CEO with the appropriate resource.

4. **Coaching Is Personal Versus Strategic.** While the purpose of coaching is to support an individual's professional growth, it is also important to be working toward the organization's larger objectives and goals. Coaches who lack industry experience and organizational knowledge may remain too focused on the individual's personal strengths and challenges without coaching to skills closer aligned to the organization's broader strategic needs.

5. **Coaching Lacks Diligence in Measuring Impact.** Measuring coaching's ROI is always a challenge even though there are numerous methods for determining its impact on the organization. Unfortunately, follow-through and diligence around measuring and tracking changes in leaders' behaviors are often abandoned in the coaching process. Therefore, utilizing custom assessments after the coaching engagement concludes is a critical way to evaluate the impact of a long-term coaching investment.

6. **Coaching Remains Remedial Versus System-Focused.** While coaching has grown in its use to maximize the strengths of leaders, many times coaching is a last resort for a challenged or struggling leader. While coaching can certainly be impactful in these cases, coaching can be even more effective in an organization when it is applied as an initiative to drive a leadership strategy, enhancing capabilities of current and high-potential leaders within the organization.

7. **Coaching Lacks a Network.** When coaching is a one-off effort for struggling leaders, the transformative experience of coaching is restricted to a select few. This siloed approach limits impact, whereas coaching a group of leaders simultaneously can create a coaching culture, encouraging peer learning, building stronger accountability and accelerating skill development and application across the entire leadership team.

Leveraging Cadre Coaching to Break the Mold

The good news is that there is a tried-and-tested way to break through the seven barriers of coaching and truly benefit from the experience. Cadre Coaching, or the process of coaching a group of individuals simultaneously, is exceptionally impactful because it addresses not only individual developmental needs but also a shared set of organizational objectives. For example, several years ago FMI was asked to assist a very large general contractor that was in the middle of a reorganization and leadership transition. The engagement's scope involved understanding the complexities of the reorganization and associated desired outcomes, assessing dozens of leaders through comprehensive personality tests, and then individually coaching the new leaders in their new roles.

It's important to note that the engagement's success was not limited to everyone's ability to succeed in his or her new position. The organization had clearly defined values and objectives that it wanted to instill into its company culture. Coaching took place over a few years and involved a half-dozen coaches who regularly spoke with one another to ensure their coaching was aligned with broader company goals.

In other words, the initiative's success was not based on the individual growth of any one leader but rather on the collective energy of the leadership group. This approach helped the new leadership group transition smoothly while moving toward the company objectives and instilling organizationwide core values.

A Step-by-Step Approach

FMI's Cadre Coaching approach follows these steps to ensure maximal impact and address the common coaching challenges mentioned earlier in this article:

Step 1: Deep Organizational Analysis

Launch a rigorous examination to identify the current situation of the organization. This step includes assessing the performance, operations, culture, talent and future aspirations of the company. Collecting this data gives a candid snapshot of where the highest and best use of coaching exists.

Step 2: Develop Objectives Based on Existing Organizational Challenges and Opportunities

Using the information from Step 1, develop a clear set of objectives to target through Cadre Coaching. For example, after assessing the organization, you might determine that significant leadership transitions will occur over the next few years due to the retirement of current members of the executive team. In this scenario, cadre coaches would help those being coached prepare for a future leadership role, the skills required to lead and manage change, and the development of the next generation of leaders. At the start of all Cadre Coaching engagements, executive stakeholders, leaders being

Organizational Challenges and Opportunities Where Cadre Coaching Is Effective:

- Succession management
- Building team dynamics and capabilities
- Implementing new organizational strategy
- Culture change efforts
- Developing new competencies in response to market shifts or structural changes

coached and coaches have an alignment meeting to agree on the cadre journey and its overall objectives. This alignment process helps clarify the focus of coaching as well as developmental expectations and accountabilities.

Step 3: Cadres Select From a Group of Industry Expert Coaches

Once the organizational objectives are determined, FMI goes through a rigorous process of identifying which coaches might best serve the organization. To do this, we align organizational objectives and individual goals with FMI coaches who have the right competencies and experiences. Knowing that the strength of the client/coach relationship is an important element in creating successful outcomes, we also ensure that each leader/client is assigned a good coaching counterpart.

Step 4: Leaders Create Organizationally Aligned Development Plans

Once matched, coaches launch custom assessments to gather feedback on leaders' styles and behaviors, often uncovering hidden strengths or blind spots. Using feedback from personal interviews and 360 assessments, increased self-awareness and a deep knowledge of the organizational objectives, the coach and leader work together to create a development plan of action. Typically, development plans include a few goals that are both individually and organizationally relevant.

Step 5: Use Assessments to Measure Impact

At the beginning and conclusion of a Cadre Coaching engagement, all leaders receive a custom 360-degree assessment that is aligned with their developmental goals. For example, a leader focused primarily on developing executive presence, negotiation skills and relationships would receive a 360-degree assessment. Through that assessment, direct reports, supervisors, peers and clients provide feedback on behaviors related to those primary focus areas at the start and upon completion of the coaching. This allows FMI to gauge progress, skill development and impact.

Tying It All Together

Cadre Coaching involves numerous steps and incorporates coaches, leaders and executive stakeholders. FMI's Cadre Captains are leadership, coaching and industry experts who manage the coordination of the cadre, frequently inform executive stakeholders of leaders' development in the coaching journey, and coordinate among FMI's coaches to gauge leaders' engagement and progress. The cadre captain ensures that the coaching journey is seamless for the leader and that the coaching process results in real business impact for the organization.

Now, the true value of Cadre Coaching in part comes from multiplicity. The impact one leader has on an organization may be significant, for example, but when a group of leaders is coached at the same time, and is influenced by similar philosophies of leadership, the results are often more dramatic and pronounced. The common experience also creates a degree of connection among the team members.

The common coaching experience also helps to build camaraderie among the cadre. This, in turn, opens up new and richer lines of dialogue among cadre members. Deeper communication among executives leads to teams that are more productive.

Here's how one senior vice president remembers the impact that Cadre Coaching had on a group brainstorming session: "Several people who were undergoing coaching (including myself) participated in a committee brainstorming session. It was tremendous. During the exchange of ideas, you could observe how some of the participants had developed over the course of their coaching program—including me. The coaching experience we had in common brought it all together. It's hard to quantify, but it's something I'll always remember as a great experience. It was so much fun—my colleagues and I still talk about it!"

Executive coaches who work with a cadre of leaders also have the means to quickly grasp the dynamics of working relationships. When one coach engages with several individuals on the same team, for instance, he or she becomes a third party who can witness the interpersonal dynamic of each leader firsthand. This gives the coach a vast amount of information to work with—much more than he or she would have if coaching only one leader. Using this data, the coach can quickly recognize the reality of a situation and be more effective for all team members.

As more companies and executives turn to coaching to help them break through barriers and get to the next level, expect to see a growing number of coaches doing their part to help motivate and inspire their coachees in a very accountable manner. And as coaching as a business tool continues to grow in popularity, the basic fundamentals of the process remain intact: Help others become the best that they can be, identify negative behaviors and develop leaders to their fullest potential.

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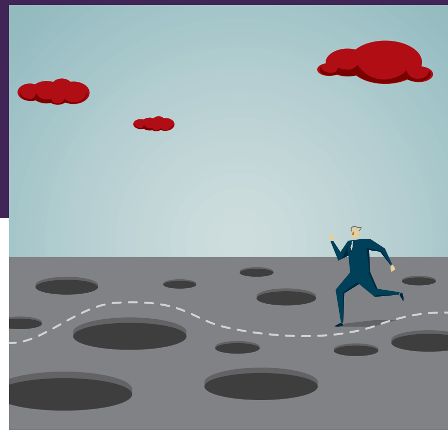
ISSUE THREE
2017



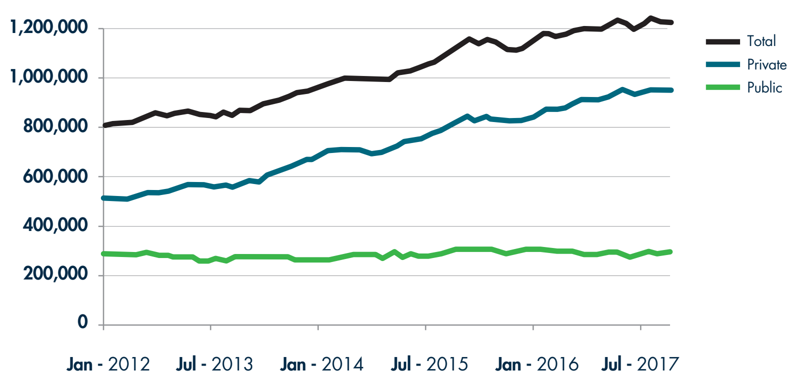
Using Subcontractor Prequalification to Help Mitigate Risk and Increase Success

By Gabriel Valls

The rebounding construction market demands even greater discipline and diligence when considering subcontractors.

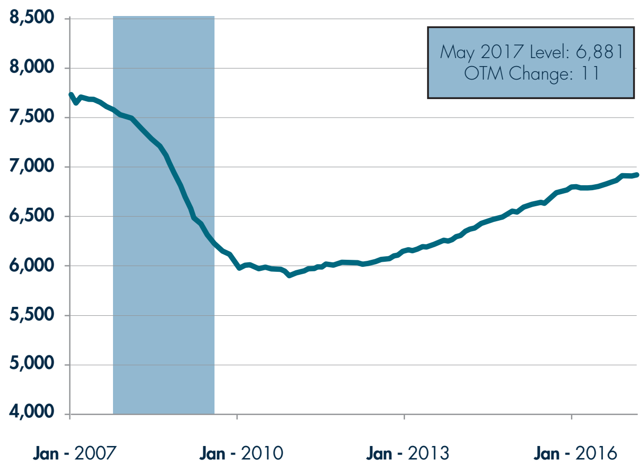
Nearly a decade ago, the construction industry suffered an unprecedented loss during the Great Recession. Fast-forward to today: Government figures show that construction spending in 2016 was almost $1.2 trillion with year-to-date figures projected to be even higher in 2017 (Exhibit 1).[1] Construction employment increased by 16,000 in June 2017,[2] according to the Bureau of Labor Statistics (BLS). The BLS also calculated that the industry added an average of 20,000 jobs per month between January and May 2017—a 54% increase when compared to gains averaging 13,000 per month in 2016 (see Exhibit 2).[3]

Exhibit 1. Construction Spending
(Seasonally Adjusted Annual Rate) Millions of dollars



Source: U.S. Census Bureau, July 3, 2017

Exhibit 2. Employment in Construction
January 2007 - May 2007 |Seasonally adjusted, in thousands



Source: Bureau of Labor Statistics, Current Employment Statistics survey, June 02, 2017.
Shaded area represents recession as denoted by the National Bureau of Economic Research.
Most recent two months of data are preliminary.

On the surface, the forecast looks extremely favorable. Scratch that surface, though, and you'll find an industry pitted by the effects of the Great Recession, with subcontractor default being one of the most visible of the consequences.

In fact, subcontractor default is an even greater risk in robust 2017 than it was during the downturn of 2008. Subcontractor default increases as markets rebound, due in large part to the cash requirements of funding a growing backlog while still grappling with the human capital and financial strains suffered in the down times.[4]

Considering that a single subcontractor's contract can reach well over $100 million, general contractors that fail to award contracts wisely are putting their companies, their projects and their reputations in jeopardy.

Subcontractor Default Insurance losses today can and have surpassed $65 million on major projects. For those companies that want to position themselves against default, prequalification can be one of the best leading indicators for success—provided it is done properly and continues to evolve with the changing market.

Growing Pressures in an Evolving Marketplace

Because the pressures to perform and meet budgets are substantial, pursuing due diligence as it pertains to prequalification remains a hurdle for many general contractors. The economic rebound has created a lot of work—possibly more work than the industry can comfortably handle on a per head count basis. But right now there's a limited labor pool to match this influx of work. Many construction workers left the industry during the Great Recession, not to return. The Associated General Contractors of America (AGC) analysis of government data reports that although jobs have increased, unfilled job openings continue to affect the industry.[5] At a time when much of the current, skilled workforce is aging, unskilled or insufficiently trained workers are likely filling many positions.

What's more, owners are pursuing unique, one-of-a-kind projects and may be setting unrealistic design and schedule expectations. The projects are bigger than ever, easily reaching beyond $1 billion. This puts even more pressure on general contractors, which in turn contractually pushes such pressures onto their subcontractors. What is interesting about this approach is that the organizations least capable of shouldering such financial pressures—the subcontractors—are forced to carry most of the burden.

This is why prequalification must be undertaken with diligence and seamlessly integrated with the general contractor's corporate culture. The old adage of "we have done business with them for years" no longer holds. As the breadth of a general contractor's reach expands into new market sectors and territories, it requires discipline—not a "see what sticks" attitude. Subcontractor red flags and weaknesses are visible to those who take the time to look for them.

Most ENR Top 400 general contractors should be, and probably are, conducting some type of preliminary prequalification work.

In this new, post-Great Recession landscape, the risk of making a poor award decision can result in general contractor bankruptcy. Here are some key questions to consider:

1. Is prequalification part of your organization's culture?
2. Are you a learning organization—one that evolves with the changing market and embraces change?
3. Does senior management embrace the results of prequalification, or will economic and competitive pressures overcome the obvious results of your prequalification?
4. Are you doing what you say you do?

Implementing a rigorous system will not only help streamline the process, but will also make it easier to find subcontractors with whom to create strong working relationships with in the future.

Changing With the Times

Aligning prequalification with due diligence requires an evolving mindset and self-discipline.

Break bad hiring habits. The rebounding construction market is not simply a return to pre-2008 construction levels. It's a new environment with significant and different challenges. A general contractor's behavior must follow suit. "I trust that guy" is not a reason to award a contract. Nor is making "one exception" when the data and due diligence point in a different direction. I have yet to meet a general contractor whose staff does not know when it's taking a gamble on a subcontractor. Going forward, a differentiator will be a general contractor's ability to pause and reconsider making such a decision.

Embrace prequalification as an ongoing initiative. An effective prequalification process should become part of an organization's culture, and it should be pursued consistently. For example, you should continually visit prequalification in the course of an upcoming project, and it should be done for each and every award.

Own the process and evolve for future success. Without a doubt, surety and Subcontractor Default Insurance are significant assets, offering valuable protection in today's high-stakes environment. Subcontractor Default Insurance, for example, has become a product that many general contractors depend on. This insurance product relies on the general contractor to prequalify subcontractors, to help ensure optimal results, and make prudent award decisions based on the subcontractor's proven ability to perform.

Seven Keys for Future Success:

1. Embrace and own the process.
2. Embody a culture of risk management.
3. Become a learning organization.
4. Seek leading indicators for future success.
5. Improve your operations and look for ways to incorporate best practices.
6. Develop a well-defined prequalification program focused on established protocols and individual accountability.
7. Apply lessons learned from past claims experiences to ensure they are not repeated.

Building Upon the Basics

When it comes to prequalification, challenging and enhancing the lens to evaluate subcontractors are very important. Three areas continue to be the focus, each with its attendant issues:

Character:

- What is the reputation of the firm and its principals?
- Has it ever defaulted on a contract?
- Is it in litigation?
- Does it have a strong claims management program?

Capacity:

- Does the subcontractor have a history of successfully completing contracts similar to this one in terms of scope, size, complexity and geographical area?
- What is its current manpower, and is this sufficient for the project under consideration?
- Have the facilities' capacity and maintenance practices been fully evaluated?

Capital:

- What are the quality and accuracy of the subcontractor's financial statements?
- What is the strength of its balance sheet?
- Does it have sufficient equity and liquidity to support the work?
- Does it have a good credit/pay history?
- Does it have an established banking relationship and adequate line of credit?
- Has it been profitable over the past three years?
- Does it have a surety relationship?

In today's environment, expanding the lens is paramount for success. General contractors must view prequalification the same way they view properly descoping a bid. The process must be methodical, repeatable, trackable and supported by the organization's top tier. Essentially, prequalification is an ingrained aspect of the organization's culture.

In today's business environment, consider expanding your process to include:

- Prequalification for each award
- Creation and maintenance of a database
- Aggregation tracking
- Risk mitigation plans
- Post-project evaluations

Focus on all the tools that you and your peers have on hand and fully embrace all of the risk management strategies available in the marketplace. There's no better time to begin optimizing robust prequalification practices and learning from others in order to strengthen your organization and help secure its future.

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CITATIONS

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Four Steps to a Winning Divestment Strategy

By Dan Shumate and Carter Brenneman

In a business environment where 83% of E&C firms are interested in acquisitions, it pays to set your criteria, establish your team and lay down the rules of the road before jumping in.

As project sizes grow, and as the share of megaprojects rises as a percent of total construction put in place, the demand for large, technically sophisticated firms has increased. We're also seeing a continued integration of design and construction, both in terms of project delivery and business models. Combined, these trends have led large E&C players to increase their acquisition activity, especially engineering and design firms.

In FMI's recent M&A trends study, 79% of firms with over $1 billion in revenue stated that acquisitions were a current part of their strategy, compared to 42% of firms with less than $500 million in revenue. Mirroring recent deal history, engineering and integrated E&C firms indicated they were much more likely to be acquisitive in 2017, with 83% stating acquisitions were a current component of their strategy.

Similarly, of the nearly 4,000 M&A transactions FMI has tracked since 2007, roughly 5% were acquisitions by eight firms, primarily large engineering-led companies such as Stantec, WSP Global and AECOM. This trend is less pronounced on the construction side, where competitors are more fragmented, projects are delivered locally, and economies of scale are less pronounced.

Over the last few years, the ENR 400 has accounted for roughly one-third of all construction put in place in the U.S., a ceiling it has not topped since the 1970s. Despite this, we are seeing increased buyer appetite in the construction segment, especially among self-performing contractors.

In this article, we'll explore the current M&A trends, show where the challenging points are, and provide four rules of the road that all E&C firms should follow when considering and/or orchestrating mergers, acquisitions and divestitures.

Is It Worth It?

In tracking nearly 400 E&C transactions in the U.S. and Canada in 2016, FMI found activity to be roughly on pace with that of 2015 and 2014. Fast-forward to 2017, and acquisitions remain a component of most E&C firms' current strategy, with many companies prioritizing small strategic deals over major transformational acquisitions. For those firms currently considering an acquisition, the ability to integrate effectively was identified as the most important factor in achieving a successful transaction.

Before executing a strategy of "growth through acquisition" or "strategic refinement through divestiture," company leaders need to ask themselves this important question: Is this worth it? For acquisitive growth, this next question is: Does the risk of investing capital in a business outweigh the risk of loss or setback? And for divestitures: Do people in a division that have been with the company through the thick and thin outweigh the potential advantages that come with a focused strategy?

Creating a Focused Strategy

Many construction companies never complete an acquisition. Instead, they are passed from generation to generation and tend to grow at a measured and predictable pace. Contrast this with a company like Quanta Services, which over the past 20 years grew its revenue from $80 million to $7.6 billion. This growth was due to a focused acquisition strategy in a segment where Quanta understood the end market and was disciplined in pricing—strategies that drove the growth of the largest power services company in the U.S.

In addition, Quanta has not simply purchased companies and held them indefinitely. Also shaping the firm's strategy and improving shareholder returns were strategic divestitures of business segments that were underperforming due to changing market dynamics. Companies that engage in both acquisition and divestitures to actively control what is in their portfolio deliver increased shareholder returns.[1]

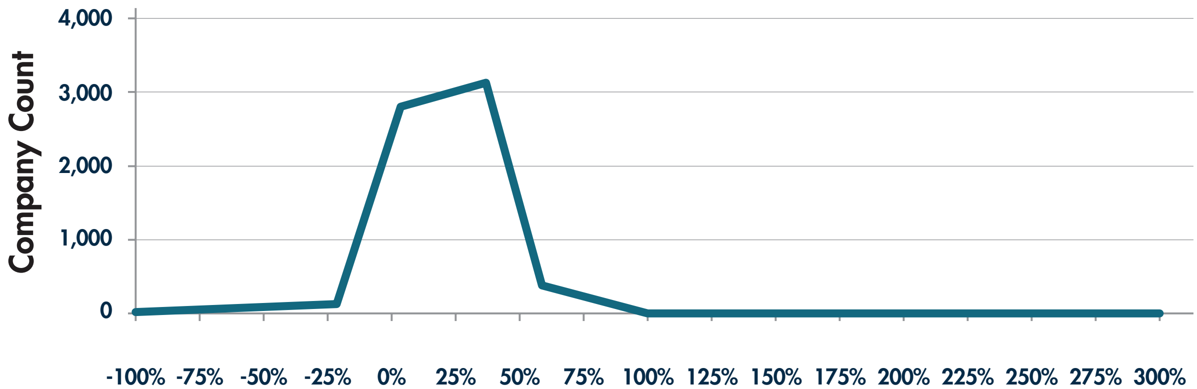
Let's look at an analysis of the valuation and share price return of over 6,000 divestitures or spinoffs by public companies since 2000. In Exhibit 1 below, a pattern emerges that persisted throughout the data: a right skewed histogram that has a very long tail on the positive end of the spectrum. We would expect the right skew because there is a natural barrier to price ($0); and if a company makes a decision that has very negative effects on the business, then there is a downside to the percentage decrease of the company's stock price. However, the magnitude of positive increase in stock price results in a notable finding, with both the short-term (5 days) and middle-term (180 days) results showing an increased chance of outperforming the market.

Further study has demonstrated that over longer time intervals, excess returns for companies that complete divestitures averaged 4.4% globally.[2]

[1] Dranikoff, Koller, Schneider (2002). Harvard Business Review.

[2] Restructuring and Repackaging Corporate Assets, May 9, 2008, Citigroup Global Markets.
Excess return is defined as: Actual Return – (β x Market Return).

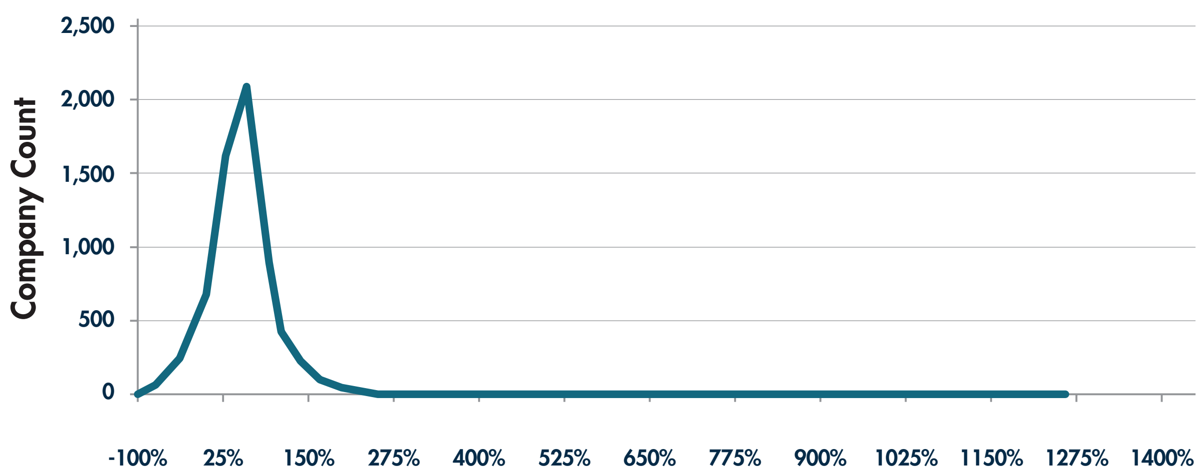
Exhibit 1. Histogram of Stock Price Change
(Five Days After Transaction Announcement)



Source: Data compiled from S&P Capital IQ and analyzed by FMI

Exhibit 2 illustrates not only the right skew, but also the significant long tail that can occur, resulting in outsized shareholder return. The average stock price return over 180 days was 10.9% alongside a median of 4.5%. Additional analysis by other firms produces similar results. In a study written by Bain consultants for HBR, "An investment of $100 in the average company in 1987 would have been worth approximately $1,000 in 2007, but a similar investment in the 'best divestors' would have been worth more than $1,800."[3]

Exhibit 2. Histogram of Stock Price Change
(180 Days After Transaction Announcement)



Source: U.S. Census Bureau, July 3, 2017

[3] Mankins, Harding and Weddigen (2008). Harvard Business Review.

While the divestiture can be a boon for a shareholder, many of these transactions actually produce limited returns. The reason for the divestiture, strategy moving forward and the financial changes after close all impact the likelihood of success. Reasons for a divestiture can vary widely from operationally focused to financially focused. Common reasons include:

Strategic Focus: Management aligns the business with its primary strengths.	**Capital Structure Change:** Management can reduce leverage, improve credit rating and increase financial flexibility.
Operational Improvement: Management exits from low growth and profitability segments.	**Increase Cash:** Management increases cash to allow for acquisition or significant capital purchases.
Highlight Growing Business: Rather than focus efforts on underperforming groups, management can highlight a business unit by divesting of others that do not meet the same expectations.	**Market Timing:** Management determines that a business segment is overvalued by buyers and exits that business.

The Four Rules of the Road

Acquisitions and divestments do not come without risk. Many of the best-in-class acquirers have dedicated teams to select the appropriate companies and then integrate those firms into their organizations. Employee turnover and risk management impact operations while capital structure, distributions, investor profile and credit impact the financial decisions.

We reviewed the work on "how the best divest" for application to the construction industry to determine the four rules of divestment.[4] Here they are:

Rule 1: Establish a dedicated team. Whether determining to complete a major spinoff such as Babcock and Wilcox from McDermott or selecting whether to keep a division in place, a team of individuals dedicated to the analysis of the fit and opportunity of business units within a company is critical. For smaller companies with limited resources, management should take on the role of reviewing business units and service offerings annually.

Rule 2: Set your criteria. While market timing is stated as a potential financial reason for divestment, timing the market is incredibly challenging in practice. It's important to establish a set criterion to effectively determine whether a division or subsidiary should be a candidate for divestment. For example,

[4] Mankins, Harding and Weddigen (2008). Harvard Business Review.

a division's return on investment must meet a three-year average of 15%, or that division could become a candidate. The specific values should be highly focused on the individual market and industry; however, the criteria can prevent hasty decisions or market-timing mistakes.

Rule 3: Dig into the details before pulling the trigger. Removing components of a business can be as impactful as incorporating new ones. Management should select the people who will be involved in the divestment and assess the associated impact on existing operations. For a materials company that can easily separate an individual quarry's people and operations, this can be straightforward. However, the decision to sell the service division of a large commercial electrical company can be much more difficult. Often, the service division of the company will have similar estimators, dispatch and controllers, and be a component of active contracts held in the construction division. The best divestors have a strategy of de-integration before making the decision to go to market.

Rule 4: Articulate the benefit to a potential buyer and motivate employees to stay on board. The last rule is a requirement of any acquisition or divestiture in the engineering and construction space. Without the people involved in the transaction, there is no transaction. Therefore, it is important that you clearly articulate the potential benefit to an acquirer of the division or subsidiary that is being placed on the market. This process helps ensure the divestment does not fail or receive a poor valuation. In addition, it's crucial to retain key employees to facilitate the successful divestment of a unit. A champion within the division can be very helpful for selling the concept internally and presenting the asset for sale. Incentivizing the unit's management team with compensation, and providing select management with knowledge of the eventual sale, can also positively impact the outcome.

As the E&C industry becomes increasingly dotted with mergers, acquisitions and divestitures, the success rates for these deals will depend heavily on the teamwork, legwork and due diligence that take place long before any documents are signed. Utilizing divestments to illuminate value, create liquidity and flexibility, and improve operations has a clear valuation benefit. In both the short term and the long run, companies that align their acquisition and divestment strategy with the core competencies of their business can outperform their peers.

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FMI QUARTERLY
ISSUE THREE
2017

Positioning Your Organization for the Win

By Rick Tison and Jay Bowman

It's not enough to play the game well, you must also decide what game you want to play.

When Southwest Airlines started flying in 1971, it offered direct flights between Dallas, Houston and San Antonio, utilizing older airports in Dallas and Houston that were closer to downtown. Those beginnings sowed the seeds of a strategy that allowed the airline to offer lower fares by offering only short-haul, point-to-point flights, utilizing one type of plane to simplify maintenance, and no international flights.

At the time, Southwest's model differed significantly from other major airlines, most of which operated hub-and-spoke model networks and profited from long-haul, international flights. Over the next 40 years, Southwest's focus allowed the company to grow from those three cities to being one of the largest domestic airlines. More importantly, Southwest has consistently outperformed industry profitability benchmarks.

The success of Southwest's strategy resulted from the airline's decision to play a different game than the competition. In many ways, it wasn't entering the airline business. Instead, Southwest entered the transportation business—getting people from point A to point B—and just happened to use planes as the mode of transportation. Southwest's most direct competition came from buses more than from traditional airlines.

Competing to Be Different, Not Better

Southwest is a classic example of viewing strategy as competing to be different—not better—and in a way that customers value, which Michael Porter outlined in his seminal Harvard Business Review article "What Is Strategy?" At its core, strategy comes down to aligning the organization's current and new capabilities to achieve its market aspirations and priorities. This requires clarity on what those aspirations are, the state of current capabilities, and how to close any gaps.

A common temptation FMI sees when working with industry firms around strategy is the pursuit of best practices. Unfortunately, many organizations take a misguided approach to best practices that conflates correlation with causation. In other words, if a successful company employs a specific practice, then that practice must lead, at least in part, to its success.

Consider this: Early attempts at human flight offer a prime example of the cautionary tale of best practices. These attempts focused on creating the necessary conditions to emulate other things that could fly. A common observation was that those flying things tended to have wings and feathers, which led to the conclusion that wings and feathers were critical components of flight. Sadly, especially for those who made high-altitude flight attempts, wings and feathers only correlated with flight—they did not cause it. While best practices do exist, they only create the "best" results when employed as part of a coherent strategy—it is not the combination of wings and feathers, but the ability to create lift that allows us to fly.

When applied in this manner, best practices are not focused on leveraging or creating a specific source of advantage that differentiates you from the competition in a valuable way. At the time Southwest went into business, for example, other airlines employed a hub-and-spoke model to increase network utilization. This was the best practice for those airlines. For Southwest, however, this practice would have undermined the source of advantage it created through its strategy (i.e., the convenience of point-to-point service and lower prices).

Southwest smartly did not try to build a network where this model applied. In response to the threat Southwest posed, many competitors tried to emulate the newcomer's point-to-point strategy. Most failed to create real value for shareholders and had to abandon these business models.

How to Position to Win

Borrowing a page from Southwest's playbook, positioning to win starts by selecting the right game to play (i.e., what customer values do we want to differentiate on?). In the engineering and construction industry, we have identified three primary sources of advantage that companies leverage to differentiate from the competition: efficiency, customer advocacy and sector expertise. Here's a breakdown of each:

- **Efficiency**—focus on price and schedule efficiency. Engineering and construction is a price-competitive industry, so this is a significant source of advantage for leading firms in many different areas of the industry. This source of advantage is not just about offering the lowest price and shortest schedule, but also about providing certainty on hitting those low budgets and tight schedules.

- **Customer Advocacy**—focus on delighting the customer by better understanding his or her specific needs and providing a customized service and experience.

- **Sector Expertise**—focus on depth of expertise around a specific sector that allows you to offer a better product or service to the customer.

Getting all three differentiations right isn't always easy. Companies tend to make two major mistakes when pursuing these sources of advantage. For one, they try to be all things to all people. And they don't realize that there is always more than one way to play the game.

The real value in this approach is not about picking what you will be famous for but, instead, understanding what you will not be famous for. If your business is based on sector expertise, for example, then you must provide a certain amount of customer care. You must also strongly resist the urge to overinvest in customer care. Doing so only adds cost without creating real benefit in your competitive position against a competitor who is focused on those same customer values.

There's More Than One Way to Play the Game

There is never just one way to play any game. While certain markets can dictate the modes of competition and sources of value, winning the game is rarely so straightforward. Take the world of college football as an example. In Frank Beamer's first year as head coach of Virginia Tech in 1987, the program won only two games. During his career, Beamer went on to lead Virginia Tech to 23 consecutive bowl games, including a national championship appearance in 2000, before retiring at the end of the 2015 season.

How did Beamer turn Virginia Tech's fortunes around from those humble beginnings? His success at Virginia Tech lies in his decision to play the game differently than other teams. His aspirations were the same (i.e., win games), but his approach was different. Other teams used their offenses to score points and their defenses to stop the opposing offense from doing the same. Beamer's perspective was unique. He felt that every player on the team should focus on scoring points, including defense and special teams' players. This perspective and related style of play significantly contributed to Virginia Tech's success.

In hindsight, focusing all phases of the game on scoring points sounds obvious—our aspiration is to win games, after all, and the team with the most points at the end of the game wins. Additionally, the team that creates scoring opportunities during any phase of the game creates an advantage over the competition. The challenge for competing teams—much as was the case with Southwest's competitors—comes in aligning the capabilities of the team to execute on the insight to create real advantage.

Art + Science = Winning Strategy

Positioning to win combines the art and science of strategy. As such, it's critically important to approach strategy with the necessary analytical rigor to:

- Understand the size, shape and direction of the market.
- Comprehend where your company is positioned relative to the competition.
- Understand how your firm is perceived by your clients.
- Have a clear view of your organization's state of readiness to exploit market opportunities.

These are all necessary elements of a winning strategy, but they don't stand alone. Positioning to win also requires posing the right questions to push thinking beyond accepted industry norms. For example:

- What value do our industry and company not serve to clients?
- In what ways does our industry create pain and frustration for various stakeholders?
- Is there a way we can do things differently?

Ultimately, positioning to win requires clarity around your aspirations, an understanding of how you are going to create value differently than the competition in a way your customer values, and a ruthless dedication to value that is fully supported by your organization's activities and capabilities. Think beyond accepted norms and best practices to determine the right combination of activities to deliver and capture that value.

It's not enough to simply get your leadership team aligned in the room around strategic decisions on what game to play and how to win. Those decisions must be lived by everyone in the business every day.

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FMI QUARTERLY
ISSUE THREE
2017

Boost Your Bottom Line and Strategy With Incentive Compensation

By Mike Rose

How to align employee performance with corporate strategy to ensure that staff behaviors are consistent with the company's overall mission and vision.

A breakthrough idea may put you on the competitive map, but staying there requires good execution and perseverance. The problem is that too many companies are bad at both and wind up failing during the execution phase. According to research published by Harvard Business Review, "Employees at three out of every five companies rated their organization weak at execution."[1]

Successful strategy execution requires individual actions and behaviors at all levels of the organization to be linked and aligned with the overarching corporate strategy. In this article, we show how incentive compensation can be effective in driving and aligning employee behavior with broader organizational goals and objectives. This ultimately leads to better financial performance and successful strategy execution over time.

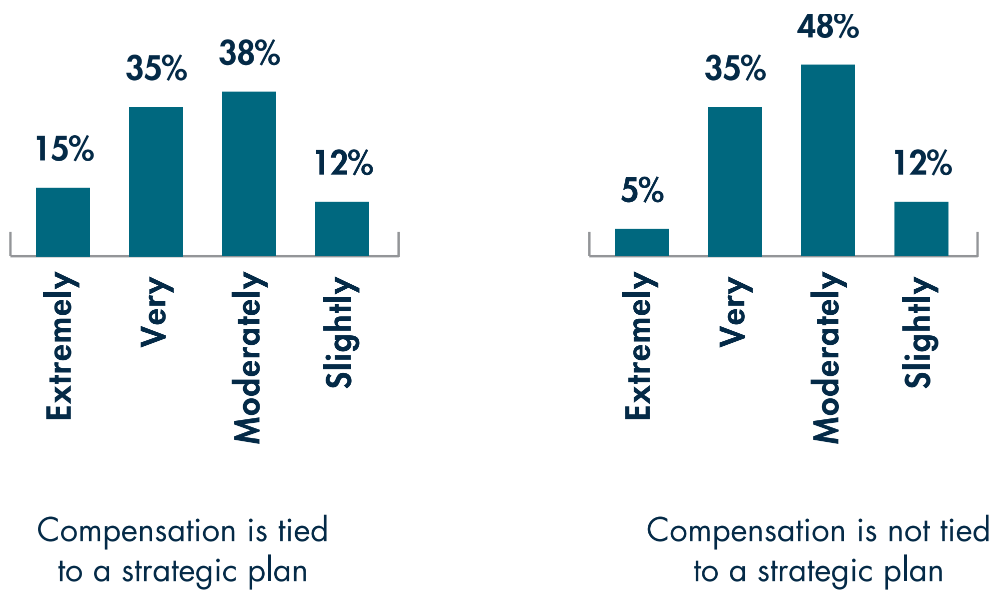
The Big Disconnect Between Strategy and Incentive Compensation Plans

In a recent FMI compensation survey, we found that nearly 30% of firms lack a strategy, and 57% of those that do have a strategy do not tie short-term incentives to their strategic plans. This is critical because firms that tie their incentives to strategy find their compensation plans extremely effective (three times more often than those

[1] Gary L. Neilson, Karla L. Martin and Elizabeth Powers. "The Secrets to Successful Strategy Execution." Harvard Business Review. June 2008.

that don't link their plans to strategy – see Exhibit 1). Consequently, by not tying incentive plans to strategy, there may be a significant missed opportunity to support and drive strategic initiatives through incentive plans that align employee behavior with the overarching company strategy.

Exhibit 1. Effectiveness of a short-term incentive program in achieving its objectives if compensation is/isn't tied to a strategic plan



Source: 2016 FMI Compensation Study

In our work with clients, we have found that structured incentive compensation can be an extremely effective tool in motivating employee behavior. A well-designed incentive compensation plan supports the alignment of employee performance with corporate strategy and helps ensure that staff behaviors are consistent with the company's overall mission and vision. This compensation approach also differentiates top performers and high potentials from other employees in a tangible manner, which supports long-term retention efforts for these critical staff members.

How to Set Real, Measurable Goals

Consider this: A construction firm decides to execute a strategy that is focused on growing new markets, increasing net profits and maintaining a strong safety record. The organization's culture is team-oriented but also relies strongly on individual contributors. Leadership intends to aggressively expand into new markets, increase sales by 50% and create a more sales-oriented culture.

Because net profit is a central objective of this new strategy, the compensation plan's corporate component must have a net profit measure (before taxes and incentives). In addition, each business unit has a revenue growth objective coupled with a net profit multiplier.

The following examples highlight what this could look like for three key positions:

Operations: Project Manager

Each project manager has three individual goals:

1. ***Margin Gain:*** +2% (averaged across all projects) over the plan year.
2. ***Safety:*** Specific required number of safety site visits and a safety discussion with each foreman.
3. ***Revenue:*** Revenue generated from new projects that the PM is currently managing.

Each project manager's specific goal may vary depending on the nature of the projects managed, his or her role on the project, experience and skill level. A margin gain goal keeps the project manager focused on increasing margin regardless of the estimated margin. This eliminates some of the issues associated with project-specific bonuses, namely, that they are subject to "gaming" (where project managers may desire high-margin projects, particularly if they receive a margin-based commission and avoid low-margin troubled projects). Focusing on a goal like margin gain removes these issues and provides management the flexibility to assign the best project manager needed for the job.

Business Development: Client Developer and Business Developer

A business growth focus requires professionals who are dedicated to identifying and closing new opportunities. Lead generation versus closing sales requires different skill sets associated with two separate roles: client developer and business developer. These two roles work closely together to form a cohesive sales unit.

Client Developer: Focuses on developing leads from new prospects.

Goal: Individual lead generation. This includes a specified number of qualified new customer opportunities. Qualified opportunities result in a quote and may require management review.

Business Developer: Focuses on closing qualified leads from both new and current customers.

Goal: Target sales at a specified gross margin (GM). This involves applying a commission to sales and adjusting with a GM multiplier that is based on the GM estimate. The commission steps up for sales above a target level or sales goal. For example, the target commission is 5% on sales, but can go up to 7.5% for GM greater than goal or is reduced to 2.5% for GM less than goal.

With the above goals in place, operations and business development work as a team; project managers develop leads from current customers while client developers generate leads from new accounts. These leads are then funneled to the business developer who ultimately closes the deals. This structure does not preclude the addition of other team members (e.g., estimators), but each must have a clearly defined role and goals that support the overarching organizational strategy.

The Power of Effective Incentives

Over the years, we have witnessed many examples of how effective compensation plans can make a real difference in overall corporate performance. Here are three examples:

Example 1. We worked with a mechanical contractor whose strategy emphasized safety, so the company leaders decided to incorporate safety into their compensation plan. As a result, the organization saw near-miss reporting increase by 1,500%, and its recordable rates, having been stuck in the 3.5-4.0 range, dropped by about 50%.

Example 2. In this case, one of our heavy civil contractor clients implemented a growth strategy that included expansion into new markets, with an emphasis on increasing net income. The incentive compensation plan motivated and aligned the branch managers through an 80% weight on corporate net income achievement (see red box in Exhibit 2). As a result, the organization accomplished 150% of its corporate goals at year-end and saw net profit jump from 5% to 7%.

Example 3. In another case, an equipment dealer was experiencing declining gross margin. The strategy called for taking market share from competitors. The compensation plan placed an emphasis on gross margin through a commission multiplier. A market share bonus was also included. In the first year of implementation, the declining trend in gross margin was reversed and increased by 2.31%.

How to Get Structured

Structured compensation plans are typically made up of three main components: corporate, business unit and individual. Each plan participant's incentive bonus is the sum of those components (i.e., corporate plus business unit plus individual) as shown in Exhibit 2.

Exhibit 2. Three Key Elements of a Structured Compensation Plan

When designing a structured compensation plan, it is important to focus on the following nine key areas:

1. **Define the Strategy:** Clearly articulate the strategic objectives and translate them into quantifiable objectives. For example, an organization may set out to enter new markets. To measure success in this endeavor, the company will specify an objective like "increase revenue by 50% at a net profit of 3%." Using clear and quantifiable objectives that apply across the organization serves as an excellent measure for the corporate and business unit components of the incentive compensation plan.

2. **Define the Compensation Philosophy:** To motivate behavior through the incentive plan, bonuses must be significant and competitive (i.e., at least at the 50th percentile), and particularly for high performers. As a result, it is important to access market data provided by reliable survey houses. Our research showed that having a compensation philosophy in place increased the effectiveness of short-term incentive programs significantly.

3. **Define Roles and Responsibilities:** A new organizational strategy may require new roles and responsibilities. For example, a strategy that focuses on aggressive revenue generation may include sales responsibilities for project managers. In addition, new roles may be required (e.g., client developers who focus on developing leads from new accounts).

4. **Balance the Design:** Each component in the compensation plan has a weight, and those weights add up to 100%; so properly weighting the plan depends on the organizational strategy and culture. For example, a strategy and culture that depend heavily on building successful teams may place more weight on the corporate and business unit components. On the other hand, a strategy that depends on highly motivated individual contributors may place more weight on the individual components.

5. **Align the Plan with Strategy:** Choose those measures for each component of the incentive compensation plan that align most closely with the strategic objectives. To keep things simple, most plans typically have only one measure for the corporate and business unit components. Invariably, but not always, net profit is the measure that directly aligns with strategy.

6. **Set Goals for the Individual Component:** Individual goals form a key element in the connection between strategy and behavior because they communicate what specific outcomes determine success. FMI's experience shows that the goals set at the individual level are critical to translating objectives into results-producing behaviors. Typically, three individual goals are set (although there may be more), and they should be SMART: specific, measurable, achievable, relevant and timely (achievable within a year). Creating too many goals, however, leads to a lack of focus.

7. **Communicate:** Communicating the organization's vision, strategy and compensation plan in a manner that shows the connection among all three ensures that employees understand how their individual contributions affect the overall pursuit of long-term objectives. This understanding is a key element in employee motivation. Effective communication starts with rolling out the plan clearly and explaining its objectives, mechanics and payout scenarios. Throughout the year, plan participants should receive feedback regarding progress toward their goals on a monthly basis (if possible) or each quarter (at a minimum). For participants who are falling short, managers should offer coaching and mentoring their reports on the types of activities and behaviors that will increase their progress toward goals. Goals and associated communication are key elements in reinforcing corporate objectives and ensuring plan effectiveness.

8. **Evaluate:** At the end of every fiscal year, perform an honest assessment of the strategy's and the compensation plan's effectiveness. Did the organization achieve its goals? How many goals, on average, did individuals achieve? If goals weren't achieved, what were the issues, and what kind of corrective action is required to get back on track?

9. **Consider a Long-Term Incentive Plan (LTIP) to Support the Strategy:** A long-term incentive plan (LTIP) is another effective tool for supporting retention and management succession objectives. An LTIP can also support the business strategy by driving long-term performance. For more information on LTIPs, check out "Looking to the Future: How E&C Firms Can Leverage Long-Term Incentive Plans."

Looking Ahead

For incentives to be highly effective, clarity and communication are imperative. Employees should know in advance what their bonus opportunities are, what it takes to achieve those targets, and how their efforts impact the organization's strategy.

Leaders embarking on a new strategy should consider the following questions:

1. Is the strategy clearly defined and translatable into specific metrics?
2. Do we have a well-defined compensation philosophy?
3. Do we require new roles and responsibilities to implement this strategy?
4. Does the compensation plan support the strategy?

A competitive pay strategy that addresses these questions in a comprehensive way, and that links back to broader corporate objectives, will serve as the very cornerstone of any good human capital investment approach now—and well into the future.

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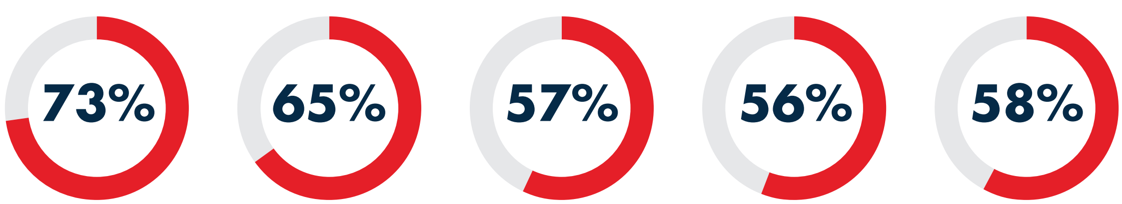
FMI Client Highlights



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