FMI

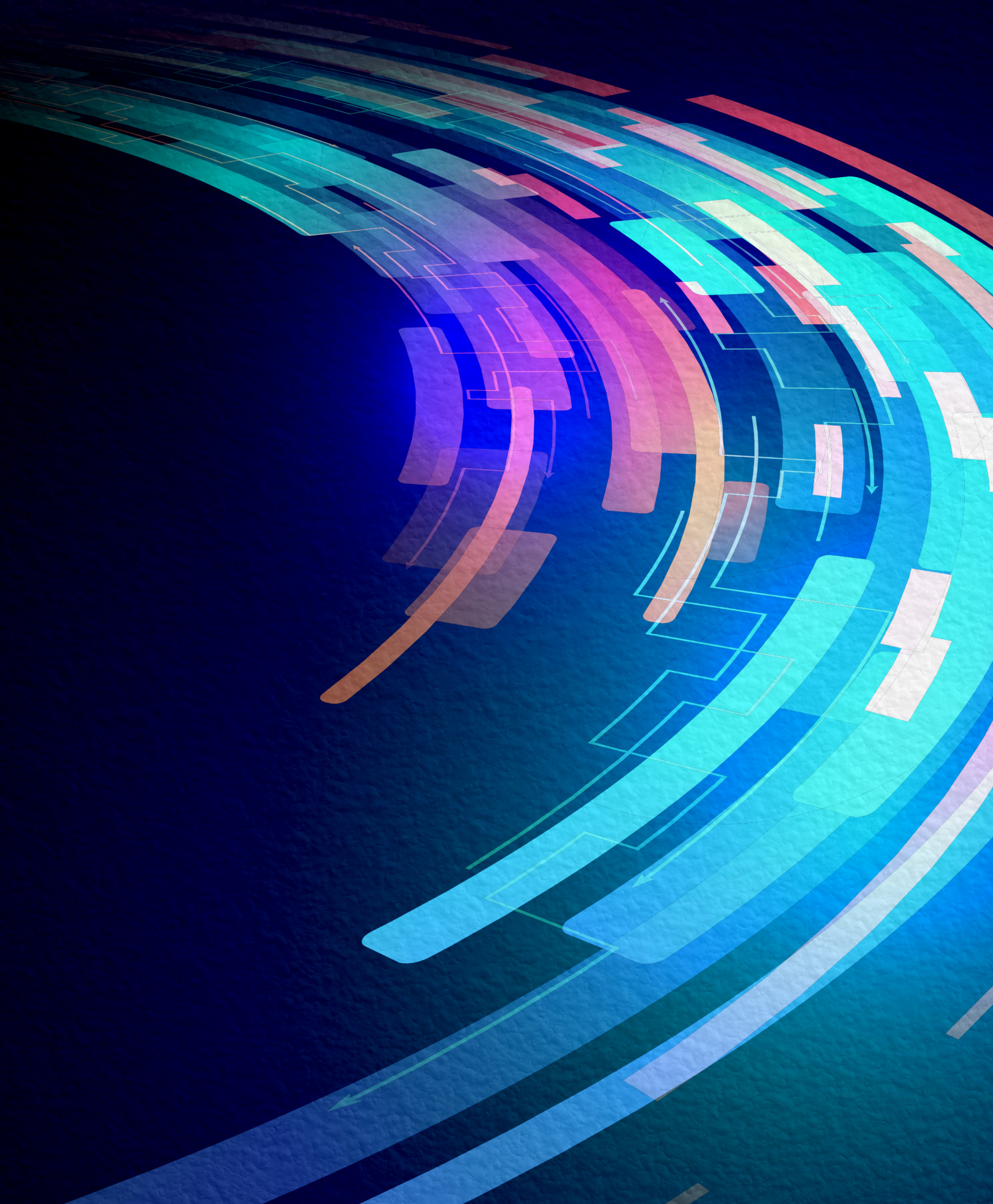
QUARTERLY

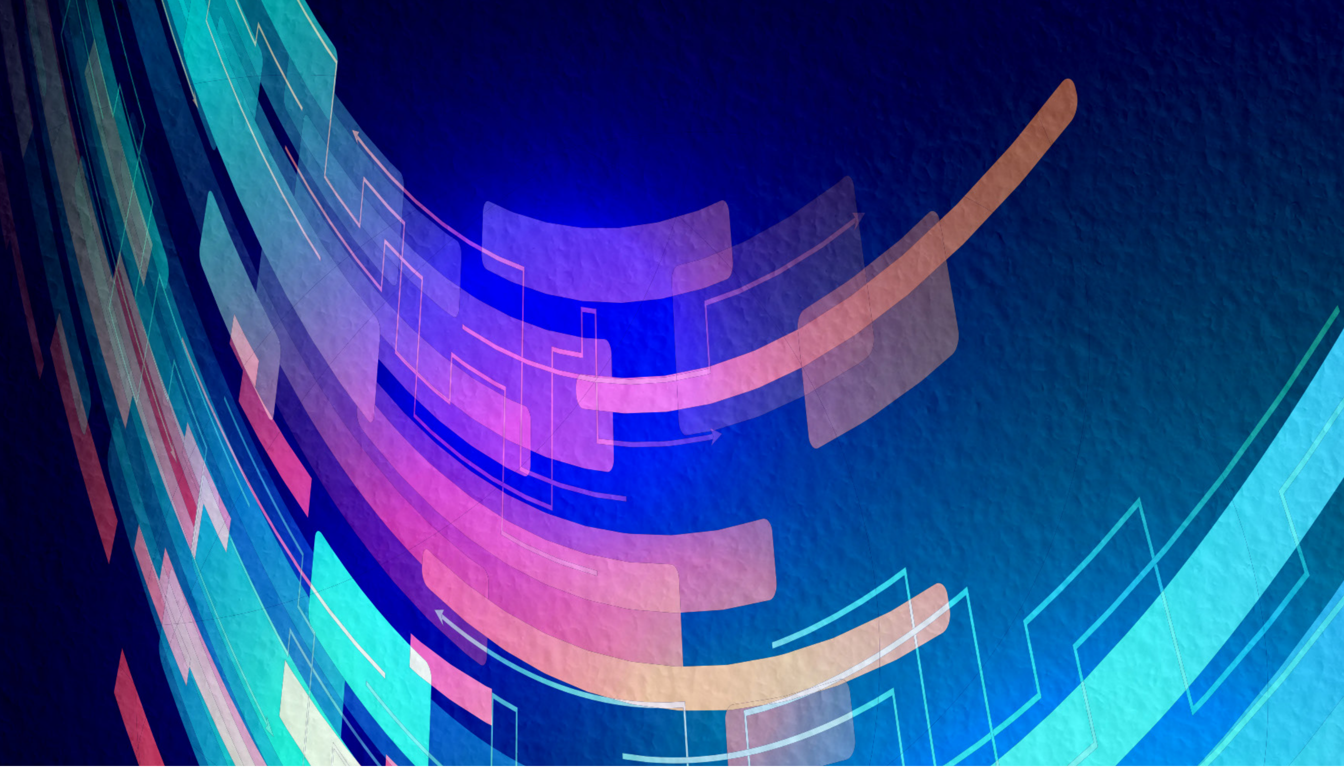
ISSUE FOUR

2020

2021and Beyond:

Why Operational Excellence Matters





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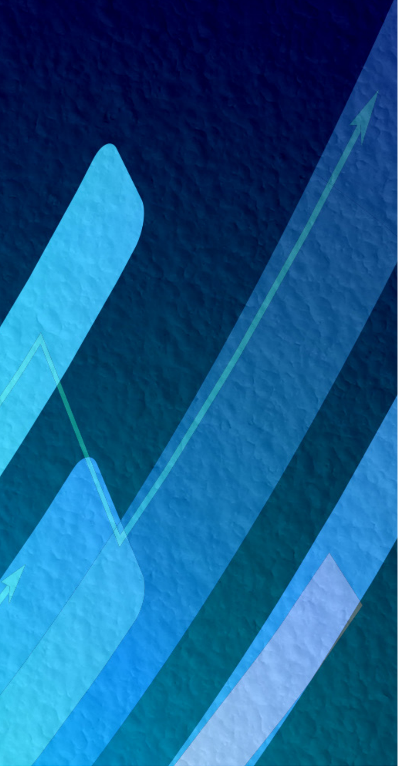


FMI QUARTERLY 2020

TABLE OF CONTENTS

Introduction 3
Chris Daum

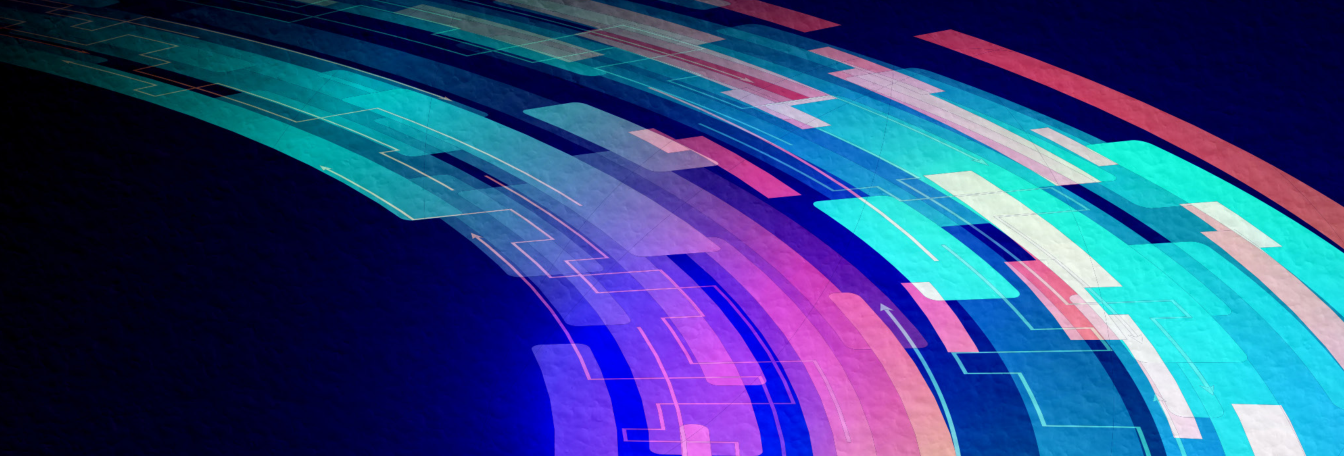
Get Lean and Mean: Preparing for 2021 and Beyond 5
By Tyler Paré

The Silver Lining of Construction Productivity and Covid-19 11
By Gregg Schoppman

Selling Your E&C Company During Covid-19 17
By Ryan Foley

Four Ways to Optimize Talent in Uncertain Times 22
By Priya Kapila

Why Focusing on Your Company Vision Still Matters 28
By Tim Tokarczyk and Emily Livorsi



Welcome to the FMI Quarterly

By Chris Daum

Welcome to the fourth edition of the 2020 FMI Quarterly and the last month of a most unusual year.

2020 has been incredibly difficult due to the pandemic, economic recession and many other COVID-19-related disruptions to everyday life and commerce. Unfortunately, we expect the industry will continue to be challenged in 2021, so leaders must remain hyperfocused on completing current projects under changing conditions while also preparing for tougher market conditions to come.

However, as critical as performance-based strategies are to weathering difficult markets, it is vitally important that a leader remains committed to the company's vision and the core purpose and values that define the organization. After all, strategies will evolve as market conditions change, but the continuous pursuit of your envisioned future is constant.

So with both the near and long term in mind, this edition of the Quarterly includes articles on operational excellence: getting "mean and lean" to outperform, improving productivity and managing talent, as well as reminding you why staying true to your company's vision still matters. One article introduces the concept of a COVID-19 productivity factor that captures both positive and negative effects of pandemic-driven changes to crew size, job site conditions, project schedules and other work processes. In another piece, members of FMI's Performance practice describe six elements necessary to out-execute the competition, taken from our work with dozens of the industry's leading companies. Lastly, in an article titled "Does Vision Still Matter?" principals from our Leadership & Organizational Development practice contrast average leaders from visionary leaders during times of crisis.

In closing, it may seem absurd to think of any silver linings resulting from the damage wrought by COVID-19. However, in much the same way the financial crisis that caused the Great Recession alerted the industry to a pending downturn, the pandemic is forcing the industry to tighten operations and management practices in response to the pandemic. After a decade of sustained growth, you are now called to lead and manage through a period of uncertainty and potential disruption. The FMI team is here to help.

Chris Daum is the president and chief executive officer of FMI Corporation. Chris oversees the management of all FMI businesses and services and leads the firm's strategic growth efforts. He can be reached via email at ***cdaum@fminet.com***.

Get Lean and Mean: Preparing for 2021and Beyond

By Tyler Paré

What does increased competition mean for your business? How will you become more competitive?

While the impact of the coronavirus pandemic will vary by geography and market segment, broad-based demand for construction services is expected to decline over the next two to four years. The downcycle will increase competition; bull markets will attract new entrants while bear markets will offer fewer opportunities for established incumbents.

What does increased competition mean for your business? How will you become more competitive? In this article, we explore the current market challenges that are putting pressure on pricing and margins. We will also offer some guidance on how to navigate these challenging times:

1. Don't Panic
2. Get Lean and Mean
3. Execute

Perception vs. Reality

I recently listened to a developer bemoaning the lack of downward movement in construction prices in the wake of the pandemic. She argued that, with expected declines in demand for construction services (and increased competition as a corollary), the price of these services should also decline.

It is true that many contractors' book-to-burn ratios are underwater. In other words, they are booking work at a slower rate than they are burning backlog. If this trend persists for a protracted period, annual revenue will decline, and a construction business's economic model will be threatened if adjustments to fixed costs are not made proactively.

However, many contractors expressed having too much work and being stretched beyond capacity prior to the onset of the pandemic. The pullback induced by the pandemic, for some, was a welcomed reprieve and a chance to slow down, reevaluate and get the organization caught up. Translation – we have yet to see a broad-based trend in dramatic price reduction for construction services.

That may only be temporary. Eventually, declining backlogs will place pressure on contractors to win more business and be more aggressive. The construction industry lags the broader economy by 12 to 18 months, and we have yet to see the true impacts on construction demand and contractor backlogs.

Pricing

Most construction companies employ a cost-based pricing methodology. They develop an estimate of the direct cost inputs (labor, equipment, material, subcontractors, etc.) and then add margin to cover overhead and <u>sufficient</u> net profit. For prices to retreat, it would require a reduction in one or more of these variables.

The Pandemic's Effect on Costs

Labor

- Labor wages are not expected to decline dramatically—rarely do these figures move backwards, particularly in an industry that is perpetually lacking talent.

- Productivity is likely to decrease because of increased COVID-related regulation (social distancing, point of entry control, sanitization, etc.).

Equipment

- With decreased utilization, the per-hour cost of ownership is likely to go up.

Materials

- Shocks to the global supply chain have created material shortages across the industry, increasing the cost of building products and construction materials worldwide.

If direct costs are increasing, prices should also rise, not drop. The developer I spoke with did not like this rationale. "But won't contractors become hungry for work and lower their prices?" she rebutted. "I feel like they have been making money hand over fist in the last runup. Don't they have room to cut their margins?"

Pressure on Margins

If there is not expected to be much short-term relief in direct cost reductions, most of the price competition will come down to margins and how aggressive contractors are willing to be.

While contractor margins have crept up year over year for the past decade, average trade contractor net margins were still in the mid-single digits, and general contractor margins were roughly 50% of those margins prior to the pandemic.

Net margins for construction businesses have always been misaligned with the inherent risks in the industry. Growing margins for the construction industry are not a bad thing. Even if margins have increased (in some cases doubled) as FMI's financial benchmarking data would suggest, it would be difficult to argue that contractors were taking advantage of the bull market, let alone price gouging.

Additionally, falling revenue means that overhead as a percentage of revenue will increase. If significant adjustments to fixed costs are not made, contractors will actually need to increase gross margins to sustain normal levels of net profitability. Mathematically, the argument for contractors being able to drastically slash their margins begins to break down.

Theoretically, contractors have room to cut their margins, but not by much. Downward pressure on contractor margins spells risk for all project stakeholders. At a basic level, would you rather partner with a highly successful, profitable construction company or a desperate contractor operating on razor-thin margins, one hiccup away from default?

If contractors are willing to slash their bid margins to zero, they are going to have to make it up somewhere else – cutting resources in an attempt to reduce direct costs can lead to potential production and schedule issues; cutting overhead costs can decrease overall project support relative to quality, safety and schedule; and trying to make it all up on change orders can lead to strained relationships and potential delays.

FMI's guidance for navigating a market downcycle:

1. Don't Panic

Knowing that we are facing a multiyear downcycle, temper your work acquisition urgency accordingly. Panicking too early and loading up on cheap work (i.e., poorly, aggressively or emotionally estimated) is a bad strategy that can result in years of headaches.

Every construction market has irrational players—those that will torpedo the market and come in screaming low on bid day—taking work and forsaking margins, sending reverberations through the market and causing the competition's estimators to scratch their heads. Don't be that contractor.

2. Get Lean and Mean

a) Be selective.

Increase your project selectivity (go/no-go process) discipline. Get competitive on the work that you know you want, know you can win and you know can deliver on. Don't swing at every pitch, especially those in the dirt. Chasing too many low probability opportunities can burn out your estimating department, leading to low-quality estimates fraught with mistakes and award of troubled jobs that can could haunt you and hamstring your organization for years.

b) Know your true costs on bid day.

Oftentimes, there is hidden margin in the direct cost line items of construction estimates. Estimators will call this contingency or waste factors; others might call it sandbagging. In good times, you can still win work with overly conservative estimates. When job costs underrun budgets, these savings directly translate into margin. Estimators and project managers both lay claim to these victories.

In reality there is probably room to tighten your estimates. We encourage contractors to base these adjustments in historical data and facts, not just intuition. By analyzing the direct cost variances across a large sample of work (the last three to four years), you can identify trends and areas where you consistently pick up margin and theoretically have room to tighten estimating practices. (Caution: Equal scrutiny should be given to those line items that consistently overrun budgeted costs).

In a bull market, overstressed estimating departments can become lax in their processes and procedures. “Plug” numbers and “SF” numbers may have been sufficient for small items in the past, but it is now critical to have detailed costs for all budget items. It’s also important to carefully validate your subcontractor costs by increasing coverage, leveling efforts and prequalifying. Stay close with your key subs and vendors—leverage those relationships to get advantages on bid day. Reevaluate contract terms that may garner advantageous prices from your subs.

c) Focus on operations.

Tighten operational processes, controls and productivity. Get back to basics with respect to pre-job planning, scheduling and look-ahead,

Avoid the Compounding Effect of “Sharpening Your Pencil”

Example

An estimator knows that he/she must get more competitive to win work. He/she removes all the “fluff” from the estimate and may even factor in overly aggressive productivity estimates. The chief estimator reviews the cost estimate, then skinnies down the additional pricing factors such as contingency, overhead markup and margin. The president then steps in and says, “We really need to win this job; let’s cut the margin.” You now have aggressive pricing behavior at three different levels. Often these measures are taken in isolation, without discussion or consultation among all the players. This can create a highly risky estimate. Ensure your work teams and decision-making are closely aligned when getting competitive on bid day.

manpower coordination and project closeout. If you are tightening your estimating practices, there is less room for error, and projects need to be have a high degree of discipline and adherence to proven best practices.

Ensure you have robust project controls that can help you and your management team identity troubled projects early, affording enough time and opportunity to course-correct before things spiral out of control.

Productivity is a journey, not a destination. If you have made steps to improve productivity in the past, now is the time to revisit and double down on those efforts. FMI recommends establishing a task force of your operational leaders to improve labor productivity and equipment utilization.

Also, ensure that your field leaders and subcontractor partners feel appreciated and supported. Stay close to them and listen to what is going on in the field. They are the lifeblood of your business and will be the ultimate differentiators in winning or losing in the current environment.

d) Rightsize.

Interrogate your fixed-cost infrastructure. Cutting overhead alone is not a sound strategy for maintaining profitability in a downturn. However, all aspects of your G&A need to be highly scrutinized, including your organizational structure, roles, compensation, real estate, owned equipment and technology. Understanding your key efficiency ratios of revenue, gross profit and net profit-per-head by employee classification can help you make prudent cost adjustments and right-size the organization.

3. Execute

These strategies are not unique. In fact remove the challenges of 2020, and you can argue that most of these tactics make good business sense no matter the economic climate. The difference we are hearing from firms in the industry today is the level of focus and urgency related to these strategies. Contractors understand that they need newfound levels of intensity and intentionality in addressing their companies' performances.

Wayne Gretzky famously said, "I skate to where the puck is going to be, not where it has been." Now that the industry is aligning on "where the puck is going to be," contractors are all skating in the same direction. Who can skate there (i.e., get lean and mean) the fastest will be the competitive differentiator in the post-COVID era.

Assess your executive team's ability to execute on change management initiatives necessary to win in an increasingly competitive market.

About the Author

Tyler Paré is a principal with FMI. Tyler leverages his construction experience, coupled with his advanced knowledge of business mechanics, to help clients optimize profitability and mitigate risks. His consulting work focuses on implementing work acquisition and project execution best practices in support of competitive strategy. He can be reached at ***tpare@fminet.com*****.**

The Silver Lining of Construction Productivity and COVID-19

By Gregg Schoppman

An examination of the new normal COVID-19 productivity factor.

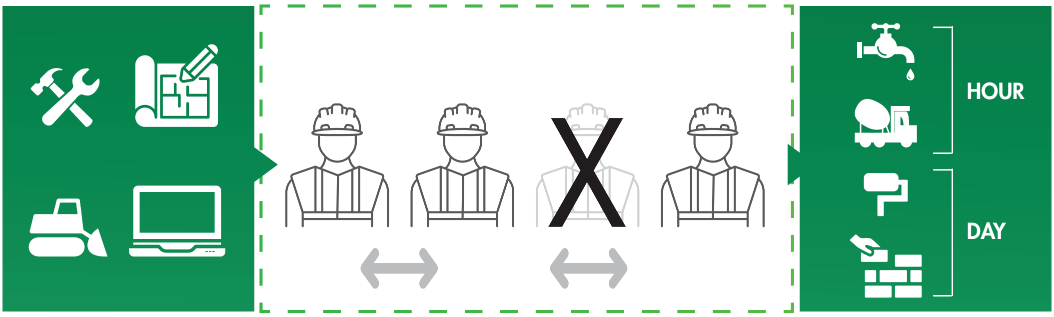
In early 2020 most business leaders probably didn't think a pandemic would shake the foundations of the world economy. In fact, the continued threat of diminished skilled labor and the related, detrimental impact to productivity were the common industry challenges that most construction executives faced at the time.

Today businesses have new sets of rules, guidelines and tactics to implement in order to succeed in the operating environment thrust upon everyone as a result of COVID-19. While the pandemic's earliest impacts on engineering and construction (E&C) remained unknown, many construction leaders shifted their focus to known variables such as social distancing, technology and clients' demands.

Looking ahead, business leaders will undoubtedly find new ways to thrive, but they'll also make errors as they react to constantly changing dynamics. One area to watch closely is job site productivity, which is unlikely to remain static. However, there are probably several misconceptions and, more importantly, some of the pandemic's consequences may even benefit contractors in the long run.

For instance, there was a collective industry groan at the thought of testing every employee and cleaning every tool prior to commencing of work every day. However, there was also a moment of reflection where leading managers also recognized that for every productivity detractor, there was the potential of increased efficiency. All of the elements in Exhibit 1 are considerations that affect daily productivity and, in many cases, the upside is something that cannot be discounted.

Exhibit 1. Productivity Drivers and Inhibitors in the Wake of COVID-19



CREW SIZE

With social distancing in effect, crew sizes will be limited (i.e., five-person crew to a four-person crew).

SPACING Part 1

Crew stacking will be a limiting factor, reducing area over population.

SPACING Part 2

While adjacent trades may be limited, will output be negatively affected?

CLEANING TOOLS IMPACT

What will be the loss of productivity due to cleaning equipment and tools at the beginning and end of work shifts?

TECH LEVERAGE Part 1

With a movement toward paperless, firms will see gains in operational productivity.

TECH LEVERAGE Part 2

With social distancing rules, communication will have to be targeted and direct, limiting time away from jobs (i.e., wasted meetings).

TECH LEVERAGE Part 3

What new innovative tools and equipment will aid production?

CLEANING MATERIALS IMPACT

What will the loss of productivity be as it relates to cleaning materials that come on-site?

The Upside of New Crew Sizing and Spacing

With social distancing rules in effect, there may be a need to reduce crew size. However, in many businesses, crew sizes have ballooned with no explanation or challenge to those increases. The question becomes: Can we do the same (or more) with less?

There are many studies that show the optimum spacing for personal productivity. Oil companies have explored these spatial constraints for years to determine effective spacing requirements in areas where safety and productivity must be maximized (e.g., on offshore rigs). Similarly, many construction managers assume that output increases when you cram more employees on a job site. The problem is that there is a law of diminishing return when it comes to overloading resources on a job site; simply adding bodies within confined spaces will only impede productivity. The good news is that new rules may prohibit placing more people in an area. Trade contractors will rejoice at this, knowing they will not have to work on top of other trades simultaneously.

The Flip Side of Spacing

In some cases, contractors need more employees on-site to get the work done (e.g., for installing a window, placing a lintel or tying rebar). New rules may require novel methods and means of getting this done. Additionally, as different trades occupy a space, general contractors and owners may not allow crew stacking, even if they haven't reached the capacity allowed for a particular space. This may require longer durations for specific activities, and it should be reflected in project estimates and budgets accordingly.

Crew transportation should also be considered and evaluated in terms of cost impacts. For example, in many markets carpooling is common and helps employees save money. In a COVID-19 world, some organizations are limiting group transportation, thus increasing costs for employees or the project cost profile in the form of additional fuel expenses. Even if the cost is minimal, this can impact the overall project.

Cleaning Time: The Pros and Cons

Personal hygiene is not limited to hand-washing. It takes time to clean tools and work areas, both at the beginning and end of work shifts. Be sure to allocate time for preventive maintenance, as the new rules may dictate a less than optimal use of a 40-hour workweek.

The materials that arrive on job sites may also need to be cleaned prior to use. Obviously, a greenfield project may have a final cleaning phase that will provide a certain level of closure for customers. However, an electrical contractor working on a renovation of an active medical clinic may need extra time to clean switchgears and light fixtures. Be sure to factor this into the budget development process.

Additionally, contractors may have to do a more thorough final cleaning. In the past this could have meant simply vacuuming, floor waxing and restroom cleanings. Today, owners' expectations may include a higher level of "cleaning commitment." At first glance, many contractors would concede that this is a change order as it deviates from the contract documents. Where this is undoubtedly a change in scope, it would be foolish to think that there would be no impact to general conditions (i.e., original final cleaning of one to two days, new final cleaning of five to seven days). In summary, these changes require careful planning and forethought and open communication with owners.

Overall, workspace hygiene and cleanliness will change and could have ramifications for contractor costs, but there's also another perspective that should be considered. Outside of extraordinary exceptions or requirements, trade contractors and general contractors alike have largely struggled with simply keeping sites clean. Spurred by the pandemic, this new focus on cleanliness and hygiene may actually improve productivity and job site safety.

Leveraging Technology

Optimizing digital technology for timecards, job reports, punch lists, submittals, schedules, purchase orders, quality assurance or quality control, and other documents is probably just what the construction industry needed. By going paperless, crews can focus on the work and gain efficiencies that were previously out of reach. For example, crews can use digital tools to report both time and quantities, obtain real-time productivity information and quickly adapt to changing work environments.

Use of videoconferencing tools such as Zoom, Webex, Microsoft Teams, GoToMeeting and FaceTime has also accelerated due to the pandemic. In fact, communicating via virtual tools was often a last-ditch effort for some in the pre-COVID era. Now, in the absence of true face-to-face interactions, these tools have become essential to maintaining schedules and good communication. They've become as ubiquitous as a hammer drill or backhoe on job sites, enabling teams to close the distances and utilize time more effectively.

The Formulaic Approach

Most construction organizations use elaborate estimating programs and baseline crew rates that provide a multiplier for all work quantities. For instance, if a contractor estimates that it will need 100 linear feet of water piping, there is some labor multiplier that represents the appropriate crew blend (i.e., one crew leader, one equipment operator, three laborers).

However, for many organizations, the crew cost blend is one dynamic that may not receive the required level of scrutiny. For example, simply bolstering it with a cost of living increase doesn't work anymore. In fact, best-in-class firms are taking a more formulaic approach to dissecting the cost drivers. Exhibit 2 illustrates a theoretical formula that represents the new multiplier: Many may initially question how to come

Exhibit 2.

NEW CREW RATE = (Old Crew Rate – Θ) * COVID FACTOR

COVID FACTOR = (B + X + Δ + E + ф + Γ + H)

Θ – Crew Size Decrease
B – Crew Size Loss of Production Decrease
X – Tool and Hygiene Cleaning Cost Production Decrease
Δ – Clean Materials Cost Impact
E – "Productive Site Through Cleanliness" Enhancement
ф – "Less Distractions" Enhancement
Γ – "We can't carpool" Transportation Cost Increase
H – Spacing Enhancement

up with the values for these factors. First, developing these productivity variables is an equal balance of art and science. Going through the process of identifying and quantifying these numbers is a win for any firm.

Successful businesses delve into their cost structure and avoid broad generalizations on productivity. With so much emphasis on increased time associated with cleaning and hygiene right now, contractors might mistakenly assume that costs should increase *across the organization*. This, in turn, could adversely affect the firm's competitiveness. To avoid this problem, companies should focus their planning and analysis efforts across each project.

There are changes happening that all businesses should recognize as becoming new standard operating procedures. These changes must permeate across all aspects of the business, including (but not limited to) estimating, budgeting, planning, cost monitoring, productivity reporting and financial benchmarking. As challenging as the pandemic has been, COVID-19 is simply a manifestation of an ever-present list of business challenges that require leaders to pivot and adapt. If it wasn't COVID-19, there would be some other obstacle to overcome. Overall, it is essential that construction business leaders adapt, react and pivot quickly to succeed in today's changing operating environment.

About the Author

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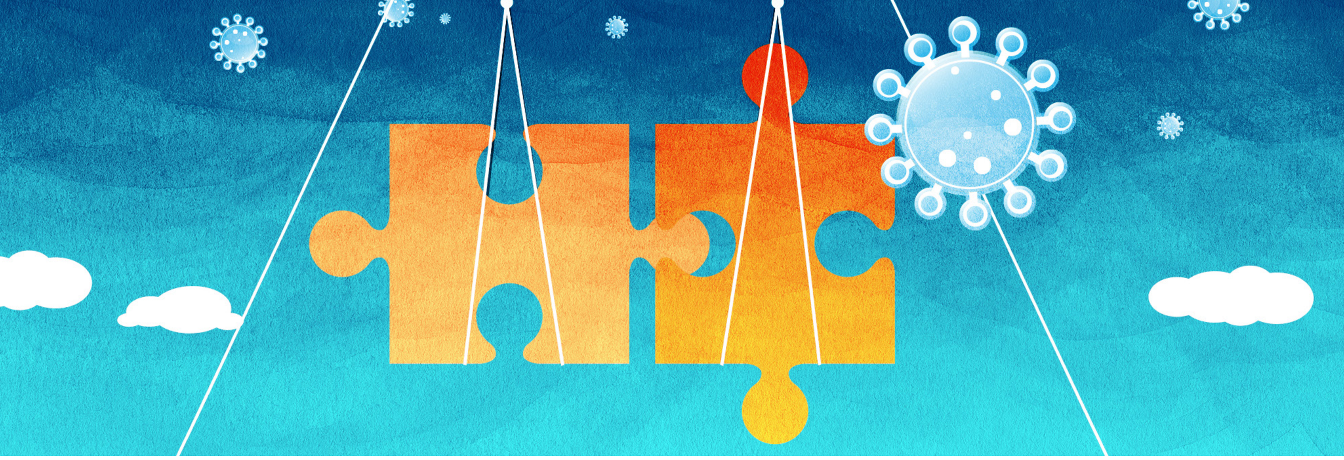


Selling Your E&C Company During Covid-19

By Ryan Foley

A look at COVID's impact on engineering and construction M&A and what could be around the corner in 2021 and 2022.

With COVID-19 continuing to affect engineering and construction (E&C) around the world, the industry's mergers and acquisitions (M&A) activity has also felt the ramifications of the ongoing pandemic. In March 2020, FMI saw about one-third of its contractor deals get paused, put on hold indefinitely or canceled as acquiring companies turned their attention to more pressing matters. This was done to protect the buyers' balance sheets, shield those buyers from vulnerable end markets (i.e., office and hospitality), and address overall trepidation about the world's economy.

During the late summer and early fall, FMI witnessed a marked uptick in transaction activity and interest on the part of buyers and sellers in the E&C space. As some of the early virus-related panic began to subside, select buyers came back to the deal table. Concurrently, sellers began calling FMI investment bankers to discuss exit strategies.

While we're not in a full recovery, we are seeing sellers become more interested in potential transactions as well as shifts in deal structures, heightened due diligence and surprisingly stable valuations. This article will explore these M&A trends with an emphasis on risk mitigation and heightened due diligence in the age of a pandemic.

Buyers Are Still Buying

The first notable shift in the market environment was, not surprisingly, created by buyers. In March there was a distinct subset of acquisitive contractors that put their ongoing or planned transactions on indefinite hold. This was particularly true for end markets like office, retail, amusement and hospitality, all of which are now in the throes of combatting a substantial decline in project backlogs.

In early spring, FMI received several calls from large, well-capitalized general and industrial contractors expressing an eagerness to deploy resources on acquisitions. While none of these firms expected a global pandemic to be the catalyst, those buyers who were waiting for a market correction in early 2020 were keen to communicate their desires to find good acquisition opportunities.

Concurrently, those acquirers who hit the pause button on M&A as a growth strategy—and particularly specialty trade contractors—were suddenly back in the market. We are now also witnessing increasing interest from market segments such as heavy civil, which remains bullish on the prospects of a permanent infrastructure package sometime in 2021.

In addition, companies and people migrating away from dense urban areas and natural disaster-prone regions are creating demand for housing and, to some extent, commercial development in select locations such as Texas, Utah and the southeastern U.S.

Curious Sellers Are Coming Out of the Woodwork

As the country settled into a pattern of addressing and dealing with COVID-19's impacts, sellers began to take an interest in potential exits. In August and September, FMI Capital Advisors was inundated with calls from prospective sellers seeking information on the marketplace, valuations and M&A processes. We attribute this to several factors. First, many business owners are nearing retirement age and aren't interested in managing through another downturn after the Great Recession.

Second, we see business owners looking to exit their companies after back-to-back record-breaking years. We do, however, caution these prospective owners to avoid trying to time the market as it can be exceptionally challenging. Put simply, sophisticated acquirers won't be fooled by the notion of continued record years and will be paying particular attention to work in progress (WIPs) and project pipelines.

Third, as construction cycles tend to lag gross domestic product, we still see a degree of optimism from both buyers and sellers. However, the great overhang of uncertainty could dampen these ambitions next year and even into 2022. Lastly, the change in U.S. presidency could spur concerns about a higher tax environment, driving some sellers to the deal table.

Changing Deal Structures

While there is great uncertainty heading into 2021, buyers are seeking ways to mitigate the risk of a precipitous drop in the financial performance of target companies. As a result, changing deal structures have become a sign of the times. We're seeing earnouts (i.e., portions of the purchase price contingent on future earnings) as well as sellers' notes increase in offer structures from 10%-20% of purchase price to 20%-30%. This is not surprising, as construction is notoriously unpredictable. Also, these mechanisms help buyers and sellers bridge the gap on valuations and get to the closing table.

Heightened Diligence

The environment during COVID-19 is creating increased due diligence streams. In the second quarter, there was tremendous uncertainty surrounding Paycheck Protection Program (PPP) loans; their impact on M&A transactions was a large unknown. Would the loan be forgivable? And if not, should the acquirer assume the loan? The Small Business Administration and other government institutions had no answers to these questions, yet the lessons learned in the Great Recession taught Congress that the first priority is to get the money out as quickly as possible and figure out the regulatory environment and fraud risks later.

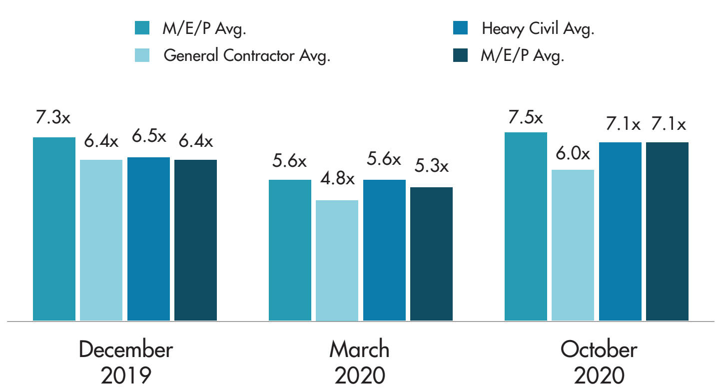
We now know that the most common treatment for PPP loans places the onus of forgiveness on the seller. Other trends we have seen are increased scrutiny of unfunded pension liabilities, WIP profit fade/gain trends and other financial instruments that could be negatively impacted by an economic downturn.

So Where Are the Bargains?

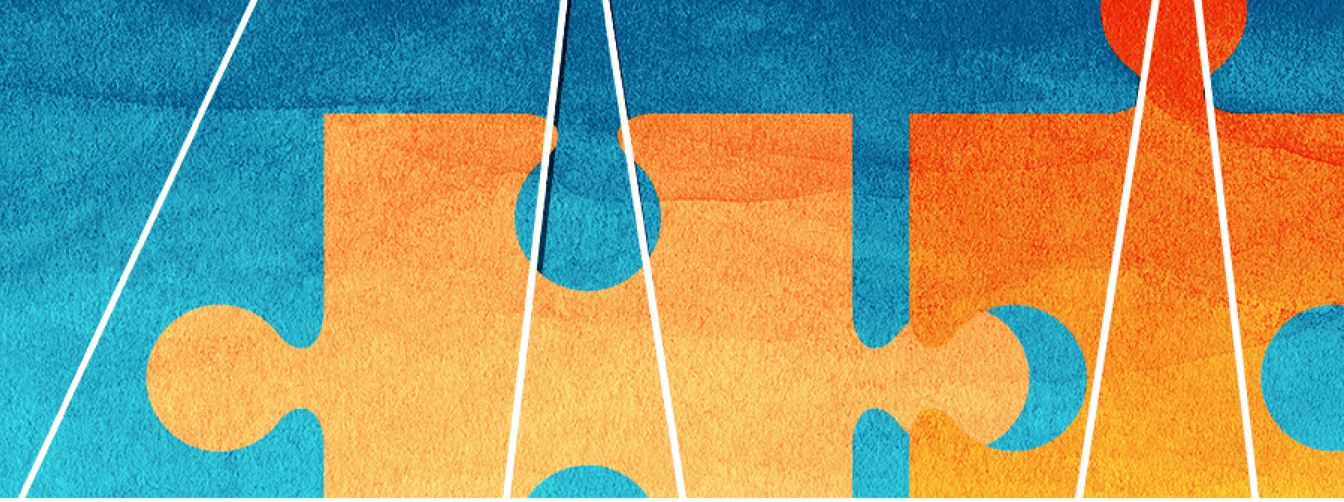
Both buyers and sellers are now wondering just what the current market and economic volatility means for valuations. Surprisingly, the answer is not much. With companies working through robust backlogs, both buyers and sellers are still experiencing attractive financial performance on existing jobs. At the other end of the spectrum, opportunistic buyers anticipating a downturn in valuation multiples have been disappointed as sellers have not yet conceded a willingness to trade for less. Of course, this may change as project backlogs are expected to soften in the coming months, possibly all the way into 2022.

In December 2019, for example, mechanical, electrical and plumbing (MEP) public comparable companies were trading at 7.3x enterprise value forward EBITDA. This multiple dipped to 5.6x enterprise value in March 2020, but as of October 2020, these multiples were largely unchanged at 7.5x. In fact, for E&C as a whole (both domestic and international public companies), this multiple increased from 6.4x in December 2019 to 7.1x in October 2020 (Exhibit 1).

Exhibit 1. Enterprise Value / 1-Yr Forecast EBITDA



Source: CapitalIQ



Our Crystal Ball

As we close out 2020 and move into the new year, FMI expects these M&A trends to either continue or begin to take shape:

- Based on conversations with contractor management teams, we expect an increase in deal activity in 2021 versus 2020, particularly due to the lost quarter that happened in early 2020, when M&A transactions were on hold.
- We also expect to see deal announcements in mechanical and electrical trades, where there continues to exist robust interest from large private and publicly held companies.
- In addition, we anticipate a few announcements from industrial contractors with heavy exposure to oil and gas seeking to diversify into other end markets such as food and beverage and pharmaceutical.
- We expect continued bullishness on the proposed infrastructure and pandemic rescue package to spur deal activity in the heavy civil and highway segments (although this will be offset by diminished state and municipal budgets).
- On the bear side, we expect M&A activity among commercial contractors with exposure to retail, office, hospitality, transportation, amusement and multifamily to be dormant.
- In addition, while we expect there will be interest from large general contractors to acquire attractive targets, we expect valuation to remain a hurdle for closings. For example, we're seeing a number of buyers that want to acquire contractors that service data centers, pharmaceuticals, warehousing and distribution. The question is, why will sellers be willing to trade when they are amid record-setting demand.

All in all, the M&A market for construction is faring better than we anticipated at the outset of the pandemic. We hope that vaccines and treatments continue to show positive progress through clinical trials and that at least one outcome of the election will be less uncertainty, which always bodes well for both the economy and demand for new construction.

About the Author

Ryan Foley is a managing director with FMI Capital Advisors, FMI Corporation's investment banking subsidiary. Ryan co-heads the Contractor & Construction Services industry practice of FMI Capital Advisors, FMI Corporation's Investment Banking subsidiary. In this capacity, Ryan provides strategic M&A and capital raising services to the construction and engineering industry. He can be reached at ***rfoley@fminet.com*****.**

Four Ways to Optimize Talent in Uncertain Times

By Priya Kapila

Tips for effectively assessing your current labor pool, making the necessary adjustments and preparing for future success.

As the end of one of the most unusual years in recent history draws to a close, it is naturally a time for reflection and, even more importantly, a time of planning for the days ahead. Engineering and construction (E&C) companies are undoubtedly considering their 2021 forecasts, including examining backlogs and reviewing business development opportunities and bid prospects. Many are also considering discounts for subcontractor and supplier challenges as well as potential project delays and cancellations. Key among these projections for next year should be an assessment of workforce needs.

Four Labor Optimization Moves

In many markets, competition has remained high and margins have continued to be squeezed amid mounting health and economic concerns. During the first half of 2020, one in three contractors acted quickly to reduce costs by decreasing headcount.

However, there was no pause in the demand for skilled talent. According to the U.S. Bureau of Labor Statistics (BLS), the construction industry saw monthly net gains in job creation, and the number has been rising through the most recent data for October. While total industry employment is below pre-COVID levels, the unemployment rate remains relatively conservative at 6.8%, which is slightly less than the U.S. average across all industries. In other words, many workers have employment options.

This does not mean contractors cannot still take steps to improve efficiencies and, in doing so, streamline their organizational structures. It simply means they must proceed with care and caution. Here are four steps companies can take now to ensure their labor forces are optimized for 2021.

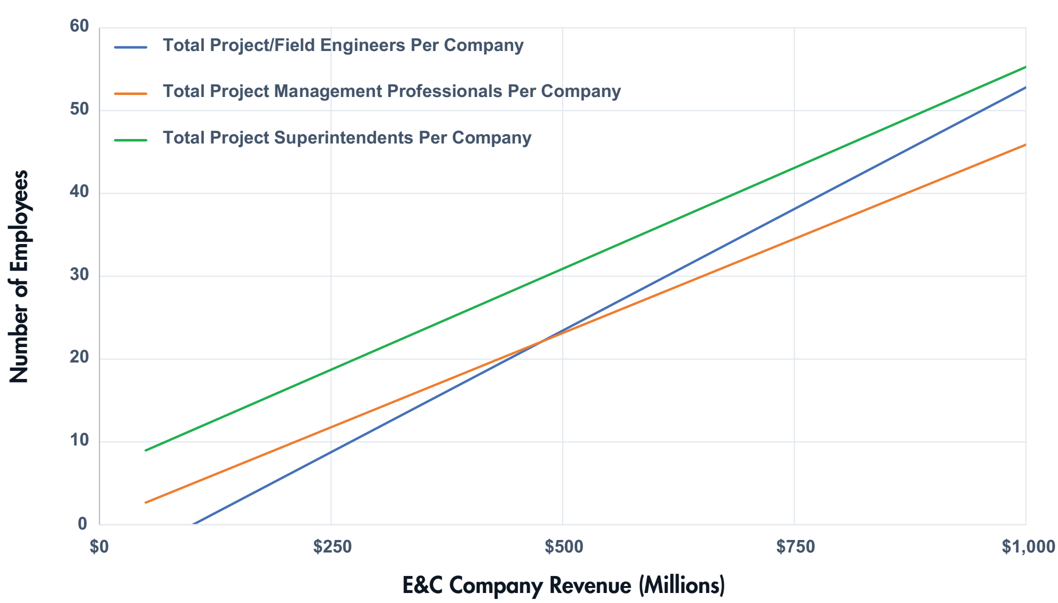
Step 1: Determine Current and Future Staffing Needs

Before an executive team can create the preferred organizational structure, it must examine the company's financial position, business development plan, and operational capabilities and prospects. Nonfinancial factors must be considered too; a comprehensive overhaul of the company's strategic direction and activities may be ideal, but if employees perceive the changes as a cultural conflict, the possible gains may not outweigh the potential for turnover and disengagement.

The risk of reluctance or resistance to change is one reason that most companies would be well-served by creating a restructuring plan now. If there are deal breakers, it is best to flag them as soon as possible. If there are unique people and processes that are believed to be integral to the company, it might be preferrable to place these outside any restructuring efforts or ensure that the changes are gradual and clearly communicated. Not surprisingly, executives who have worked to create and promote a positive view of leadership are often able to oversee changes best.

Industry benchmarks should not be the sole consideration for leaders in developing an optimal structure, but they can yield helpful insights on how similar companies are organizing their employee populations. For example, FMI's 2020 Construction Professional Compensation Survey reveals that among general contractors, most hire one project manager, superintendent and project engineer for approximately every $18 million in revenue, on average (Exhibit 1).

Exhibit 1. Project/Field Employees by Company Revenue



Source: FMI's 2020 Construction Professional Compensation Survey

The broad review of the corporate outlook should be narrowed to determine the talent characteristics that are most important to the firm. For example, a general contractor that sees an opportunity to further break into the self-perform arena may focus its attention on establishing qualifications and expectations for field leadership and trade staff. Another contractor in a highly competitive environment may highlight the need for a best-in-class estimating department. The identification of critical areas does not negate the need to evaluate job roles throughout the organization, but leaders should prioritize those positions or teams that are most likely to support the company now and in the future (recognizing they may be different).

Step 2: Evaluate Employees' Skills, Interests and Potential

Employees are continuously assessed for competencies, asked for insights on their aptitudes, and questioned about their potential and desire for advancement. For many contractors, this is a utopian concept. While annual performance reviews have become common across the E&C industry, they are still fraught with inconsistency and incompleteness. And, unfortunately, one approach to improve the process—requiring a completed review for raises and bonuses—has few benefits other than ensuring most employees and managers speak at least once a year about performance.

Performance reviews primarily focused on behaviors versus results can cause problems. Often, executives and HR leaders are concerned that it causes undue stress and overfocus on tangible results rather than long-term contributions and employee development. What's more, in times like these, when companies are considering reining in salary increases and incentive awards, linked performance reviews lose nearly all value in the eyes of employees.

In the absence of a more robust training and development program, performance reviews can still be a good starting point. If used, they should offer clear, objective commentary of employees' current job performances and their reflections of company values. If employees are in the habit of developing customized goals with their managers, this feedback can also offer insights on what is important to each employee (i.e., where they want to excel or improve). In addition, the difficulty of the performance goals established can be an indicator of his or her manager's general views of capabilities. More detailed assessments can be conducted and, in some instances, should be. However, starting with available resources will lead to less disruption to the employee base while leaders contemplate new structures.

Step 3: Align Jobs With People

Discussing the future potential of team members – and how it aligns with the future goals of the firm – is a sensitive topic; therefore, it is ideal that functional needs are determined independent of the assessment of people at first. The act of reconciling necessary and desired staffing with the current workforce is likely to result in some conflicts. In other words, there will be vacancies for key positions as well as employees who do not necessarily fit in the ideal organizational structure.

Companies should also focus on managing job gaps. Even contractors seeking cost savings and an overall reduction in the workforce may find that there are new or modified jobs needed for future business improvements. Therefore, once these unfilled jobs are identified, leaders must make an action plan to place the right individuals in them.

Finally, there should be a clear understanding of the characteristics and skill sets desired after analyzing staffing needs. Filling the gaps might be achieved through retraining current employees or recruiting new, experienced team members.

In both instances, the time and cost of getting workers up to speed must be evaluated carefully. Cultural and compliance factors may have an impact also; in particular, when a significant reduction in force occurs, who is left standing takes on great significance. Companies may also consider engaging independent contractors or consultants, but, generally, this should be done to satisfy interim needs or accomplish short-term initiatives.

The more sensitive side of the alignment equation includes the methods required to effectively transition employees who will no longer have a clear role within the company. First, the approach for identifying those likely to be terminated must be reviewed to ensure fairness and compliance:

- Employees must be evaluated according to consistent criteria that reflect the company's values and strategies.
- The best practice is to assess all employees, even those in jobs that will be eliminated.
- The process should represent a top-down hierarchical structure, but not neglect critical input from team members across the organization.
- Employee evaluations must be undertaken quickly and quietly. Rumors will begin circulating rapidly, and the sooner they can be quelled with guidance from leadership, the better.
- Leadership must determine what type of consideration is required and if the company will offer additional severance benefits (e.g., salary continuation, paid leave payouts, ongoing health care premium coverage, outplacement services, etc.).

Step 4: Develop the Restructuring Plan

A contractor's communication plan has momentous impact on the success of the restructuring process. While there are schedules to put in place, training and onboarding programs to develop, and overall strategic alignment to confirm, the way changes are managed and conveyed will have lasting effects.

Leaders may exercise discretion in how transparent they are when communicating workforce adjustments. If reorganization is seen as necessary to take on significant new opportunities, then a reasonable level of optimism should be messaged. On the other hand, if the talent shifts are needed for dramatic course correction, it may be best that leadership communicates a new future to prepare for a turnaround.

In any scenario, the suggestion that a reduction in force is simply a cost-cutting endeavor will not be met well. Feedback following a restructure is nearly always challenging, but a forward-looking perspective will be the best mitigator of anger, sadness and frustration.

Employees in roles that are eliminated should be informed promptly and be given all appropriate details related to their departures. Shortly thereafter, as the message gets out, further explanation should be shared internally and among key external stakeholders.

Not surprisingly, the views of employees who remain have much more influence on the long-term performance of the company than those let go. One survey from the Great Recession era showed that nearly all employees are less likely to recommend their company as a great place to work, and 3 of 5 employees think their organizations' prospects have worsened after a layoff. There is further evidence suggesting that employees are more likely to voluntarily leave a company when future job satisfaction and security are increasingly uncertain and are usually the top performers leave first.

Navigating Uncharted Territory

Given the difficulty of 2020 and the outlook for 2021, contractors should consider the caliber of current talent and future wants and needs to bolster potential. This is even more important after a decade of continued growth, where there was a common perception that anybody would be a good fit for an open position.

The need to rein in spending and create an organization that is structured for success means it is now time to take a hard look at optimal job roles and current employee characteristics. Using the strategies outlined in this article, companies can effectively assess their current labor pools, make the necessary adjustments and build for future success.

About the Author

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Why Focusing on Your Company Vision Still Matters

By Tim Tokarczyk and Emily Livorsi

Watching, waiting and ignoring changes until the COVID-19 pandemic is over isn't going to work. Here's why.

It's been 26 years since Jim Collins and Jerry Porras published their landmark study in "Built to Last," and the world has changed significantly since October 26, 1994. We've seen dot-com bubbles burst, terrorism emerge as a global threat and the pace of technological change skyrocket. We've navigated through the Great Recession of 2008, and we've seen the proliferation of disinformation propelled by social media.

Today we're in the midst of a global pandemic and economic downturn, the likes of which we've never experienced in our lifetimes. Industry leaders would be forgiven for asking this question: Does vision still matter when we cannot even predict what will happen tomorrow, let alone months or years from now?

The answer is: Yes, vision still matters. And as we see when returning to the insights in "Built to Last," leaders still need to set the foundation and goals that will guide their organizations for the coming years despite continuous uncertainty. To do that, we need to remind ourselves of what vision is and how it can be a transformative tool for our organizations.

Holding Steady Amid Uncertainty

"Built to Last" introduced the world to the concept of "preserve the core and stimulate progress." This is the foundational principle that makes vision such a powerful tool. The first part of vision, defined by a core purpose and core values, is meant to identify the aspects of an organization that should never change. Having a clear purpose and core values provides stability and a reference for everyone to use when making business decisions.

In our current climate, employees need to know that your company's defining characteristics won't change. This is important because your core purpose (why the company exists beyond making money) and your core values (the enduring tenants of behavior) provide guidance for your people. The problem is that the words themselves do not accomplish anything.

To transform your company and build it into an enduring organization requires more than nice-sounding words. Many organizations have a written vision, but few have taken the steps to become truly visionary companies.

To overcome this issue, core values and purposes must be communicated frequently across the organization. Employees need to receive feedback on how they are performing relative to the purpose and values, and they need to understand what they should be doing and changing.

Putting it to the Test

To test how well you have embedded your core purpose and core values into your organization, ask yourself the following questions:

1. Do you have a clearly defined core purpose and core values?
2. When was the last time you celebrated someone for aligning with your purpose and values?
3. What training does your organization conduct to align people with your purpose and values?
4. Do you ask interview questions of potential hires to evaluate whether they align with your culture?
5. How do you handle it when workers perform well in their jobs, but do so in ways that don't align with your purpose and values? Do you ignore it because they're high performers, or do you address it directly?

The answers to these questions will help you determine how well you're preserving the core, which is critical to building an enduring organization. In times of uncertainty, this foundation will center your employees and help them stay focused.

In 2019 FMI interviewed industry executives who led through the Great Recession and asked leaders what factors and leadership moves helped them weather the storm. Many leaders identified having a clear core ideology—and not straying from it—as critical to the health of the business.

Stimulating Progress

Next, Collins and Porras stated that companies need to stimulate progress to accomplish their goals. This often takes the form of a big, hairy, audacious goal (BHAG), with a clear description and understanding of what the organization is trying to accomplish with this goal.

The BHAG unifies the organization around a single goal—a long-term strategic objective that requires change. The core purpose and core values provide stability, but for an organization to survive, it must also change and adapt. In times of uncertainty, your people need to know where the organization is going.

A long-term strategic goal gives your employees direction and guides day-to-day work toward accomplishing that vision. Whether this direction concerns organizational growth, expanding into new markets or segments, redesigning the organization from the inside out, transforming your talent to be best in class, or revolutionizing the industry, your people need to know where the company is heading and how their contributions support those efforts.

To test how well you've clarified your long-term strategic direction, ask yourself the following questions:

- Can your employees clearly define the organization's long-term (10- to 20-year) goals and direction?
- Do your employees understand what they need to do today to help the organization achieve its long-term goals?
- Have you made considerable, measurable strategic progress over the past year?
- Have you celebrated and communicated this progress to the whole organization?
- Do you have a clear picture of what needs to happen over the next year to drive the organization forward? How about over the next five years?
- Do you have clear metrics that allow you to measure progress and a plan to refocus if you get off track?

These are just a few of the key questions that leaders must consider when building a long-lasting culture and organization.

Visionary Versus Average Leaders

To help illustrate the differences between visionary leaders and average leaders, consider the thinking of two different leaders in the following scenarios:

Scenario A: Average Leader

I have no idea what the future looks like. Our backlog is strong going into 2021, so I feel good about that; but I'm not sure what 2022 will bring. We weathered the first wave of COVID-19 well, but I'm not sure what will happen in the next few months. It's better for us to focus on the day to day and just get through this. Eventually, things will quiet down, and we'll be able to get back on track then. At this point, I'll remind my people to focus on what they can control, do their jobs and we'll be ok.

Scenario B: Visionary Leader

I have no idea what the future looks like, but I'm confident that we're heading in the right direction. We have an exceptional culture, and we need to remind people that true success involves performing well day to day, but also aligning with our purpose and values. If we stay true to who we are, we'll be able to thrive in any environment. We also need to keep our eye on the long-term goals of the organization. While we're dealing with uncertainty, we can't let up on the gas. We have big expectations of the organization and all employees, and there's much we need to accomplish in 2021 if we hope to achieve our BHAG by 2035. We need to leverage the collective experience and wisdom of our people for innovative ideas to overcome our current challenges.

The key difference between these two scenarios is that in times of crisis, average leaders hunker down. They focus on the tactical, the short term. They pause their long-term thinking until there is more certainty. Visionary leaders recognize that in challenging times, they must think strategically and refocus their people on what matters—the core purpose and core values.

Working Toward a Brighter Future

2020 has been a challenging year for all of us. Even businesses that are thriving have endured an uncommon level of stress and new obstacles. The industry has faced many challenges this year, including navigating new work-from-home policies, dealing with COVID outbreaks at the office or on job sites, and shifting focus as project work was paused or stopped, to name a few.

Without intentional focus, leaders will shift to the short-term tactics, pausing vision work in order to endure. Other leaders will take the visionary path and increase communication and refocus their people on the company's core purpose and core values. They'll think strategically about what the future of the organization looks like in a post-COVID world, collaborate more, leverage their people and chart a path forward to ensure continued business success. "Built to Last" was right all those years ago—vision really does matter.

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