

# Making a Success of Succession: Is There an App for That?

February 2, 2017 3:00pm  
The Union League, Philadelphia PA

**Karen Blose –AEdvise LLC**

**Emily Gunther - CLA**

Investment advisory services are offered through CliftonLarsonAllen Wealth Advisors, LLC,  
an SEC-registered investment advisor. | ©2017 CliftonLarsonAllen LLP

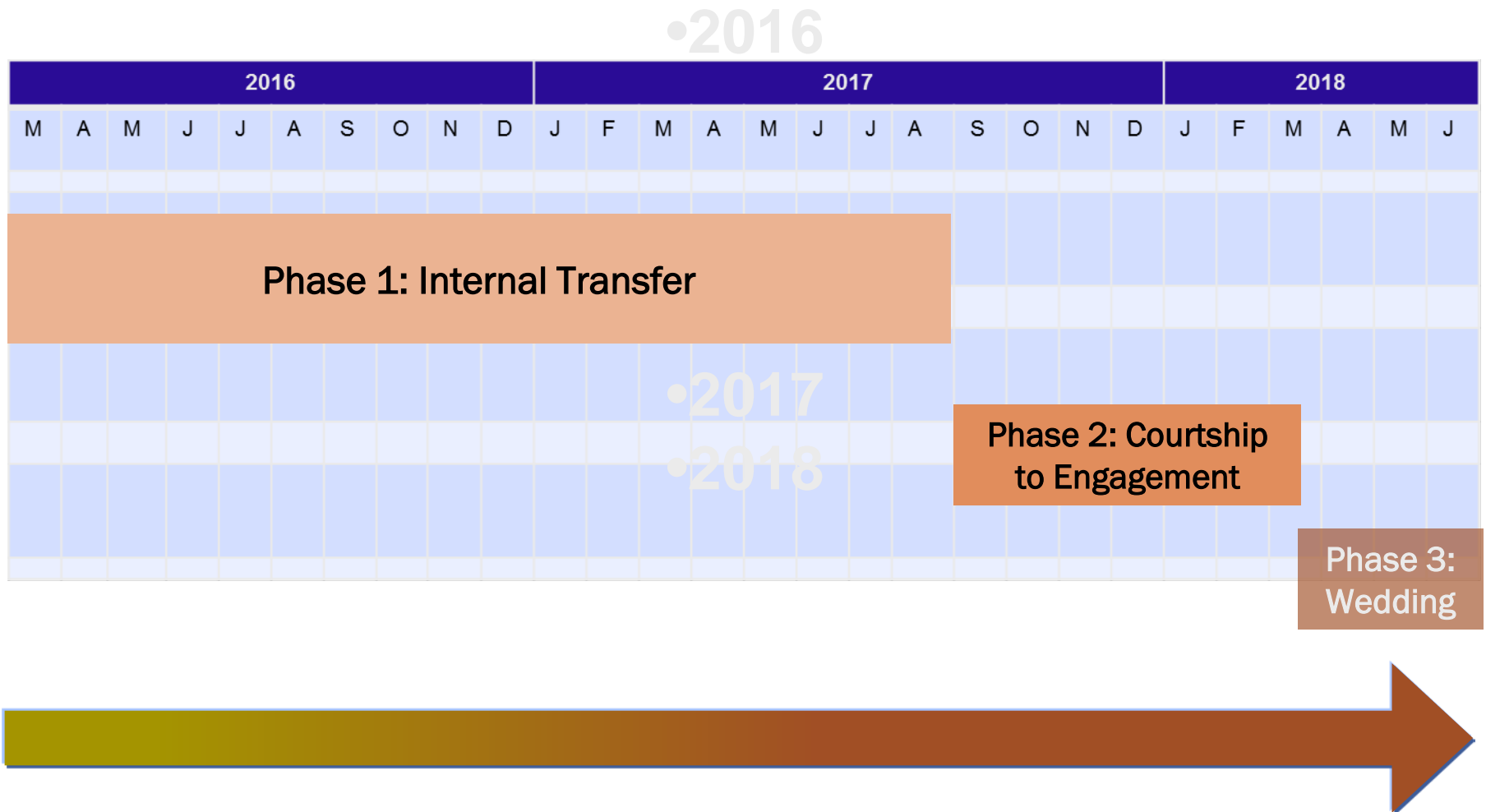


# Program Outline

- **Timeline of a Transition**
- **Every Transition Needs a Plan**
- **Harmonizing Expectations with Achievable Results**
- **Internal vs. External: Succession or Selling out?**
- **Developing the Price**
- **Using Experts**
- **Terms Other than Price**
- **Communications/Confidentiality**
- **Next Steps-Internal Sale**
- **Next Steps-External Sale**
- **Negotiating Issues**
- **Timeline for Closing**



# Timeline-From Consideration to Conclusion



# Every Transition Needs a Plan

- Competitors are getting bigger

Independent firms are  
disappearing

- I built this Firm from nothing so I  
want my just desserts

Fame, \$\$\$, Firm of the Year

- I love this-Can I work forever?

No Plan = Plan to be Immortal

# Choices for Transition

- Internal Transition

- ❖ Management

- ❖ ESOP

- External Transition

- ❖ Merger

- ❖ Stock Sale

- ❖ Assets Sale

---Professional Licenses Issue



# Internal Transfer to Management

## What do Sellers want

- Continuation of the Firm
- No disruption to Projects
- Turnover mantle of Responsibility
- Get my Equity Out

## What do the Successors want

- Ambition/Recognition as a Leader
- Will the Firm still be Profitable?
- Is the Price Fair? Can I afford it?
- Will I be just another Minority Owner?
- What happens when I Retire/Leave?



# **Seller(s) Perspective-Internal Transition**

- **Positives for Internal Sales to Management & ESOP**
  - Continuity of culture/values
  - More gradual transition
  - Greater Client acceptance/retention
- **Positives for Internal Sales to ESOP**
  - Tax Planning Advantage-deferral of gain for Sellers
- **Negatives for Internal Sales to Management & ESOP**
  - Unproven Leaders/Lack of Candidates
  - Successors have Different Values/Entrepreneurial Attitude
  - Price may be lower
  - Payment may be dependent on Future Profitability



# Buyer(s) Perspective-Internal Transition

- **Positives for Internal Sales to Management & ESOP**
  - Continuity of culture/values
  - More gradual transition
  - Greater Client acceptance/retention
- **Positives for Internal Sales to ESOP**
  - Tax Planning Advantage-stepped up basis
- **Negatives for Internal Sales to Management & ESOP**
  - Unproven Leaders/Lack of Candidates
  - Inherit Liabilities of Sellers
  - Bureaucracy and external expense for ESOP compliance





# Seller(s) Perspective-External Transition

- **Merger/Stock Sale**
  - Potential Inclusion/dilution of core culture/values in new merged firm
  - Greater Client acceptance/retention
  - Price is higher; May be dependent on earn-out
  - Tax Planning Advantage-recognition of gain for Sellers
  - Project Liabilities are with Successor v. Lose Control
- **Asset Sale**
  - Difference in Entrepreneurial Attitude
  - Price may be dependent on Future Efforts
  - Selected A/R and Liabilities may stay with Sellers



# Buyer(s) Perspective-External Transition

- **Merger**
  - Clash of culture/values
  - Greater Client acceptance/retention
  - More gradual transition-harder to remove deadwood
  - Liabilities may flow to successor
- **Stock Sale**
  - Greater Client retention/continuation
  - How good was Due Diligence? Successor liabilities
- **Asset Sale**
  - Leadership transition uncertain
  - Tax Planning Advantage-Buyers
  - Difference in Entrepreneurial Attitude post closing



# Design Firm Prices: Highest to Lowest<sup>1</sup>

- Strategic Acquisition w/ External Buyer
- Merger
- ESOP Sale
- Internal Sale to Management
- Desperation Sale

<sup>1</sup>Strogoff Consulting, Inc. 2011 AIA program





# Developing the Price

## Art or Science?

# How Will Buyers Value a Business?



# Book Value

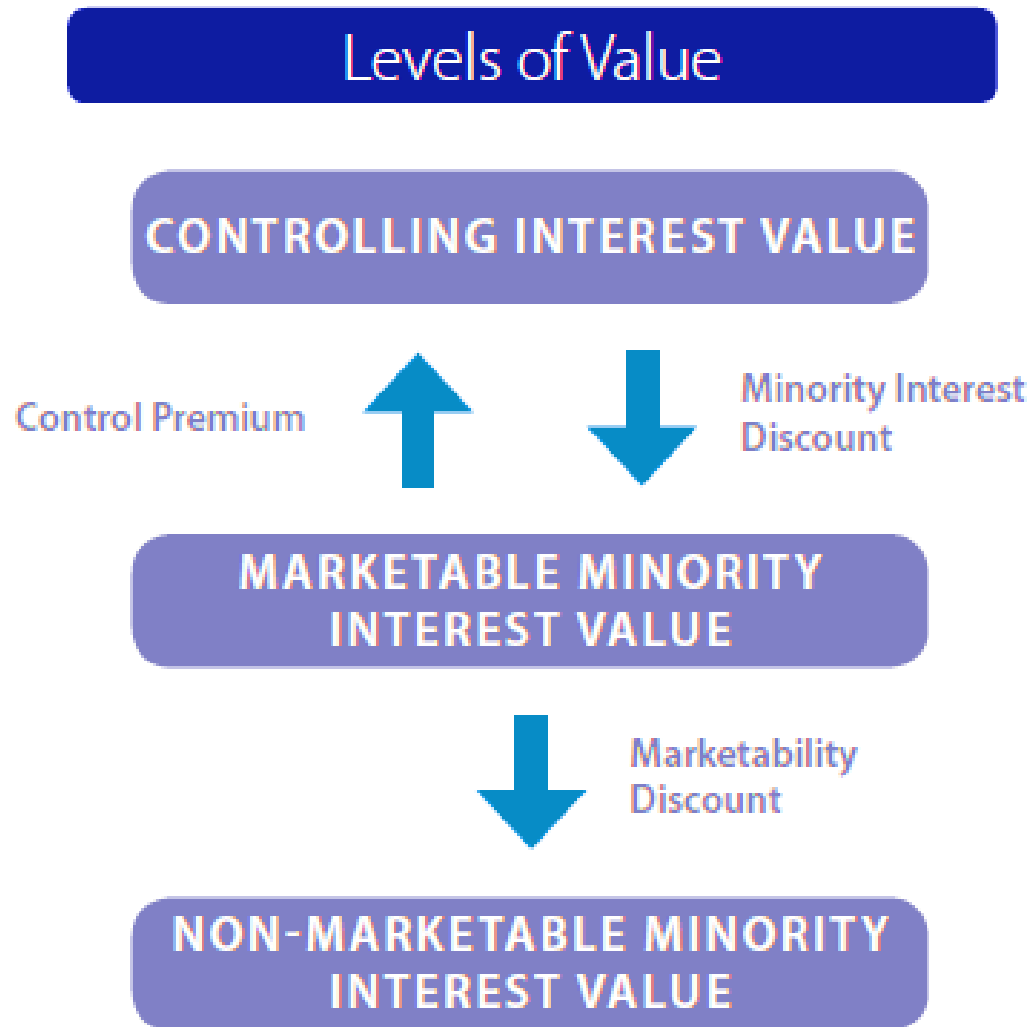
- Often referred to as shareholders equity or partners capital
- Accounting term used to define the sum of the capital invested by the shareholders, earnings retained and reinvested over time
  - Aka “Skin in the Game”
- Assets minus liabilities



# Fair Market Value

- Usually higher than book value
- “Real” value is usually not the stuff the firm owns but the ability to generate earnings and create cash flow
- Goodwill – intangible asset
  - Workforce
  - Experience and Expertise
  - Reputation
  - Client relationships





*A/E Business Valuation and M&A Transaction Study (2017 fourth edition) - Rusk O'Brien Gido + Partners*







# Determining Fair Value

- Market Based Approach
  - Transactions of similar firms
- Income approach
  - Present value of future cash flows
- Asset approach
  - Own significant tangible assets, future earnings unknown
- Discounts/Adjustments
- No 2 firms are identical
- Not an exact science



# Factors to Consider in Appraisal

- Future earnings potential
- Growth rate and backlog
- Strength of balance sheet
- Capabilities and depth of management team
- Competitive environment
- Outlook for the market served by the firm
- History of litigation and claims
- Market sector – private vs. public work
- Client concentration



# Rules of Thumb

- 1.5 times book value
- 3-4 times EBITDA
- 40-45% of Net Service Revenue
- 30-40% of Gross Revenue
- \$60,000 - \$70,000 per full time equivalent (FTE)



# ByTheNumbers Design, LLC

Firm Metrics:	
Gross Revenue	\$ 25,000,000
Net Revenue	\$ 15,000,000
Book Value	\$ 3,750,000
EBITDA (after Owner comp.)	\$ 1,125,000
FTEs	60
Value Calculations:	
1.5 x Book Value	\$ 5,625,000
3 x EBITDA	\$ 3,375,000
40% Net Revenue	\$ 6,000,000
30% of Gross Revenue	\$ 7,500,000
\$60,000/FTE	\$ 3,600,000



# Rules of Thumb – Proceed with Caution

- Factors with little correlation to fair value
- No relevance to changes in the market
- Applied to a Firm with atypical performance
- Just too simple
- Historical performance differs from future performance
- Not based on arms-length transactions





# Is Price the Most Important Factor?

What else actually matters?

# Terms other than Price

- Timing of cash payment(s)
- Financing
- Earn out
- Future roles for key employees
- Ownership in the “new” entity
- Legacy
- Covenant not to compete
- Employee agreements
- Tax Structure



# Communications & Confidentiality

- Legal Requirements vary-by entity form
  - Directors Duty of Good Faith;
  - Directors Duty of Due Care; and
  - Directors Duty of Loyalty
  - Fiduciaries to Shareholders
- Assessed by the “Business Judgment Rule”
- ESOP requirements under ERISA
- Too much transparency can be disruptive to operations





# Harmonizing Expectations & Achievable Results: Internal Transition

- Takes Time to Develop a Transition Plan
- Best for Long Term Perspective of the Firm?
- Perspective of the New Owners



# Next Steps- External Transition

- Finding Broker
- Putting Together the Firm Dossier
- The Price Adjustment Process
- Corporate Dating
- Evaluating the Suitors

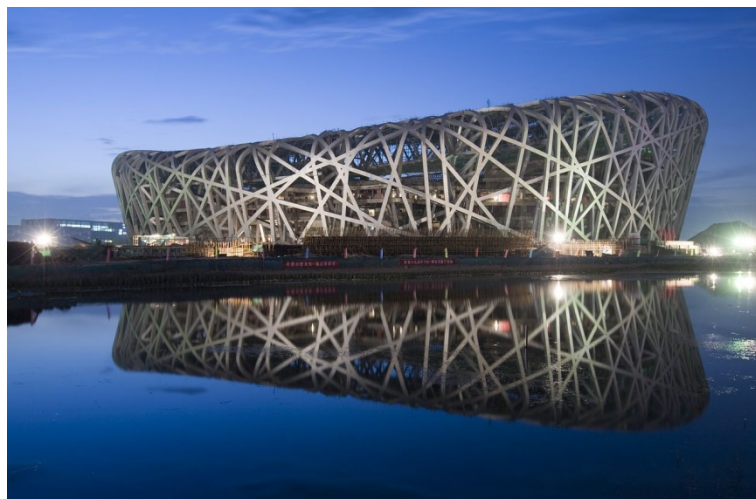
[CLAAconnect.com](http://CLAAconnect.com)

# Not all Brokers are Created Equal

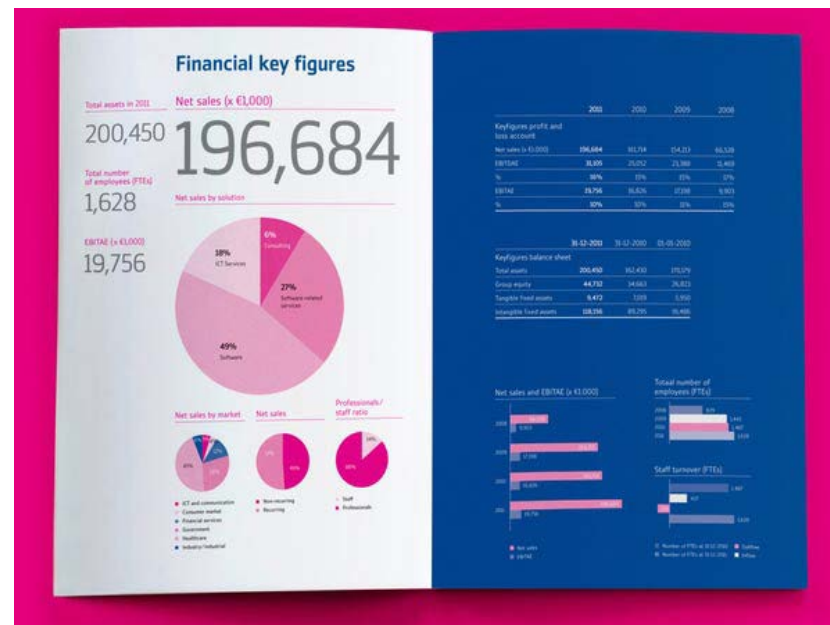
- Industry focus
- Knowledge of the market
- Fee structure
- Paying to “list” the firm



# Putting Together The Book



or



**Cleaning up the Anomalies you have lived with for years**



# Price Adjustments

- Non-recurring income and expense items
- Income/expense items associated with non-operating assets/liabilities
- Normal operating and/or industry results
  - Compensation
  - “Frills” and perks



# Tax Implications

- Asset purchase
  - More common
  - Favored by buyers as it protects them from unidentified or contingent liabilities of the seller
  - Allows for step up in basis of depreciable assets
- Stock
  - Preferred by buyers as it generally allows for a more favorable tax treatment
- Sellers beware of differences between book basis and tax basis (of assets or stock)





# What is the Business story?

**Strategic?**

**Value Added?**

**Geographic Expansion?**

**Market Sector Expansion**

# Corporate Dating/Evaluating Potential Suitors

- Who goes on the First Date?
- S/He wants to meet my Family?
- Creating a Cover
- The Business Must Go On

- S/He's Good Looking but can s/he Design? Market? Manage? Mentor?
- **GOAL:** Mesh the Criteria
  - Design Philosophy and Approach
  - Leadership Style
  - Marketing Style
  - Communication Style





# Negotiating Other Issues

# Looking Ahead:

- **Incentives for Current Principals**
- **Avoidance of Disincentives & Non-Compete Restrictions**
- **Post-Closing Governance**
- **Keeping Operations Running**
  - **Joining Studios**
  - **Joining Support Functions**





# Timeline to Closing

Letters of Intent

Due Diligence

The Legal Agreements

# Due Diligence

*Per Merriam-Webster - research and analysis of a company or organization done in preparation for a business transaction (as a corporate merger or purchase of securities)*

- Extremely comprehensive
- Establish a value for assets and liabilities
- No stone left unturned



# Due Diligence

- Financial Matters
  - The last 3 years
- Technology/Intellectual Property
- Customers/Sales
  - # of clients/customer concentrations
  - Backlog
- Material Contracts
  - Customers, employees, JVs, leases
- Strategic Fit – Culture



# Legal Agreements

- ✓ Representations and Warranties
- ✓ Escrows
- ✓ Post Closing Governance
- ✓ Incentives to keep the Principals
- ✓ Closing Requirements

Closing

Integration

# THANK YOU FOR YOUR ATTENTION!

**Karen K. Blose, Esq.**  
**AEdvise LLC**  
**Principal AEdvisor**  
**office: (609) 914-0588**  
[kblose@aedvise.com](mailto:kblose@aedvise.com)  
[www.aedvise.com](http://www.aedvise.com)

**Emily E. Gunther, CPA**  
**CliftonlarsonAllen**  
**Principal**  
**267-419-1149**  
[Emily.Gunther@claconnect.com](mailto:Emily.Gunther@claconnect.com)

**AEdvise LLC**

**CLAconnect.com**

## CONSTRUCTION

# Architects and Engineers

**Increase profitability with streamlined operations that lead to effective planning and design.**

CliftonLarsonAllen provides dynamic solutions to meet the financial, tax, and operational needs of A/E and design firms.



## What's on your mind?

- Balancing tax efficiency and the cash flow needs of the business and its owners
- Complying with the myriad of federal and state regulations while keeping a practical approach to risk and business structure implications
- Taking advantage of federal, state, and local tax and business incentives
- Managing deferred tax opportunities
- Understanding the financial and business impact of expanding services both domestically and internationally
- Managing changing ownership structures, and planning for effective ownership transition and growth

## A unique approach

We work with more than 400 architectural, engineering, and design firms nationwide, and are a premier CPA firm focused on the needs of the owners of privately held businesses.

You'll receive more than traditional accounting, assurance, and tax services — our industry-focused advisors can leverage deep technical expertise to meet your specific, ever-changing needs. You will also get strategic guidance through all phases of your firm's business life cycle while managing risk and opportunities for growth.

## How we can help

- State licensing and related entity structuring
- Ownership and organizational structure; ESOP design and consulting
- International operational expansion and worldwide tax-efficiency
- Tax incentives for unique design processes and approaches, and energy efficient design
- Strategic ownership transition planning and business valuation
- Industry-specific operational and IT consulting
- Integrated tax and cash flow planning
- FAR compliance, and consulting and maximizing overhead rates
- Private client tax and wealth advisory for owners
- Outsourced accounting services

Investment advisory services are offered through CliftonLarsonAllen Wealth Advisors, LLC, an SEC-registered investment advisor.



WEALTH ADVISORY | OUTSOURCING | AUDIT, TAX, AND CONSULTING

Investment advisory services are offered through CliftonLarsonAllen Wealth Advisors, LLC, an SEC-registered investment advisor.

A member of  
**Nexia**  
International