

2014

CONSTRUCTION
CONFERENCE:
FRAMING YOUR
BUSINESS
FOR THE FUTURE



WARD AND SMITH, P.A.
ATTORNEYS AT LAW



Ryal W. Tayloe

Practice Groups

Agribusiness

Construction

Litigation

Personal Injury and Wrongful Death

Real Estate Development

Practice Concentrations

Business and Commercial Litigation

Construction Litigation

Contract Litigation

Real Estate Litigation

Personal Injury Litigation



Dave Simpson

NC Government Relations and
Building Division

Carolinas Association of
General Contractors



MANAGEMENT CONSULTING • INVESTMENT BANKING
for the ENGINEERING and CONSTRUCTION INDUSTRY

Positioning Your Business for the Market Recovery

Presented by
Hank M. Harris Jr.
to the



**2014 Construction Conference:
Framing Your Business for the Future**

September 25, 2014

2014 Highlights



- High-volume nonresidential segments in 2014
 - ▣ Power (\$96.5 billion)
 - ▣ Highway and Street (\$81.3 billion)
 - ▣ Educational (\$78.0 billion)
- Strongest percentage gainers in 2014
 - ▣ Lodging (14.0%)
 - ▣ Conservation and Development (12.0%)
- Weakest segments in 2014
 - ▣ Health Care (-2.0%)
 - ▣ Public Safety (-2.0%)
 - ▣ Educational (0%)

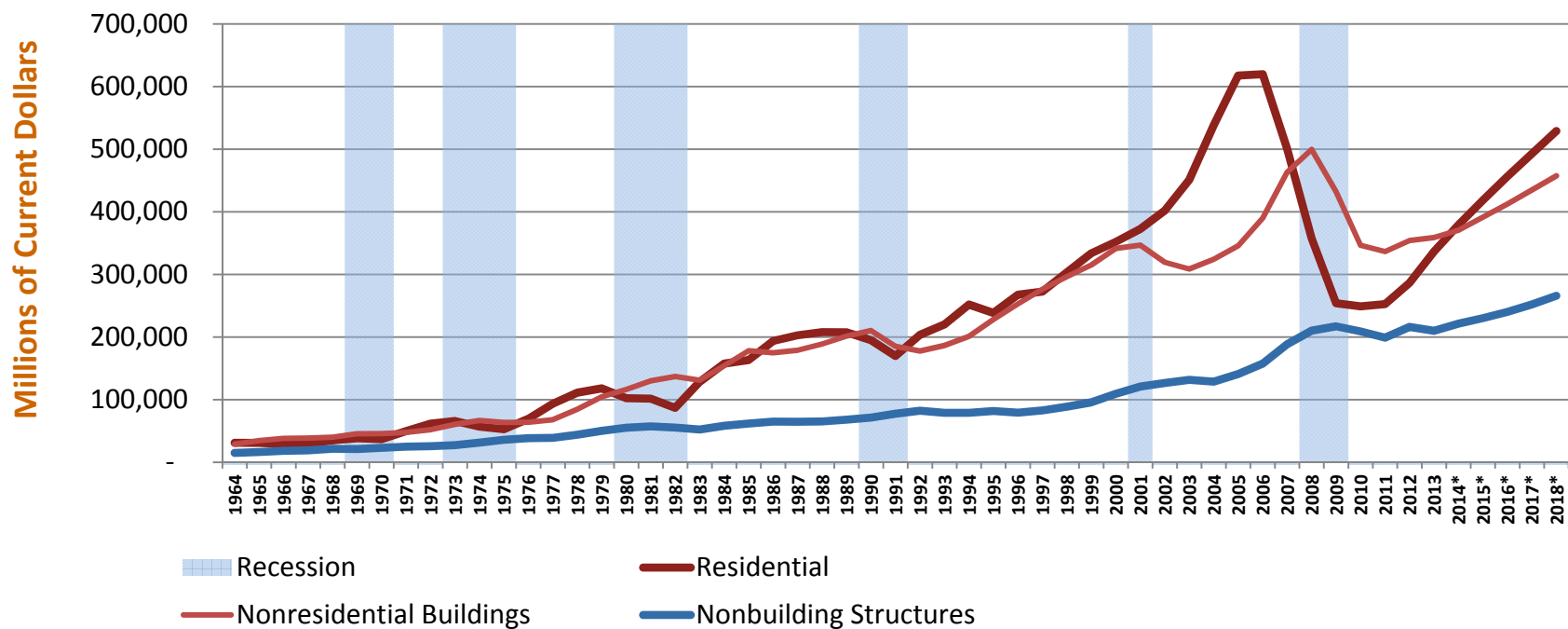
Total Put in Place

Year	%
2012	9
2013	6
2014	7

Construction Spending

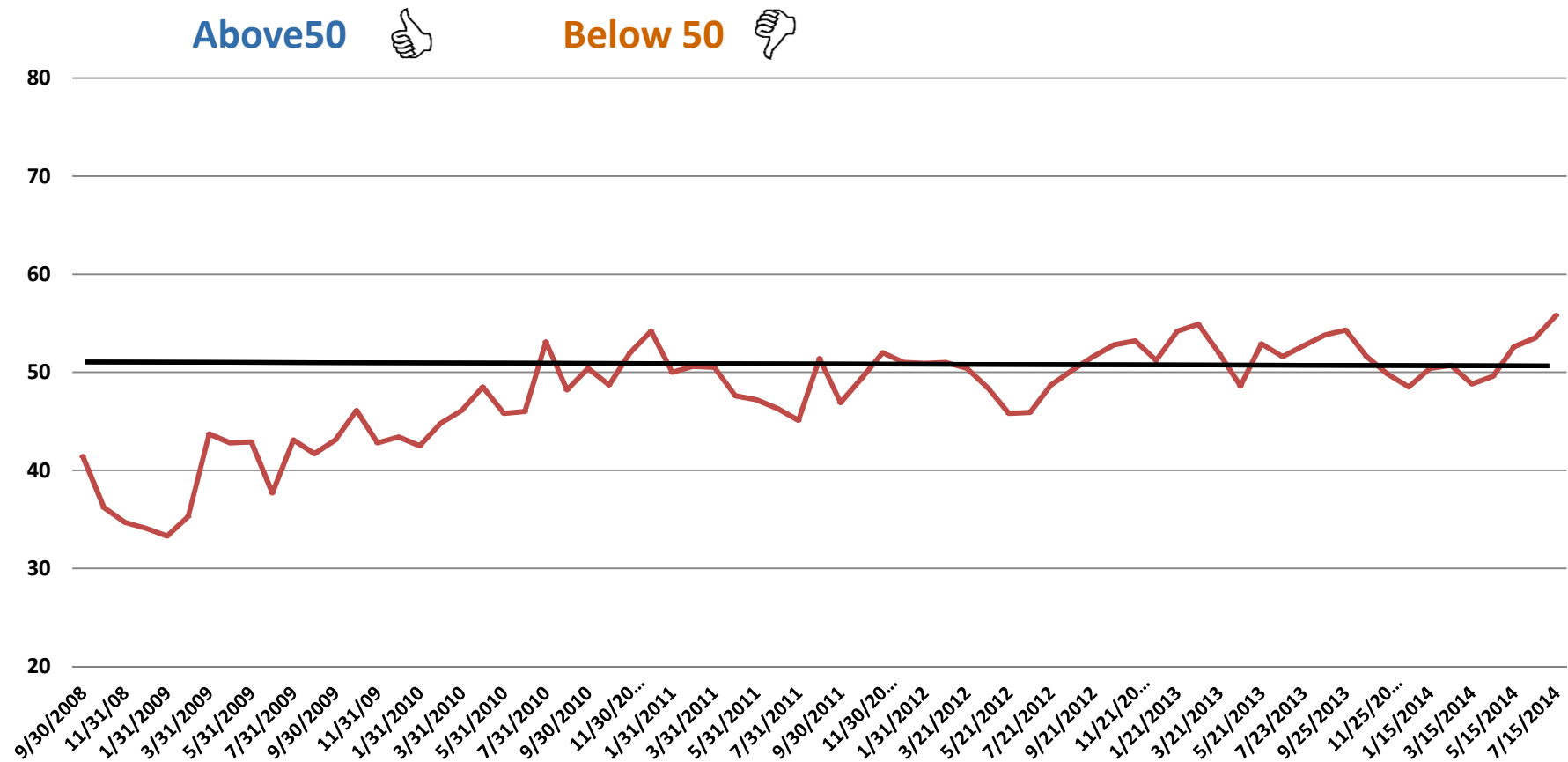


Construction Put in Place



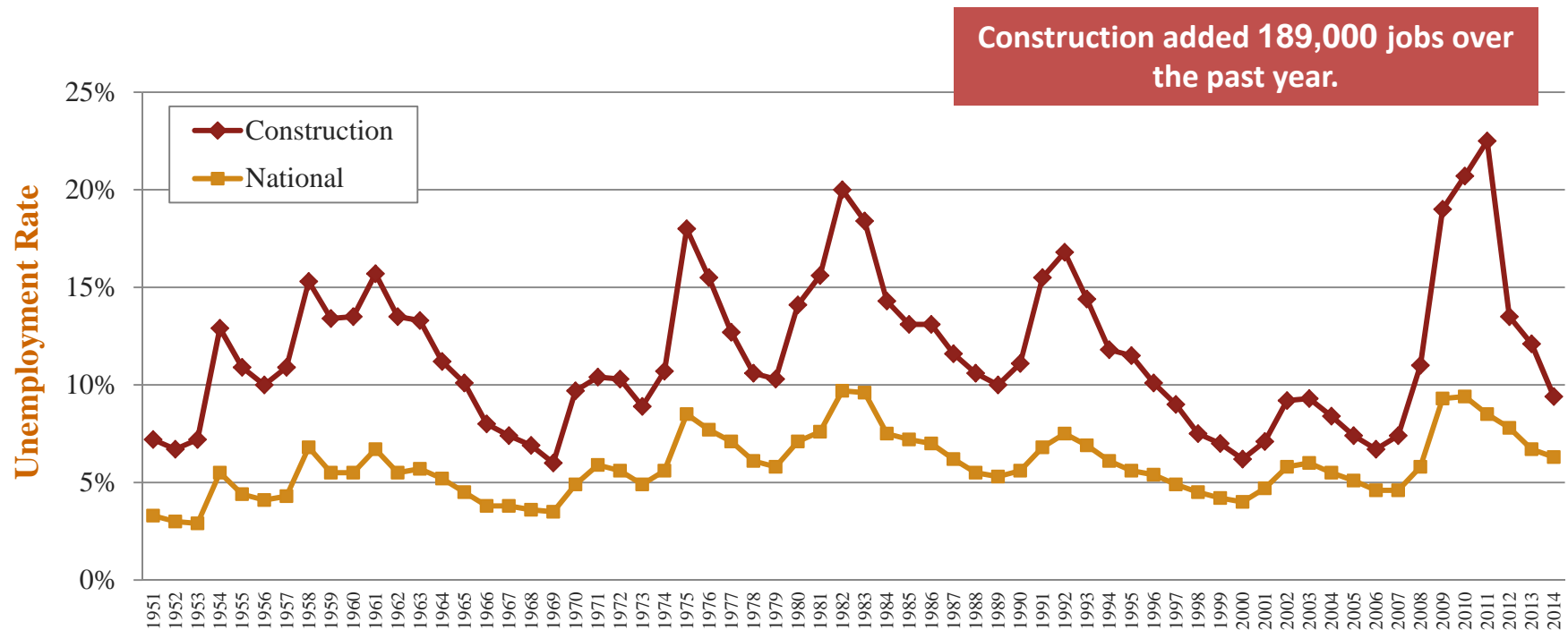
* FMI Forecast

Architecture Billing Index (ABI)



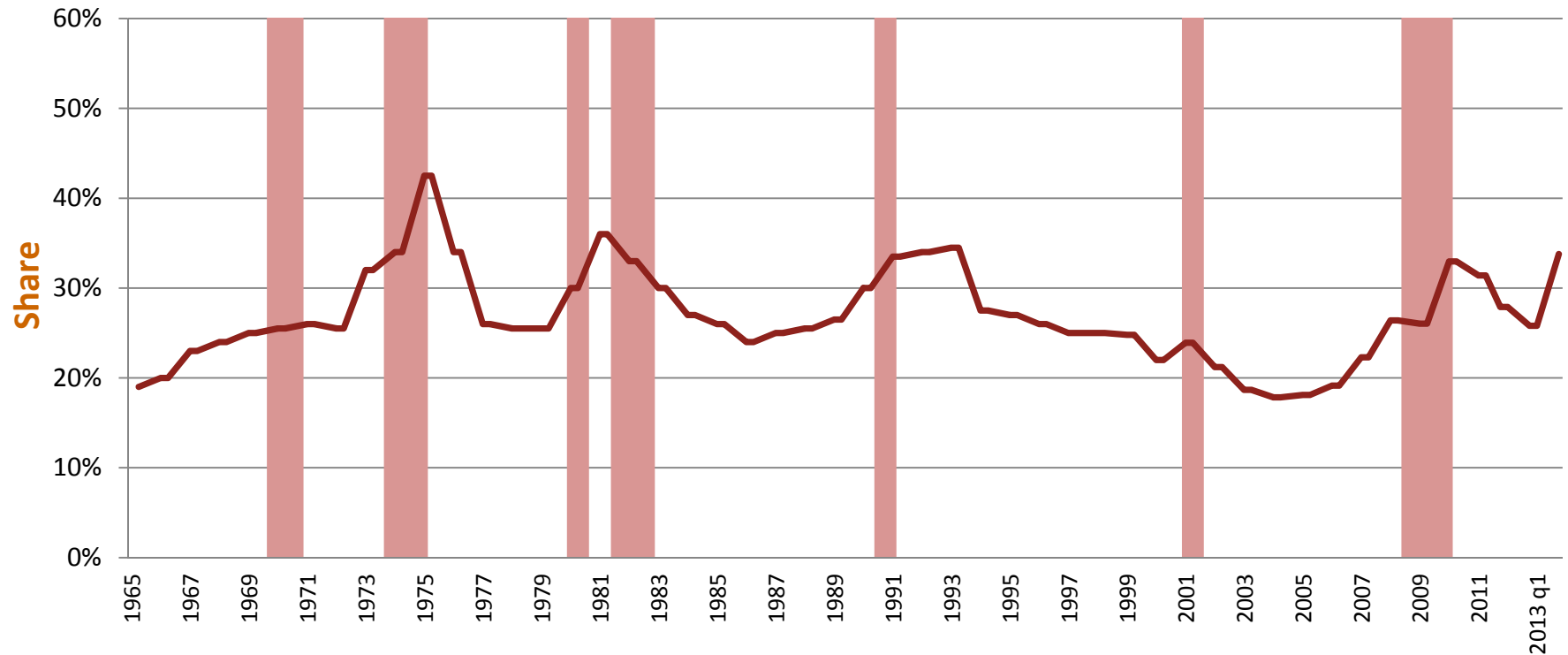
Source: AIA

Construction Unemployment vs. National Unemployment



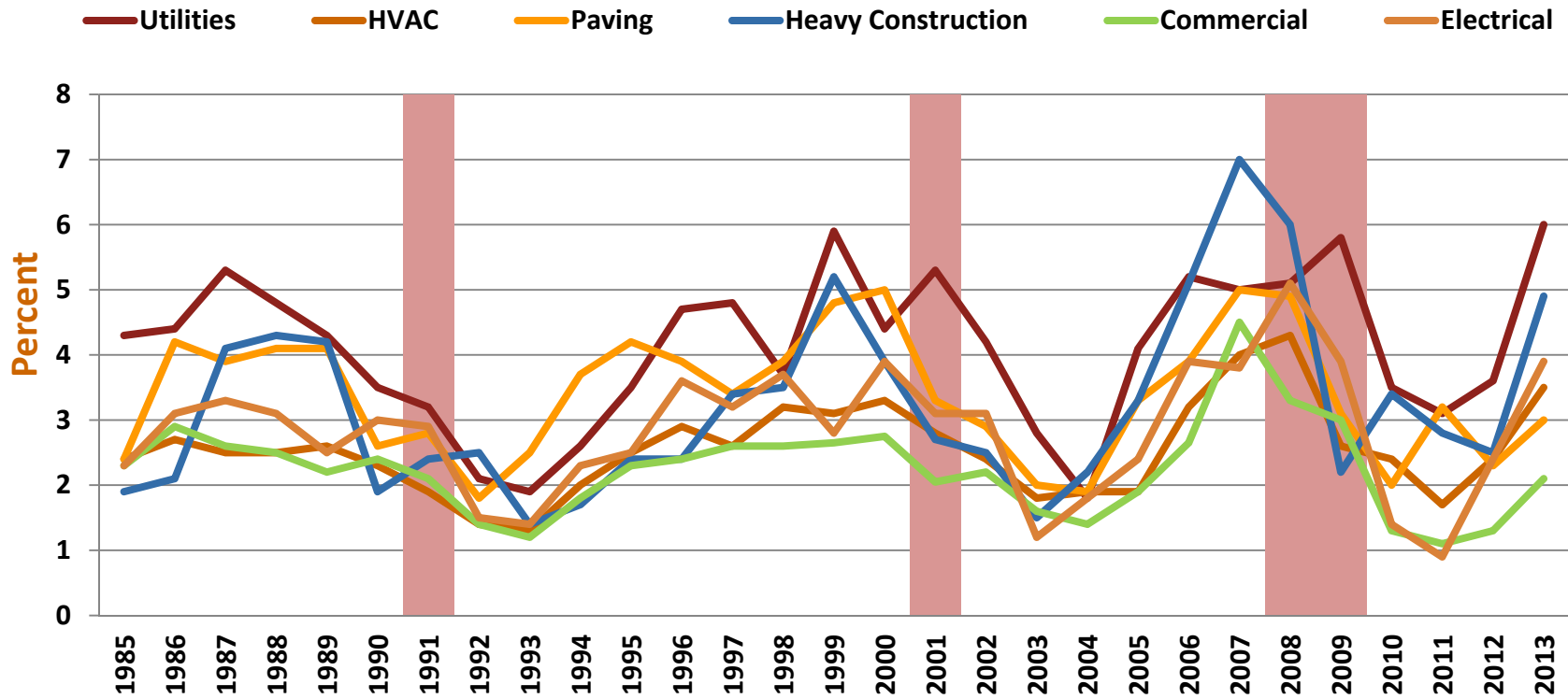
Source: U.S. Department of Labor, AGC of America

ENR 400 Share of Total Construction Put in Place



Source: ENR, FMI

Contractor Profit Before Tax



Source: Risk Management Associates, Philadelphia, Pa.
Recession Periods Are Shaded Red

- You are perfectly designed to get the results being generated
- Now is the time to make changes





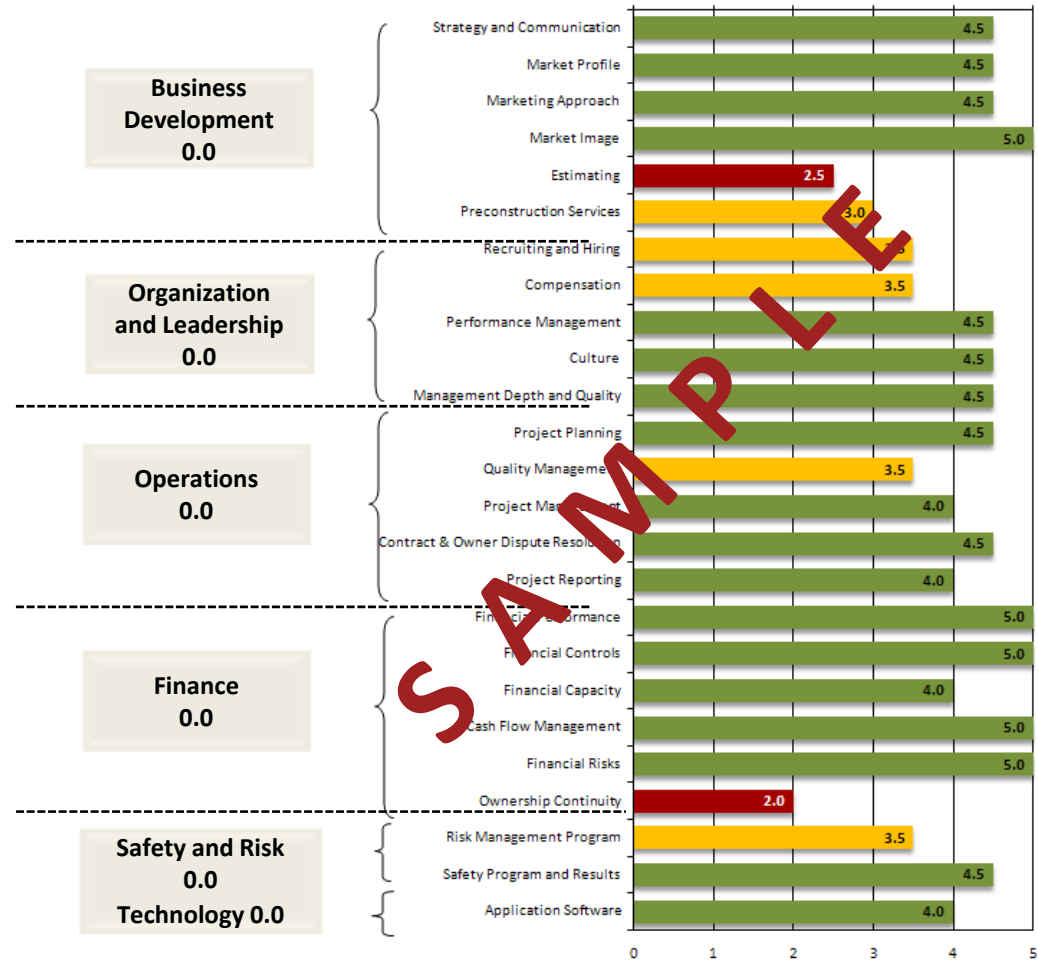
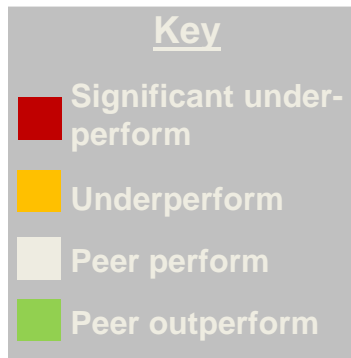
"You have brains in your head and
feet in your shoes,
you can steer yourself in any way
you choose!"

Dr. Seuss

Value Driver Scorecard



Overall Score = 0.0



The ***decisions*** you make about what you (collectively) envision for growing your company over the long term.

Elements include:

- Where the firm will compete
 - Geographies, segments, owners, etc.
- How you will compete
 - Services, scopes, differentiators, etc.
- Differentiation and innovation
 - What unique value will you provide

May also include intrinsic goals (values-based)

Results in an action plan that closes the gap

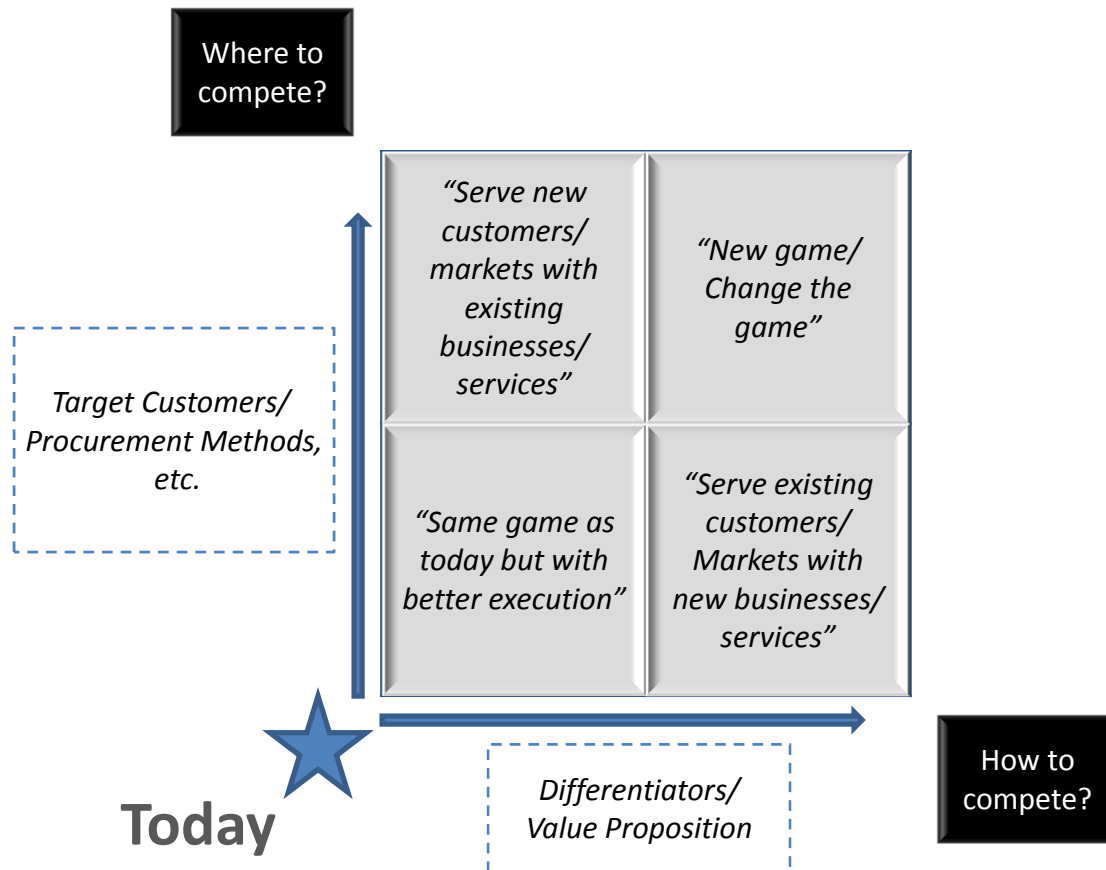
Discipline of Market Leaders – Michael Treacy and Fred Wiersema



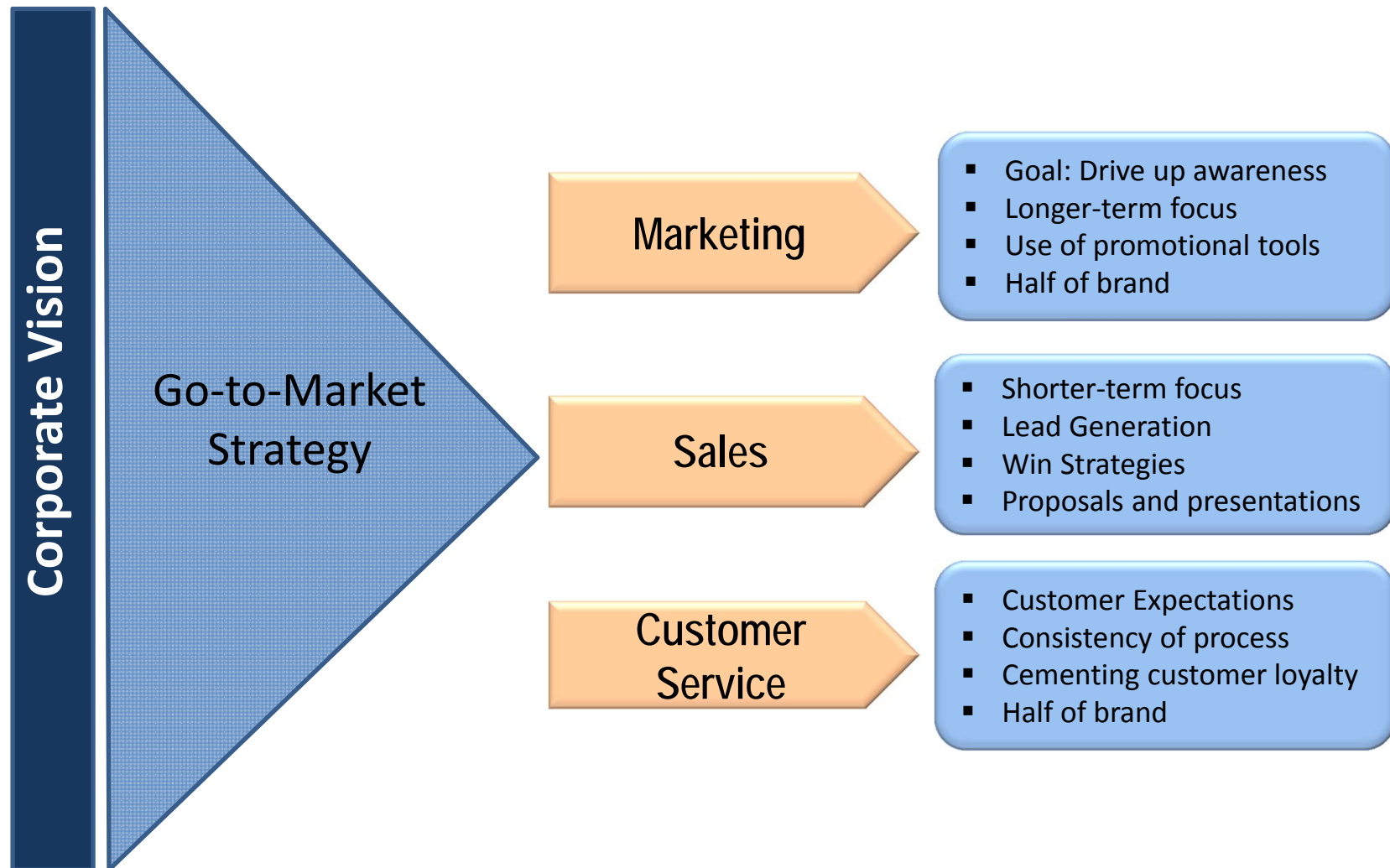
- **Spread the Risk**
- **Take Small Bites**
- **Balance Your Strategies**
- **Commit to Superior Value**
 - What is your current Value Proposition?
 - What is a “Superior” Value Proposition?
- **Expand Growth Capabilities**
- **Manage for Growth**



Strategy Alternatives



- "Where to compete" defines the geography, target customers, contracting method, etc. of the set of customers you intend to pursue
- "How to compete" defines how to create a value proposition as well as the capabilities required to deliver a competitive advantage.
- Four critical questions:
 - **Who are the target customers?**
 - **What is your value proposition?**
 - **What capabilities are required to deliver that value proposition?**
 - **Which capabilities must you develop?**



A Difference of Opinion – Superior Customer Service



- Believers: 80% of firms believe they provide superior service
- Achievers: 8% of customers agree



Customers (Job or No Job) Yield the Right Focus



- Pursue customers (long view), NOT just projects!

Proactive

Chasing Relationships
(may be no job defined yet!)

- Research customer (consultants, suppliers, other subs, etc.)
- Job site visits
- Key customer visits
- Meetings (technical) with Ops/Estimating resources
- Face-to-face with Sr. Mgr./owner



THEN, if a job is imminent...

- “Design Assist” activities

BD is
either
OR

Reactive

Chasing Jobs

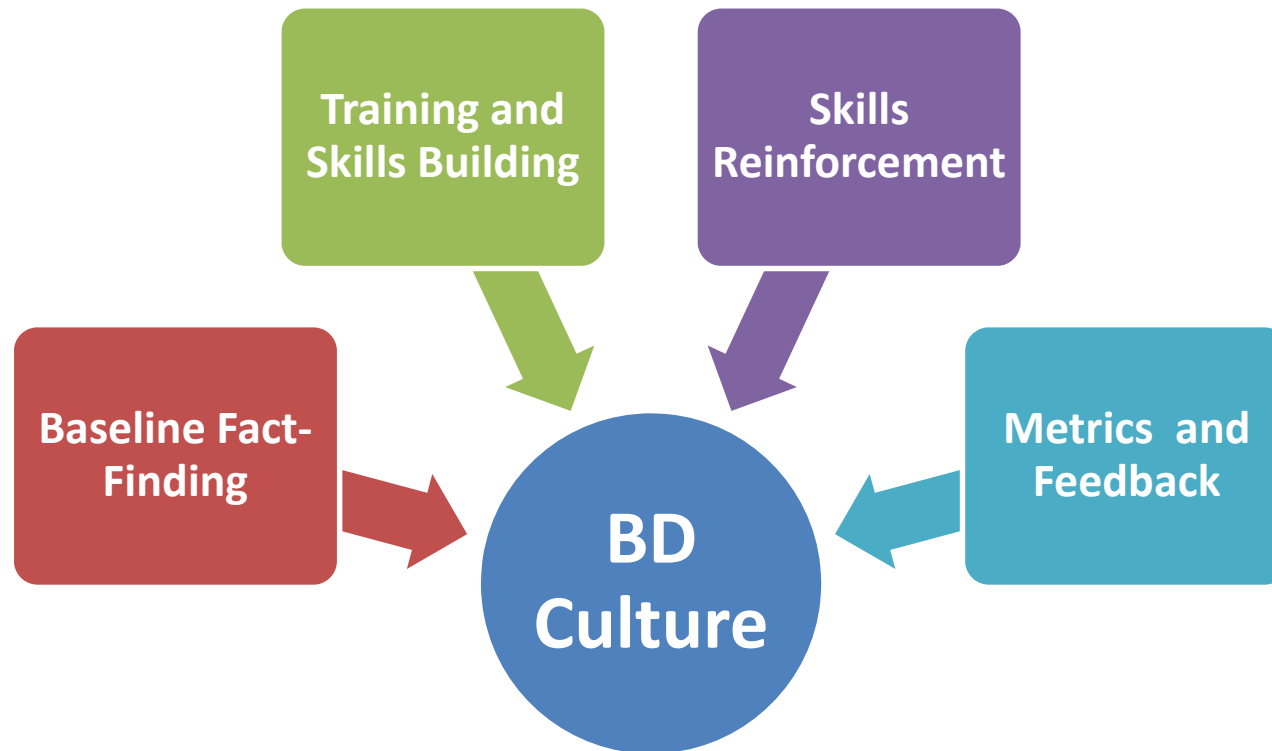
- Pre-Bid Activities
(budgeting, scope development and review, etc.)



- PROPOSALS / Bids – OPTIONS!
- Meetings / Calls to SELL
TOTAL VALUE of
your proposal submittal

100% of BD Time





Dilbert on Strategy



How Good Is Your Strategy?



- Will your strategy beat the market?
- Your strategy taps a true source of advantage?
- Is your strategy granular enough about where to compete?
- Your strategy is putting you ahead of trends?
- Your strategy is based on “privileged insight”?
- Your strategy embraces uncertainty?
- Your strategy balances commitment and uncertainty?
- Your strategy is not contaminated by bias?
- Your organization is committed to act upon your strategy?
- You have translated your strategy into an action plan?

Thank You!



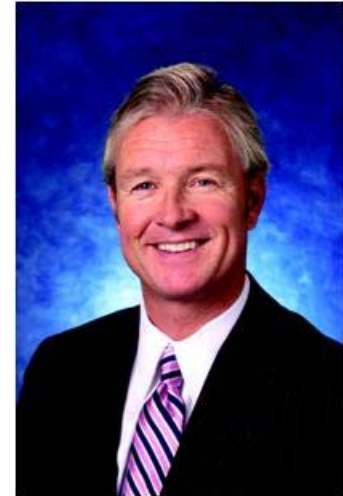
Hank M. Harris Jr., cmc President and Chief Executive Officer

Hank Harris is president and CEO of FMI, management consultants to the construction industry. Hank is responsible for the management of all of FMI and its services to the marketplace. He primarily works for firms in matters of organization, strategic planning and the execution of strategic plans through mergers and acquisitions.

Hank understands the industry from a unique perspective. His background with regional building, real estate and development organizations provides him with a practical approach, while his extensive activities in management education and consulting provide him with an objective viewpoint. Hank has consulted to a variety of industry players, and his advice is sought by engineering, contracting, EPC and architectural firms.

Over the years, Hank has published an extensive array of articles and white papers on managerial topics related to the industry. He has also written two books on the application of strategic planning to managing construction-industry firms.

Hank has a bachelor of science degree with a concentration in marketing from the University of Richmond and a master of business administration degree from Virginia Commonwealth University. He is a certified management consultant and a member of the American Arbitration Association and the Consulting Constructors Council of America. He participates in the Institute of Management Consultants and the Association of Management Consulting Firms. Hank stays active in many industry associations and serves on the boards of directors or advisory boards for several major companies and associations.



Hank Harris
FMI Corporation
5171 Glenwood Avenue
Suite 200
Raleigh, NC 27612
Tel: 919-785-9228
Fax: 919-785-9320
Email: hharris@fminet.com
Website: www.fminet.com

Visit us at www.fminet.com

FMI is the largest provider of management consulting, investment banking and research to the engineering and construction industry. We work in all segments of the industry providing clients with value-added business solutions, including:

- Strategic Advisory
- Market Research and Business Development
- Leadership and Talent Development
- Project and Process Improvement
- Mergers, Acquisitions and Financial Consulting
- Compensation Data and Consulting
- Risk Management Consulting

Founded by Dr. Emol A. Fails in 1953, FMI has professionals in offices across the U.S. FMI delivers innovative, customized solutions to contractors; construction materials producers; manufacturers and suppliers of building materials and equipment; owners and developers; engineers and architects; utilities; and construction industry trade associations. FMI is an advisor you can count on to build and maintain a successful business, from your leadership to your site managers.



Getting Paid for Your Work: Contracts, Collections, Liens, and Bonds



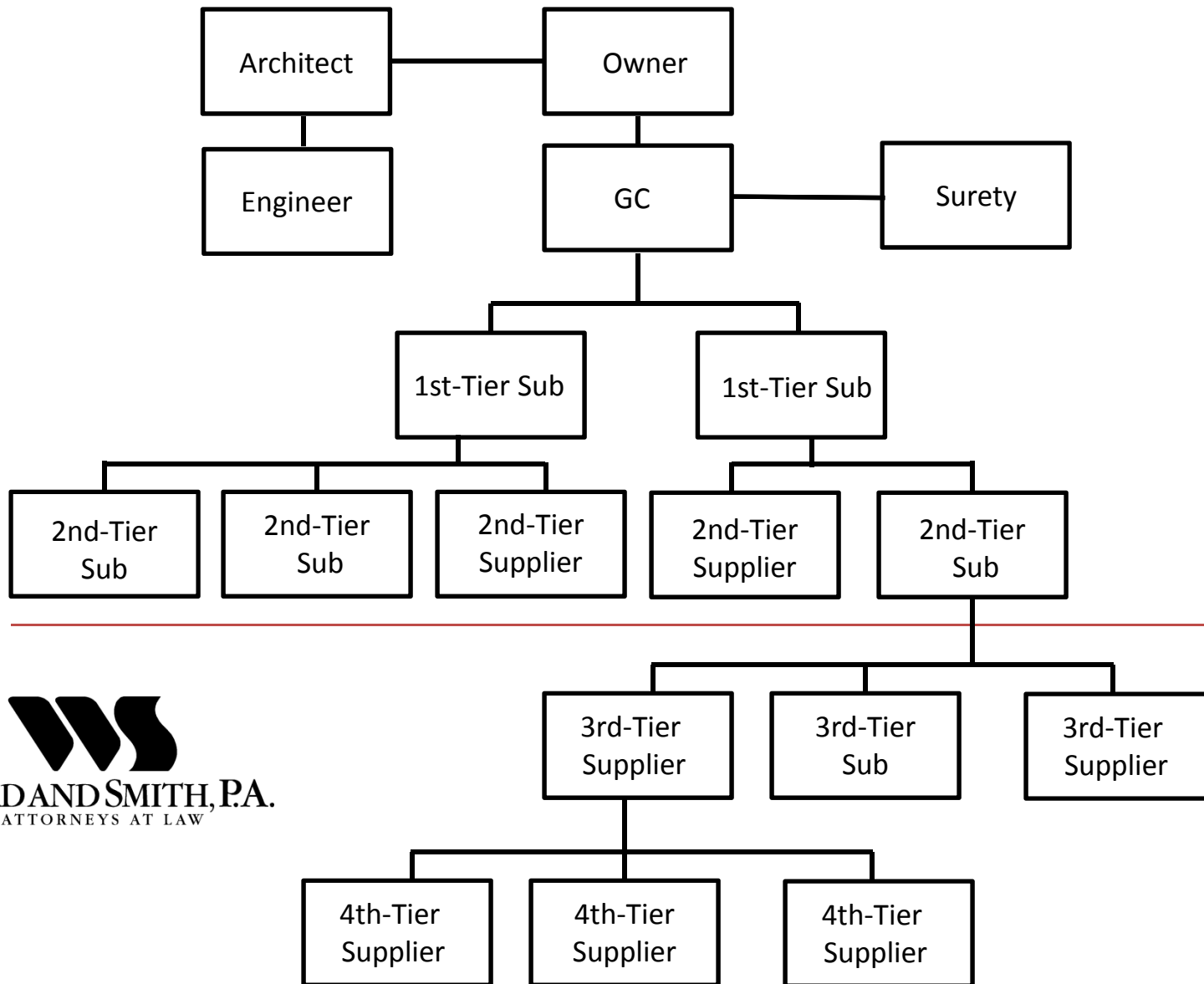
Paul A. Fanning
Ward and Smith, P.A.
paf@wardandsmith.com



Merrill G. Jones, II
Ward and Smith, P.A.
mgj@wardandsmith.com



Jason T. Strickland
Ward and Smith, P.A.
j_s@wardandsmith.com





How to Retain Key Employees



Deborah B. Andrews
Ward and Smith, P.A.
dba@wardandsmith.com



Deana A. Labriola
Ward and Smith, P.A.
dl@wardandsmith.com



Jeremy R. Sayre
Ward and Smith, P.A.
js@wardandsmith.com

What Options Do I Have to Incentivize an Employee to Stay?

- Bonus (Money Talks!)
- Restricted Stock
- Stock Options
- Phantom Stock

Restricted Stock

- It is an outright grant of a certain amount of stock to the employee, subject to certain conditions. Most common conditions are:
 - Vesting schedule (i.e. employee owns 20% in year 1, another 20% in year 2, and so on)
 - Voting versus non-voting stock
 - Subject to an irrevocable proxy
 - Restrictions on transfer / buyback provisions

Tax Implications of Restricted Stock

- Employee has to pay taxes on the grant – no way around that.
- Can pay taxes on the entire amount of the stock on the date of the grant, OR can pay taxes as stock vests. May be better to pay taxes on full grant now, if stock expected to go up in value!
- All taxed at ordinary income, but pay it now or pay it on the amount the stock has appreciated between the grant date and vesting date. Most folks choose to pay now since that should be the lower amount if stock appreciates. Good for startup companies where the only way for the stock price to go is up.

Advantages to Granting Restricted Stock

- No cash outlay for the shares by the employee, except for the taxes to be paid thereon; and,
- No cash outlay for the shares by the company.

Disadvantages to Granting Restricted Stock

- Employee may not have the money to pay the taxes on the stock received;
- May be difficult to assess the fair market value of each share received for tax purposes;
- If voting shares are granted, the percentage owned by current shareholders would be diluted; and
- If non-voting shares are granted, there are some limited instances under North Carolina law where even non-voting shares may have certain voting rights.

Stock Options

- It is an option for an employee to purchase an ownership interest in the employer at a particular price that is set by the employer. Two types of stock options:
 - Incentive Stock Options
 - Non-Qualified Stock Options
- Analogous concept exists in LLCs, but we will stick to discussion of stock options in a corporation.

Incentive vs. Non-Qualified

Incentive:

- The option price must at least equal the fair market value of the stock at the time of grant;
- Generally speaking, the option is not transferable, except at death;
- \$100,000 limit on the aggregate fair market value of stock which may be acquired by any employee during any calendar year. Also not taxable at exercise;
- The options must be exercised within 10 years of grant;
- The options must be exercised within three months of termination of employment (extended to one year for disability, with no time limit in the case of death); and,
- Gain or loss when the stock is later sold is long-term capital gain or loss if held for at least 1 year from exercise and 2 years from grant. Gain or loss is the difference between the amount realized from the sale and the tax basis (i.e., the amount paid on exercise).

Incentive vs. Non-Qualified (cont.)

Non-Qualified:

- May be issued to anybody;
- Taxable at ordinary income upon exercise, and is subject to income and employment tax withholding. No AMT consequences; and,
- The difference between the value of the stock at exercise and the exercise price is taxed to holder as ordinary income.

Advantages to Issuing Stock Options

- Once exercised, the holder has an ownership interest in the company, making him/her invested in the success of the company;
- No holding or other real limitations for non-qualified stock options;
- No cash outlay at any time by the company. Builds loyalty without having to use cash to pay for it; and,
- Any amounts paid to the employee in connection with the exercise of the option are deductible by the company as an expense.

Disadvantages to Issuing Stock Options

- The percentage of the company owned by current shareholders is diluted and, if voting shares are issued, the control of the company by the current shareholders also is diluted;
- Non-qualified stock options have tax payments all the way through for holder – at exercise and sale, but spread on the exercise is deductible to the company;
- The holder may not have the cash to exercise the option and buy the shares or to pay the taxes associated with the purchase. Cashless exercise is an option, but not always practical;
- Possible AMT issues for incentive stock options; and,
- May be difficult to assess the fair market value of each share received for tax purposes.

Phantom Stock

- Phantom stock gives the holder only the economic benefits the holder would enjoy if the holder owned a certain number of shares of the company, without the company actually issuing any shares. Most often given to employees, but can be given to non-employees.
- Holder gets no stock and holds no voting rights.
- Phantom stock generally are structured to vest over time, and can be paid dividends.

Triggering Events for Phantom Stock

Biggest decision is when payment of the phantom stock should be triggered:

- Company Sale
- Holder Performance
- Achievement of Company Goals
- Liquidation
- Retirement
- After XX number of years with the company
- Death/Disability of Holder

Advantages to Phantom Stock

- Any amounts paid to holder are deductible as an ordinary expense by the company;
- No cash outlay by the company until triggering event occurs;
- No voting rights held by phantom stock holders;
- For the holder, if a dividend is paid on the company's stock or a stock split occurs, it can be structured where the employee gets such dividend or stock split on phantom shares; and,
- No initial cash outlay for the employee.

Disadvantages to Phantom Stock

- When the cash is paid on the phantom shares, holder is taxed at ordinary income rate; and,
- Company may not have the cash to pay immediately upon a triggering event (especially if payable upon a holder's death or disability). Can structure a payout over time if needed.

Phantom Stock Example

- In 2009, Company A grants an employee 100 shares of phantom stock valued at the grant date at \$10 per share.
- The phantom stock vests at a rate of 20 shares per year over five years, and the employee's rights in the phantom stock terminate upon the employee's death, retirement, or termination from the company.

Phantom Stock Example (cont.)

In 2012, the employee retires. Employee is vested in 60 shares of phantom stock at the time of retirement. In 2012, the actual stock of Company A is worth \$20 per share, and the employee receives the difference in the grant price versus the 2012 price as follows:

\$20	Company A stock price in 2012
<u>-\$10</u>	Value of Company A stock at 2009 grant date
\$10	
<u>x 60</u>	Number of shares vested in 2012
TOTAL \$600	

Owed to the employee and for which employee pays taxes.

What is Deferred Compensation?

A deferred compensation arrangement is any plan, program, or agreement under which an employer promises to pay an amount to an employee at some future date for the employee's past, present, or future services.

Qualified Plans

A deferred compensation plan is "qualified" if it satisfies the numerous statutory requirements of Internal Revenue Code §401(a):

- Coverage and Discrimination
- Vesting of Benefits
- Funding of Benefits

Qualified Plans – Tax Treatment

- Employee – recognition of income when receive distribution from the plan.
- Employer – deduction allowed when contributions are made to the plan.

Nonqualified Plans – Tax Treatment

- Employee – recognition of income when receive distribution from the plan.
- Employer – deduction allowed when income is recognized by the employee.

Examples of Nonqualified Deferred Compensation Arrangements

- Supplemental Executive Retirement Plans
- Equity Awards
- Employment Agreements
- Bonus Plans
- Change in Control Agreements
- Tax Gross-Up Payments
- Expense Reimbursements
- Phantom Stock Plans

Nonqualified Deferred Compensation Plans

The American Jobs Creation Act of 2004 significantly changed the rules governing nonqualified deferred compensation ("NQDC") plans by adding Section 409A to the Internal Revenue Code.

What are the Requirements?

- Funding Restrictions
- Election Restrictions
- Distribution Restrictions*
- Reporting Requirements
- Written Plan Requirements*

*The two requirements most likely to raise issues

Distribution Restrictions

A NQDC plan that is subject to Section 409A must provide that distributions may be made only upon the occurrence of six specified events:

- Separation from service;
- Disability;
- Death;
- A specified time or pursuant to a fixed schedule;
- A change in control; or
- An unforeseeable emergency.

Written Plan Requirement

- Must be in writing
- Include material terms
- Amount of deferred compensation (or formula to determine amount)
 - Time and form of payment
 - Conditions of deferral elections (if any)
- Must operate in compliance with the written terms and the Section 409A rules.

Exemptions from Section 409A

- Short-term deferrals
- Severance Arrangements

Short-Term Deferrals (2½ month rule)

Exemption for payments made no later than 2½ months after the end of the year in which the right to the payment vests

- Look to provisions of the agreement

Severance Arrangements

A severance arrangement is not subject to Section 409A if the following conditions are met:

- Payments can only be made upon an involuntary separation from service or good reason separation.
- The payments do not exceed twice the lesser of (1) the employee's annual compensation for the year immediately preceding the year of termination; or (2) the Section 401(a)(17) compensation limit (\$260,000 for 2014).
- The payments are made no later than the end of the second calendar year after the year in which the employee terminates employment.

Consequences for Failure to Comply (Harsh Results for the Employee)

- Immediate income inclusion
- 20% Penalty
- Interest

EXAMPLE

- In an effort to retain its CEO, XYZ Company established a supplemental retirement plan. Under the plan, if the CEO remains employed with XYZ until the CEO reaches age 60, the CEO is entitled to receive \$10,000 a month for 60 months upon a disability or separation from service from XYZ. The plan defines the term "disability" as the CEO's inability to perform his duties as CEO due to a physical or mental illness as determined by a physician. On June 15, 2014, the CEO turns 60, retires from XYZ, and begins to collect the monthly payments under the Plan.
- It is discovered later that the plan's definition of disability does not comply with Section 409A.

EXAMPLE (cont.)

- Although the payments were triggered by the CEO's separation from service and not as a result of a disability, the former CEO will be subject to the "triple tax" because of the plan's noncompliant definition of "disability."
- As a result, in 2014 (the year the deferred compensation vests), the former CEO must pay (i) tax on the entire deferred amount of \$600,000 ($\$10,000 \times 60$ months); (ii) an additional excise tax of \$120,000 ($\$600,000 \times 20\%$ penalty); and (iii) interest.

Restrictive Covenants As An Employee Retention Tool

Types of Restrictive Covenants:

1. Covenants Not to Compete
2. Covenants of Non-Solicitation
3. Cost Share Agreements**
(**Not really a restrictive covenant)

Restrictive Covenants As An Employee Retention Tool (cont.)

Are restrictive covenants enforceable?

1. Cannot stop reasonable competition; can only limit unfair competition
2. What do you truly need to protect?
 - Employees
 - Customers
 - Information
3. Tailor restrictions to address protection you truly need
 - Janitor argument

Restrictive Covenants As An Employee Retention Tool (cont.)

Top 3 Takeaways:

1. Verify adequate consideration exists
2. Don't be greedy
3. Carefully craft your restrictions

Restrictive Covenants As An Employee Retention Tool (cont.)

What is a "Cost Share"?

Misclassification of Independent Contractors

News & Observer Series:
"Contract to Cheat"

Misclassification of Independent Contractors (cont.)

- IRS and DOL have identified misclassification as major focus and construction industry as specific target
- Congress continues to push legislation
- Significant risk of liability including payroll taxes and wage-hour violations

Misclassification of Independent Contractors (cont.)

Best practices:

1. Be honest with yourself
2. Do business with entities, not individuals
3. When possible, pay on a project basis (not hourly or salary)
4. Require invoices and pay as a vendor (not through payroll)
5. Do not provide benefits
6. Do not provide tools, uniforms, etc.
7. Require contractor to cover own expenses/overhead
8. Require contractor to be responsible for taxes, wage compliance, etc.
9. Give contractor control over schedule, method of performing work, etc.
10. Enter into formal agreement that confirms all of the above and includes indemnification



John E. Skvarla, III

Secretary

N.C. Department of Environment
and Natural Resources

2014

CONSTRUCTION
CONFERENCE:
FRAMING YOUR
BUSINESS
FOR THE FUTURE



WARD AND SMITH, P.A.
ATTORNEYS AT LAW