

Investing in Your Construction Company: The Pros, Cons, and Possibilities

As the owner of a construction business, you understand the need to invest in your company. You realize that at the very least “you will make a huge investment of both spirit and time,” as one veteran general contractor puts it. You will also plow a substantial amount of the money that your company earns back into it. You must do all of that if you want a company that remains productive and strong enough to weather the ups and downs of the economy.

To begin with, you will invest in your employees. You will make sure they feel respected. Respect, along with autonomy, is at the very top of the list of what employees want at their jobs. You will provide them with every financial benefit that your company can afford, from tool allowances through good wages and profit sharing. Or at least you will do that if you have your wits about you. As I have emphasized in my new book, *Building Freedom, A Construction Pro's Path to Financial Independence*, and will again in an upcoming article, respect and generosity toward employees are acts of enlightened self-interest. If treated well, employees stick around; you don't have to constantly replace them with new people.

Turnover costs you. It may not be visible on a balance sheet or an income statement. But if you have more than a bare minimum of turnover, it's eating away at your company. Advertising for prospective new employees, interviewing them, processing their paperwork, and then training and meshing them with your existing workforce costs time and money.

Along with compensating your employees as well as possible, you will need to provide them with good equipment. Investing in good equipment is part of the respect you want to show to your employees. Wally Staples, a veteran builder in Maine who has created a thriving design/build company, says that whenever he sees equipment that can protect his workers against injury and/or improve their productivity, he buys it. The enhanced safety says to workers, you matter to us; we don't want you to get hurt. The more efficient equipment says we want to support your efforts to be excellent at your craft.

Investment in workers is a must not only at the jobsite but in the office. There, too, you must spend for systems and tools that enhance productivity and safety. All that investment pays off for you and your company as well as each of your employees. It reduces or eliminates workers' compensation claims and the attendant, often severe, rise in insurance costs. And it keeps your company competitive and profitable.

You may or may not find it worthwhile to spend money on marketing beyond doing good work for your clients and relying on their references to bring in new projects. If you try it, just make sure it is returning more than it costs. I once read an article by a popular industry consultant who recommended a marketing program that clearly, as evidenced by their own numbers, would cost more than it returned in company profits!

Finally, as discussed in my earlier article on cash management (“Taking Charge of Your Cash,” Jun/22), you must put company earnings into a working capital account. Just as an individual needs money in the bank for basics when hard times come, a company needs capital in reserve to get through down years for the economy. That's emphatically true for our industry. When the economy slides into recession, construction can experience depression. Construction projects are largely optional, or at least not urgent. They can be postponed. They can be dropped altogether. And during hard times, they often are.

Some construction pros settle on a strategy for putting earnings back into their construction company that, in my experience, appears to often be ill-advised and misguided.

When we move beyond essential expenditures like broad compensation for employees and building up of capital reserves, just how earnings should be put back into a construction company is less clear cut. Some construction pros settle on a strategy that, in my experience, appears to often be ill-advised and misguided: They plow their capital into fancy new trucks rather than maintaining sound, older vehicles, into impressively big shops that largely sit empty or unused. And into unnecessary layers of office staffing and site supervision or handsomely remodeled offices.

What drives those investments? A range of motivations, I

imagine. But definitely in some cases, a dream of “building a brand,” selling the business, harvesting much cash, and riding off into financial freedom. Victoria Downing, the president of Remodelers Advantage, says she regularly hears that dream from new clients who enlist in RA’s educational programs. When she explains what it takes to build a company that can be sold for a significant amount of money, many of her clients shelve the dream.

CHARACTERISTICS OF A SALEABLE COMPANY

Creating a construction company that can be sold for enough money to enable financial freedom is a serious challenge. To understand how a construction company owner interested in selling their company might meet the challenge, I interviewed business brokers as part of my research for *Building Freedom*. They all stressed the importance of selling when times are good, not hesitating in the hope that a boom will continue and your company’s value will rise. They underscored, as well, what a company must not be and called out the characteristics it must have to be saleable.

To begin with, the company must not be “a hub and spoke” operation. The owner can’t be at the center and handling all the critical tasks from marketing through project management. Instead, a competent management team, versed in the use of effective systems, must be responsible for those tasks.

The well-organized management team must serve customers so well that they give the company high marks for performance. The company must be profitable. It must stay clear of debt. It must have clean books—that is, no financial records for submission to the tax authorities, on the one hand, and under-the-table cash flows on the other. Why is that? Because the hidden income cannot be considered when the company is valued, for its existence cannot be proved.

After considering all those requirements, you may think you can meet the challenge. Even so, before deciding that building a brand is the path you want to travel to financial freedom, consider what you might actually get for your company.

The Saleable Construction Company

- Is not a hub-and-spoke company with the owner at the center handling most vital business functions.
- Has a management team that is responsible for all operations from marketing through estimating and project delivery.
- Has efficient systems in place for all office functions including estimating and accounting and for production in the field.
- Enjoys high customer satisfaction ratings.
- Enjoys a strong and recurrent revenue stream.
- Is free of debt.
- Has clean books.
- Has been consistently profitable.

REALITIES OF SELLING

When I inquired of brokers what a typical construction company might go for, they offered a range of factors that can be multiplied by a company’s profit to suggest a market price. As you can see in the sidebar below, the brokers indicated that the sales value of a construction company is between one and four times its average profits—or perhaps somewhat higher for a plumbing or HVAC company. The cases I have seen suggest the midrange multiplier of two to three times profit is realistic.

Multipliers for Determining the Market Value of a Construction Company

From the least optimistic brokers: 1X Profit

From moderately optimistic brokers: 2X to 3X Profit

From highly optimistic brokers: 3X to 4X Profit for remodeling, drywall, or painting companies and 3.5X to 5.5X Profit for HVAC or plumbing companies

*Note: “Profit” here means average profit over the past several years at least. It refers to actual company profit after owners pay for running the company, which is not profit but part of overhead.

If you have spent decades building up a remodeling company, and it is earning \$500K in actual profit (as distinct from owner’s pay), then you might expect to get one million to one and a half million for it. Bear in mind, however, that even if you are fortunate enough to actually sell your company, your take will be reduced by taxes along with legal and other frictional costs of the sale—notably the broker’s commission, typically 10% of the sales price. The broker gets their commission even if you aren’t paid in full. If you do not sell for all cash, and the buyer falters and fails to pay you, the broker will be long gone with their commission.

All in all, the prospects are daunting for reaching financial freedom via sale of your construction business. There are good reasons for that. Typical small construction companies are not worth much. They are too vulnerable to the ups and downs of the economy. They are besieged by competition from newcomers who will underprice and thereby win jobs en route to going out of business. That’s why, when they are sold, it is often to employees—folks not likely to know much about investing.

SELLING TO EMPLOYEES

An owner can sell directly to one employee. They can sell to a group of or even all their employees via the legal arrangement called an Employee Stock Ownership Plan (ESOP).

ESOPs are far too complex to explore fully in this short

article—though in *Building Freedom*, I have sketched the basics and suggested a resource for readers who want to learn more. Ownership of several construction companies in my area has recently been transferred to their employees via an ESOP. During the recent boom period, the companies appeared to be continuing on successfully.

ESOPs, however, are costly, requiring expensive legal services, and they can be risky for an owner. ESOPs may finance the purchase of the company by taking a bank loan. Banks know that construction companies are vulnerable business entities that often collapse. They are not eager to extend a loan secured only by such a business. So they require that the owner's assets serve as collateral. If the ESOP falters and becomes unable to pay off the loan, the bank can take those assets.

Even when no ESOP is involved, a sale to employees can be hazardous for an owner. The founder of one respected company sold it to an employee who had been with him for years. He thought he had the right guy to take over the firm. He agreed to take payment in installments. The new owner soon bankrupted the company, never paying his final installments. In other cases, new owners have realized they were in over their heads trying to run a company. They handed the company, sometimes badly damaged, back to the original owner.

ACHIEVING THE DREAM

For all the challenges and harsh realities, I want to emphasize that the dream of building and successfully selling a company is not an impossible one. Now and again some builder does realize the dream.

There are, in addition to employees, buyers for construction companies. There are buyers from outside our industry who want to break into it. There are buyers interested in growing revenue via acquiring other companies operating in the same or a similar niche. There are existing companies interested in expanding into new areas. For example, the owner of a large cabinet shop in my area acquired a general contracting company that today dwarfs their cabinet operation.

The owner of even a small construction company can list it for sale with a business broker and turn it over to a new owner for cash on the barrelhead. That is what Paul and Nina Winans accomplished. Paul has described their journey in articles for *JLC*. With an eye toward creating a saleable company and then retiring from construction, Paul and Nina developed systems for all aspects of their company's work and trained employees in using them. They methodically upgraded their projects and increased profitability. Ten years after beginning their program of improvements, they engaged a broker who found them a buyer that paid them not in installments but in full at the time of sale.

Accomplishing a sale like the Winans' can take more than

methodical hard work. It can require luck. Paul candidly reports that was the case for himself and Nina. They were fortunate, he notes, to exit the construction industry when they did. They happened to sell at the end of the building boom terminated by the Great Recession of 2008. Not long after their sale, the recession began. Construction companies, including the Winans' after the sale was completed, began winking out of existence. Selling their company during that recession, Paul points out, would have been difficult at best.

A DIFFERENT INVESTMENT STRATEGY

Early in my career, I concluded that investing in a construction company, especially one engaged in the kind of custom work I was doing, was a dubious strategy and a dicey path to financial freedom—which I was hell bent on achieving. I opted for a different path: It did include making the essential investments in my company, especially creating an employee-centered company free of turnover. It incorporated a commitment to doing such good work that satisfied clients constantly referred us to their friends and relieved us of the costs of marketing. And it involved organizing an ultra-lean company with the lowest overhead consistent with our other values.

By working out of a compact office and storage area and honing systems so efficient that only minimal office help was needed, I

drove out-of-pocket overhead below 2% of revenue. I also minimized my owner's pay. Consequently, virtually all markup remained in the company for profit—both for my own use and for distribution to employees. I put my share of that profit into diverse investments outside of the company—largely real estate, stocks, and bonds, though only when they have been available at historically moderate prices and never during bubbles. While those investments, too, have their ups and downs and complications, they do produce more reliable returns than companies operating in the turbulent world of construction. And they require far less management time.

That investment strategy worked. I reached financial freedom at a young age—much faster, I observed, than certain fellow builders who elected to plow earnings back into “building a brand”—and I have strengthened it ever since. Additionally, I enjoyed a benefit not available to people who sell their companies. Because I still own David Gerstel/Builder, if the urge strikes, I can fire it up and take on a project. And I like that, for though financial freedom is delicious, I still love construction.

David Gerstel is a builder and the author of the construction industry best-sellers Running a Successful Construction Company and Nail Your Numbers. This article is adapted from David's newest book, Building Freedom: A Construction Pro's Path to Financial Independence.