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Blueprint

Building Profits for Construction & Real Estate



Eleven ways to help increase company value before a sale

by Pat Hayes, BKD Corporate Finance, phayes@bkd.com

Many contractors and developers neglect to adequately prepare for the sale of their companies, which can cost them a great deal at closing. As with any important decision, preparation is vital in generating the desired result.

If you're considering selling in the next 10 years, the time to prepare is now, long before the sale. Though there are many ways to develop and implement a strategic plan for increasing your company's value, the 11 ways that follow (not listed in order of importance) can help you get started.



Mold a strong management team - If buyers view your involvement as vital to the success of the business, you'll either be forced to stay on after the sale, or the value of your company may be reduced.

Identify key employees and groom them to take over the business when you depart. In the eyes of the buyer, this will lessen the risk of the company being negatively affected by your departure. You should be able to seamlessly exit the company, and a buyer

should feel your departure won't create a leadership void.

Have audited financial statements - In light of recent accounting scandals and increased scrutiny from the introduction of Sarbanes-Oxley and other legislation, having audited financial statements is almost a necessity in a transaction.

On the contrary, *not* having audited statements will increase a potential buyer's due diligence costs, thus decreasing what the buyer may be willing to pay. Not having audited financial statements may also create delays in closing the sale, which can be costly and perhaps fatal to a transaction.

Benchmarking can reveal strengths and weaknesses - Track and analyze your ratio performance in comparison to the industry. Prospective buyers will certainly analyze your company relative to themselves and the industry.

If your company is performing below industry standards, it's imperative to address that issue before going to market. If you take no action, it will likely reduce buyer interest or result in lower-than-expected valuations.

Show sustainable cash flows - Your company's ability to consistently produce a solid bottom line is of the utmost importance. Any fluctuation, whether cyclical or seasonal, can be a deterrent to buyer interest and valuation.

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Captives could give your company more control over insurance destiny

by Dennis Miceli, dmiceli@vgic.com

Ever wonder what an insurance company does with your excess premiums when you don't file any claims? Can your construction company benefit by proactively managing claims and developing loss-control strategies that really work?

If you've ever asked questions like these, learning more about captives and captive insurance could help you find the answers.

What is a captive?

A captive is a wholly owned subsidiary of a noninsurance company, and a captive insur-

ance program can provide ways to help control insurance costs. Its primary role is to insure the risk exposure of its owner and fellow subsidiaries.

For example, a contractor may insure products or completed operations with coverage associated with their operation.

Instead of paying a premium to an insurance company for protection from this risk, the contractor uses his company's own *captive* as a funding mechanism for possible future claims.

There are many different types of captives, all based on giving participants more

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Eleven ways to help increase company value...

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Though the climate of your industry's marketplace is out of your control, there are certain actions you can take to make your company stand out from the crowd:

- ✓ Institute service contracts with major customers
- ✓ Enter negotiated or sole-bidder contracts whenever possible
- ✓ Have a solid backlog of work

These actions can help portray the strength of your company's cash flow.

Invest in the future - With most transactions priced on a multiple of earnings, many company owners believe decreasing certain

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control of their insurance programs, a different concept compared to standard coverage.

Reasons to form a captive

An important reason to investigate forming a captive is if your existing insurance products do not meet your day-to-day business needs, including the insurance risks all businesses encounter. Creating a captive is one way to help meet these needs. Other reasons include:

- ✓ Reducing or stabilizing costs over the long term
- ✓ Gaining more control of your insurance program
- ✓ Favorable tax advantages
- ✓ Gaining investment income generated from premiums

How captives can save premium dollars

A captive lowers overall costs in the long term because the insurance costs are determined by a company's individual underwriting history. The pricing is not based on the underwriting history of a particular class of business or industry.

More specifically, if your company has a superior loss history and solid risk management controls, your premiums will no longer subsidize companies with inferior loss histories and poor risk management programs.

Also, the captive's group purchasing power can help secure more competitive pricing for the captive's fixed costs, *e.g.*, reinsurance, claims administration, loss control services, etc.

Captives can provide more control & financial advantages

Captives allow direct control in underwriting, claims settlements and investment decisions, and captive members play an active role in how claims are adjusted and settled.

The selection of vendors who will manage the captive is controlled by captive members who also collectively decide on reinsurance companies, claims administration firms, investment managers and other such services.

The tax advantages include deductibility of premiums and deferred taxation of insurance income. In addition, captive members enjoy the benefit of investment income generated from unused and unpaid loss dollars. Each captive member has a loss fund. The dollars in this fund earn investment income until a claim is paid.

Unused dollars in a loss fund continue to earn investment income until the captive

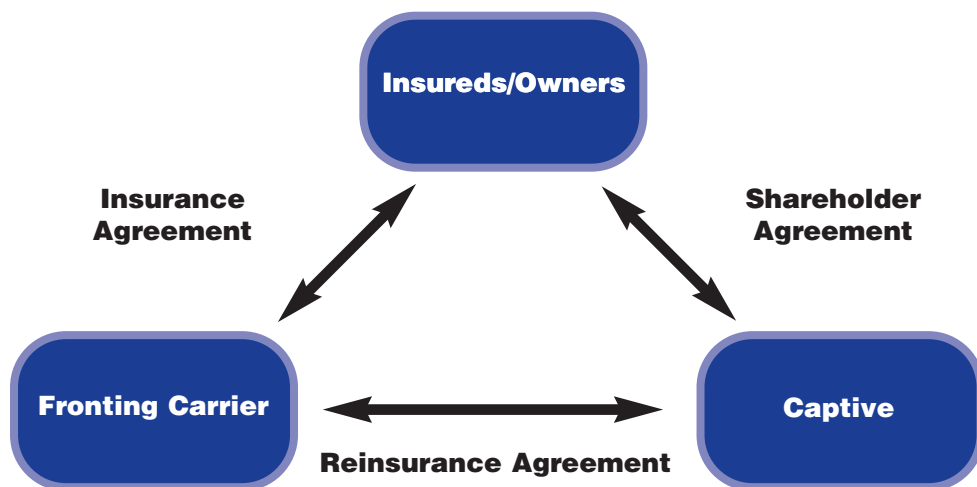
decides to close that particular underwriting year. This investment income accumulates tax free until the captive declares a dividend.

Is a captive right for your company?

Simply put, contractors and construction companies that pay annual premiums of \$250,000 or more for general liability, workers' compensation and automobile liability are potential candidates for captives.

Many ideal candidates for captive programs are innovative risk takers, committed to the long term and willing to actively control risk. If you share these qualities, it may be time to learn more about the captive concept and evaluate its benefits.

Guest columnist **Dennis Miceli** is a senior vice president with Van Gilder Insurance Corporation in Denver, Colorado. ■



expenses before the sale will pay off in a higher purchase price.

However, to defer necessary improvements to your IT systems or equipment can negatively affect value. In addition, appearances *do* matter in a transaction. Dilapidated equipment or facilities in need of maintenance will diminish the overall impression buyers have of your company.

Customer concentration can be significant - Many companies rely on a few significant customers, and buyers may view this as risky.

If diversifying is not possible, written agreements with your key customers can help mitigate the risk a potential buyer might perceive.

If contracts aren't feasible, then find a way to demonstrate how much key customers depend on your company and how their operations would suffer if they had to replace you.

Clean up your balance sheet - Remove items such as:

- ✓ Excess working capital
- ✓ Investment properties, personal vehicles
- ✓ Obsolete inventory
- ✓ Excess property or equipment
- ✓ Loans to shareholders

Cleaning up the balance sheet can reduce confusion and disagreement about which assets and liabilities the transaction will include.

Consider controlled ownership - Buyers prefer to purchase 100% of a company from a small number of like-minded owners; however, in many cases, there may be minority owners who don't share the majority's objectives.

Buying back minority-owner shares well in advance of a sale may ensure a smoother transaction and may increase value. If buying out minority shareholders isn't feasible, then it's important to have their agreement to sell along with the majority owners. You can do this by entering into a stockholders' agreement detailing their rights and expectations.

Think like a buyer - Put yourself in the buyer's shoes and imagine buying your company. What would concern you? Looking in

the mirror can be enlightening.

Many company owners are focused on the day-to-day operations and may not take time to think objectively about their company's

Market conditions can affect the values of closely held companies, so timing has a significant impact.

selling points. Be realistic. Don't turn down a good offer because you think it's too low; the result could be a lifetime of regret.

Time your sale - Market conditions can affect the values of closely held companies, so timing has a significant impact. An underperforming company may sell for more in an up market than a well-performing company may sell for in a down market.

Too many company owners decide to sell based on their age or an unexpected event, rather than the overall business climate. An experienced intermediary can keep you informed about industry and market conditions, including when the time is right to sell.

Form a multidisciplinary team - Choosing the right investment banker is an important decision in enhancing the value of your com-

pany. One with transactional experience can educate and prepare you and your company for every aspect of the sale process.

The investment banker will manage the transaction from start to finish to ensure the process runs smoothly, allowing the owner and other key members of the management team to focus their efforts on managing the business.

Selling a company is a team effort. In addition to an investment banker, members of a solid advisory team include:

- ✓ Certified public accountant
- ✓ Financial advisor
- ✓ Merger and acquisition attorney
- ✓ Estate planner

It's important each team member has the right training and experience, along with a high degree of integrity and professionalism.

Sale of a lifetime: take time to prepare

If you're like many owners, selling your company is a once-in-a-lifetime opportunity. Be fully prepared to sell when the time comes. It can help you receive top dollar for the company you built. ■

Land banking makes sense for homebuilders & land developers

by Chris Kramer, ckramer@bkd.com

When starting a new project, the first step land developers and home builders typically take is to purchase raw, undeveloped land. The next step: improve, subdivide, market or build on the land. Finally, the improved lots are sold. The taxable profit this chain of events yields is usually subject to ordinary income tax rates.

How land banking can help

Gains on the sale or exchange of investment property generally qualify for capital gain treatment, while gains attributable to disposi-

tions of "dealer" property are subject to ordinary income tax rates.

Land banking is the process of separating land development activities from real estate investment activities using multiple, taxable entities, typically limited liability companies (LLC) and S corporations.

A good land banking structure may recast a significant portion of ordinary taxable profit as capital gains.

In the case of individually owned pass-through entities (S corporations and LLCs taxed as partnerships), capital gains are subject to lower tax rates (currently as much as a

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Land banking makes sense. . .

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20% federal rate differential) and may be completely sheltered from taxation if a taxpayer has capital losses or loss carryovers from other activities.

Creating land banking entities

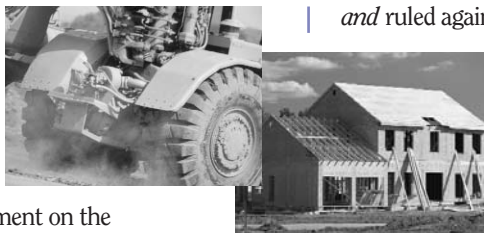
Implementing this strategy requires the formation of a new entity that exclusively engages in investment activities.

This investment entity—or land banking entity—purchases raw land, holds it in an undeveloped state for more than one year, then sells it at its appreciated, fair market

value to the related land development company.

The result is long-term capital gain treatment on the appreciation from the date of purchase to the date development begins.

Taxpayers have long attempted to avoid dealer status, contending they are investing in real estate instead of purchasing inventory for resale. Guidance in this area relies on precedent case law, which, depending on the facts and circumstances, has held in favor of



and ruled against taxpayers. The federal government has acknowledged that real estate developers should be afforded the same capital gain treatment on their bona fide real estate investment activities as

other individual investors.

However, make no mistake: A good set of facts, and the proper structure is a prerequisite to operating a legitimate land banking operation. ■

TIPRA affects Section 199 deduction

by Chip Storey, gstorey@bkd.com

Many construction and real estate firms are eligible for the Internal Revenue Code (IRC) Section 199 domestic production deduction, which is limited to 50% of the W-2 wages paid by the taxpayer.

The *Tax Increase Prevention and Reconciliation Act of 2005* (TIPRA) makes some changes to this limitation, effective for tax years beginning after May 17, 2006.

Under pre-TIPRA law, wages don't have to be allocable to Section 199-eligible production activities: If a taxpayer engaged employees in an activity that qualified for the deduction and in another that did not, the wages of both activities counted for purposes of the 50% of W-2 wage limit.

However, under TIPRA, the W-2 wages

taken into account *must* be allocable to qualifying domestic production activities.

But it's not all bad news

Under pre-TIPRA law, the share of W-2 wages of a partner and an S corporation shareholder were limited to two times the specified percentage of qualifying production activity income allocated to them by the partnership or S corporation for the tax year.

TIPRA repeals this special limitation. Now, each partner or shareholder is treated as having W-2 wages for the tax year that are equal to his/her allocable share of the partnership's or S corporation's W-2 wages for the tax year.

Also note that final regulations about the Section 199 deduction have been issued, and additional Treasury guidance is forthcoming. ■

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