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KEYSTONE EXCAVATING LIMITED: PRESERVING A LEGACY

Pernille Goodbrand, Dr. Sandip Lalli, and Cheryl Brazell wrote this case solely to provide material for class discussion. The authors do not intend to illustrate either effective or ineffective handling of a managerial situation. The authors may have disguised certain names and other identifying information to protect confidentiality.

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It was early September 2016, and Sandip Lalli, president and chief executive officer (CEO) of Keystone Excavating Limited (Keystone), needed a moment alone to gather her thoughts. She went for a walk, as she often did when making critical decisions. Lalli, who had joined the 35-year-old company in June 2015, thought about the company’s history and its current situation.

Keystone had been started by one person, Ed Elias, and one bulldozer. Elias knew dirt, and he loved equipment. He decided his life would revolve around dirt, and so he took the Allis-Chalmers HD-16 bulldozer his father had bought him and taught himself how to use it. Elias started working in Manitoba and then moved to Calgary, Alberta, where he launched Keystone in 1981. His was a classic tale of hard work and ingenuity reaping well-earned rewards. The company grew quickly, soon becoming a leader in the construction industry through its expertise in residential, commercial, infrastructure, industrial, and energy-sector construction. Elias’s family also grew, eventually becoming one with the company, as all three of Elias’s sons joined the firm. But the family-owned business was at a crossroads; revenues had been in double-digit decline for the past five years, and the 2014 recession had hit Keystone particularly hard. The decline occurred surprisingly fast, as investor confidence in Alberta’s economy weakened, and construction projects vanished at the same time current projects were being scaled back.

Lalli was not sure how to tell the Elias family that things were unlikely to improve and that there would be another challenge ahead. After months of careful consideration, she had decided to recommend ceasing operations to the Keystone board, but how could Keystone cease operations while retaining its legacy?

ALBERTA, CANADA

Alberta was one of Canada’s Prairie Provinces. In 2016, Alberta had a population of 4.23 million, with approximately half of its residents residing in two urban centres: Calgary (population 1,237,196) and Edmonton (population 915,997).[[1]](#footnote-1) Alberta’s economy was heavily skewed to the oil and gas sector, which was dependent on the price of West Texas Intermediate (WTI), a grade of crude oil used as a benchmark in oil pricing. The plunge in oil prices in 2014 had resulted in a two-year recession (see Exhibit 1).

The 2014–2016 recession stunted Alberta’s population growth, which—after approaching 3 per cent in 2012 and 2013—fell to 1.7 per cent in 2014 and 1.4 per cent in 2015.[[2]](#footnote-2) The unemployment rates rose from 4.4 per cent in February 2014 to 7.9 per cent in February 2016, with higher rates in the areas with the most oil and gas activity.[[3]](#footnote-3) Calgary, which was home to many oil and gas headquarters, had an unemployment rate of 9.2 per cent, while the Wood Buffalo region, where significant oil extraction took place, was comparable at 9.3 per cent.[[4]](#footnote-4) Despite the recession, median household incomes continued to be higher than the median for the rest of Canada.[[5]](#footnote-5)

Most business investment decisions in the Alberta economy were based on the stability and predictability of WTI. The 2014–2016 decline in the price of oil significantly slowed investments into Alberta. For a province with an economy largely built on the success of one sector, this lack of investment reached far beyond the oil and gas industry, affecting all sectors, including “housing, government and other consumer and business spending.”[[6]](#footnote-6) As revenues and capital expenditures by oil and gas companies fell, oil and gas royalty payments to the provincial government declined.[[7]](#footnote-7) At 6 per cent, 2016 was the lowest year on record for resource revenue shares as a percentage of total revenue—the average was closer to 26 per cent.[[8]](#footnote-8) The lack of both private and government investment in Alberta meant that new infrastructure projects were either cancelled or significantly delayed. The value of building permits decreased from CA$18.2 billion[[9]](#footnote-9) in 2014 to $14.2 billion in 2016,[[10]](#footnote-10) and the real gross domestic product, expenditure based, dropped from $326 billion (in 2007 dollars) to $302 billion in 2016.[[11]](#footnote-11) Despite forecasts predicting economic improvement in 2017, there was an overall sense in Alberta that even with an increase in commodity prices, the price of oil and subsequent investments in the sector would not go back to where they had been.[[12]](#footnote-12)

THE ALBERTA civil earthworks INDUSTRY

Keystone was a part of the Alberta civil earthworks industry, which consisted of foundation and bedrock excavating, backfill of foundation walls, supply and installation of granular material for slab-on-grade foundations, installation of weeping-tile drainage systems, excavation and backfill for mechanical and electrical trenching, and site grading. Keystone’s expertise was in residential, commercial, industrial, infrastructure, and environmental earthworks.

The civil earthworks industry was competitive due to a low barrier to entry; however, the risk involved and the liability of the work were deterrents for some. Most civil earthworks companies in Alberta were either small (one to five employees) or large (over 80 employees); medium-sized companies were rare. The number of equipment pieces per company varied from five to over 100. The scope of the excavation work dictated both the quantity of the equipment and the size of the workforce needed. It was Lalli’s estimate that approximately 96 per cent of the civil earthworks companies in Alberta were privately-held, family-owned businesses.

Customers in the industry were residential home builders, general contractors, environmental companies, and governments at all levels. Work was usually secured through tender—a process that involved an individual or companies bidding on specific work to win a contract. Tendering was typically done four to six months before the job started. This lead time provided the respective teams sufficient time to coordinate with the general contractor, have permits in place, and secure materials and resources.

The most common customer was the general commercial contractor, a company that tendered (or subcontracted) work for the owner of a project. In awarding work to suppliers and trades, price was of the utmost importance. Neither the quality of, nor the experience with the type of civil earthworks that the project required was necessarily a determining factor in the selection process.

Residential home builders and environmental customers also followed the tendering process, but led the selection process themselves. For home builders, the price of civil earthworks was set based on the profit margin that the builder had determined for the sale of the home to a homebuyer. This profit margin was non-negotiable, which was a commonly understood industry fact. For environmental customers, the scope of work had to meet government regulations and standards; the quality of work was the first lens in this tender-selection process.

For government work at any level, there was an open tendering process, which required that each price offered be made public after the contract was awarded. Governments also had standard procurement practices that had to be followed, which could be later audited. The government of Alberta had a standard request for proposal and evaluation criteria that were used.[[13]](#footnote-13) However, in practice, the key criterion for winning government tenders was often having the lowest price.

The complexity of the tendering process and the layers of relationships were often a threat to the sustainable workflow of construction organizations and could effectively limit the ability of companies to scale and innovate. However, once a company secured a contract, the likelihood of winning another bid increased by 76 per cent, according to Keystone’s internal tracking. Often, general contractors preferred to work with the same civil earthworks trade supplier again and again once a relationship had been established.

Success in the tendering process was one indicator of the market share within the civil earthworks industry. The others were the number of development and building permits received. However, these numbers could be misleading, as the developer and project owner could let permits expire if market conditions changed substantially.

KEYSTONE EXCAVATING Limited

Keystone was founded in Calgary, Alberta, in 1981. When Lalli was brought on as president and CEO in 2015, the company had an excavation equipment fleet of over 100 pieces and 89 employees divided between offices in Calgary and Edmonton. Keystone’s employee base and number of equipment pieces exceeded its direct competitors by 10 per cent. In the 35 years Keystone had been in existence, it had completed just under half a billion dollars of work—90 per cent of it in the last 17 years. The size of its fleet allowed Keystone to easily scale, and it had the capacity to take on major projects. Furthermore, high employee retention rates and a sound safety record made Keystone a key candidate to take on complex infrastructure projects and highly sensitive environmental projects. Employees tended to stay with Keystone for seven or more years, and its safety record was proven by high scores (95 per cent or greater), as determined by external auditors.

Keystone’s strategy was defined by two questions (see Exhibit 2): Where do we play, and how do we win? Over the course of its existence, the company had expanded its expertise through involvement in every kind of excavating project; it continuously improved project management and consistently found ways to work smarter. In 2009, Keystone implemented a mobile workforce management solution that allowed the company to gather real-time information on every piece of equipment, including company vehicles and employee time sheets. This automation minimized staffing requirements and reduced needless overtime; it also flagged vehicle and equipment idling to reduce costs and vehicle emissions. Furthermore, the software facilitated more accurate job costing and billing, allowing Keystone to provide comprehensive estimates for even the most complicated jobs.[[14]](#footnote-14) Increasing efficiency was a prerequisite for Keystone’s goal of owning the market in Alberta and British Columbia by expanding from Calgary and Edmonton into small cities in these provinces.

Despite the successes, Lalli also encountered several issues at Keystone. The strategic goals were audacious, and the company had not been proactive in branding or marketing its services. Management overlooked the need to pursue new business development and nurture trade partnerships. They were so focused on growth that they “worked themselves to the bone,” while failing to fully participate in development opportunities such as identifying new markets. Reacting to day-to-day issues also did not allow for adequate mentoring of the next generation of managers; in addition, there was no management succession plan in place. Despite the sheer size of the company, it was risk averse, which left it incredibly vulnerable in a tough economic climate. Perhaps most worrisome for Lalli was that the company board, executives, and senior management struggled to articulate the purpose of the organization: why did the company exist?

FINDING A PURPOSE AND BUILDING A LEGACY

Despite its weaknesses, Lalli believed that Keystone was a sophisticated business; she believed that Keystone had a vision, mission, and corporate culture that rivalled others in the industry. Keystone’s vision was to own the market in commercial and residential dirt management in Western Canada by 2020. Its mission was to increase equipment utilization and standardize practices. The mission and vision were ambitious but failed to mobilize the team, leaving the company lacking direction.

Lalli was hired to turn around the company, and she believed that a turnaround retrenchment strategy could reverse the decline in revenues. Keystone was privately held and founded to create economic value for its shareholders—nothing about this was out of the ordinary. But solely creating economic value had seized to mobilize the team. Lalli knew that times had changed, and she understood that companies were increasingly being held accountable for sustainability and societal impact. Lalli argued that by understanding the legacy the company wanted to leave, the company would find a “why” that was beyond profits, and would be able to articulate a purpose that everyone could get behind—a purpose-driven turnaround strategy.

From June to July of 2015, Lalli and the team worked through determining why the company existed. Understanding the legacy was an iterative process involving multiple stakeholders, including existing customers, potential customers, and Keystone’s staff—both current and former. Nothing was taboo, and Keystone’s executives were challenged by what they heard and shocked by the cynicism of the business environment. The executive team understood what the company’s purpose should, in principle, be: Keystone should operate sustainably and facilitate relationships within and beyond the company’s area of expertise. But the team also recognized that their customers would likely not pay for these value-added practices.

Keystone determined that regardless of whether it was compensated, these goals and values were part of a system of relationships and connectedness. The company knew that it had to take ownership of its role in that system, and so it determined that its purpose was to better the system. If it took care of the system of connectedness, the dollars would take care of themselves. Through consultation with their stakeholders, Keystone’s executives came to the realization that they did not control, and in some cases did not even influence, the system they were part of. This was a crystallizing point. Keystone knew that any purpose it agreed upon meant that it was going to have to take an active, inclusive role.

In August 2015, after painstaking stakeholder engagement, Keystone’s purpose became clear: it had to actively participate in improving the system in which its industry functioned; it had to elevate the social value of the industry. Keystone articulated their purpose as “better[ing] the industry and communities in which we work and live. Our company, our families, our cities, our professions.” It was imperative for Keystone to make everyone’s roles clear by articulating the role they played. A call to action for the company, families, cities, and professions would enable every stakeholder in the system to find themselves in Keystone’s purpose and become more connected.

Keystone executives also knew that they, as leaders, had an obligation to provide clarity for the business outside of a vision, mission, and strategy, and they settled on a motto: Our Life Is Dirt. The team felt it truly captured the attitude and commitment of the company and the people. They needed the outside world to see what excavators did: Keystone took massive machines—thousands of horsepower—and moved the earth, in precise 5-millimetre increments. Everything rested on these excavations, both figuratively and literally. Keystone’s contribution was the first step in any job, and having it done right set up the rest of the project for success. The work could not just be about the lowest bid on a tender; it needed to be about more than that.

REACTING TO AN ECONOMIC DOWNTURN

A key leading indicator for the construction industry was the health of the overall economy—specifically, investment in development and infrastructure. The recession of 2014–2016 was like no recession Keystone had ever experienced, and many factors compounded to create a very difficult operating environment. The drastic decrease in the price of oil, the contraction of investment in the oil and gas sector, and a steadily rising unemployment rate created a negative economic outlook. In addition, the change in provincial and federal governments in 2015 delayed infrastructure spending. These delays caused a ripple effect in the tender cycles, moving project tendering eight to 12 months away from anticipated timing. All of these factors represented a major economic blow to Keystone’s operations, and the executive team and Keystone board were all worried for the company’s future (see Exhibit 3).

The concerns regarding changes in governments at both the provincial and the federal level appeared to be justified. In Alberta, the power changed from the Progressive Conservative Party to the New Democratic Party (NDP), and some of the policies expressed by the NDP were not viewed by businesses as good for business. It was feared that climate change policies including a carbon tax, an increase of the corporate tax rate from 10 per cent to 12 per cent, and increases in the minimum wage would deter investors and businesses from investing in Alberta. The lack of confidence from investors and a lack of in-migration to Alberta affected the demand for new construction projects and created a bleak economic outlook for Keystone.

The recession also compressed the value of heavy construction equipment (also known as “yellow iron”). The value of yellow iron typically held well and was often seen as a source of financing for heavy-equipment companies, including Keystone. When the recession began, other civil earthworks companies started to sell off their equipment. But yellow iron was selling at very low—almost cost—values when the downturn started in 2014 and plunged again in 2015 when oil and gas projects stopped or decreased production. In 2015, equipment auctioneers were so busy that they expanded their sales lots. Most of the equipment was sold to buyers outside of Alberta—primarily, in the United States, the Middle East, and other Canadian provinces.

In 2016, there was still a demand for used equipment outside of Alberta, as the recession had not been as significant in other parts of Canada or in the United States. The unloading of heavy construction equipment left an equipment deficit in Alberta. Keystone, however, still had over 100 pieces. Keystone consulted with Alberta-based professional services companies about the price of yellow iron, its movement, and the available inventory of the construction equipment. It concluded that there was a deficit in inventory that would bring a premium in pricing should the economy bounce back.

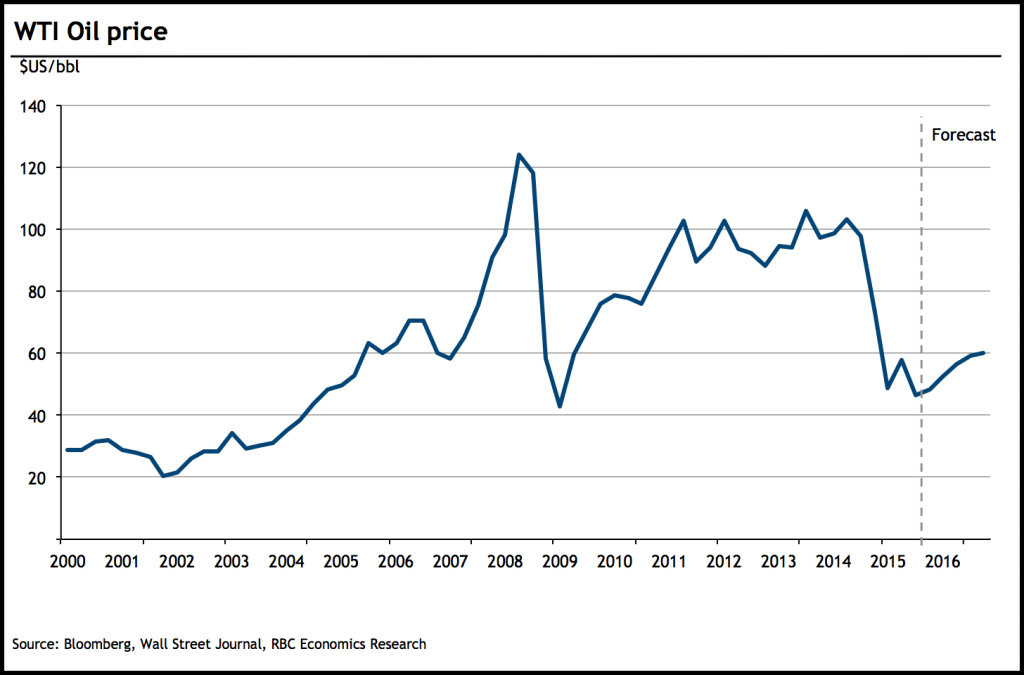
CLINICAL DECISION MAKING

The economy, however, did not seem to be bouncing back. Keystone had not won a new contract from November 2015 to April 2016, and fewer and fewer new tenders were being issued. Other companies were responding to the downturn with various retrenchment strategies and regrouping within their respective businesses. As a result, there were more competitors bidding for less work. The pricing of the work was 28 per cent to 38 per cent below market value. There were even outlier tenders that were completed at 47 per cent below the next highest bid. The margins earned over the period of November 2015 to early 2016 decreased by 32 per cent.

In September 2016, Lalli realized she needed to consider the company’s options. Keystone was already in a deficit for 2016 and looking at an even greater deficit based on the 2017 forecast (see Exhibit 4). The future looked bleak. Lalli considered divesting by closing the Edmonton office and reducing the Calgary office, exiting the residential market (except for two legacy clients), entering the environmental reclamation industry with an additional capital commitment, or placing the entire company in the marketplace as a sale of a business as a going concern. Alternatively, she considered liquidating and proceeding with a sale of assets. Even though Lalli knew that she would be working her way out of a job, she felt that a sale of assets and closure was the correct decision—but how could Lalli cease operations while retaining Keystone’s legacy?

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EXHIBIT 1: West texas intermediate CRUDE OIL PRICES



Note: WTI = West Texas Intermediate; bbl = barrel

Source: Reproduced with permission from Dawn Desjardin, “Canada Needs Oil Prices to Rebound,” in Jason Kirby, “The Most Important Charts for the Canadian Economy in 2016,” *Maclean’s*, December 9, 2015, accessed October 4, 2018, www.macleans.ca/economy/economicanalysis/the-most-important-charts-for-the-canadian-economy-in-2016/.

EXHIBIT 2: KEYSTONE excavating limited—STRATEGY

|  |  |
| --- | --- |
| **Where do we play?** | **How do we win?** |
| Commercial  Infrastructure  Industrial  Institutional  Energy  Remediation and Reclamation  Residential (Single Family, Estate, Acreages) | Innovation  Technology  Safety  Investing in Equipment  Relationships (Expertise/Consultants)  Attention to Detail  Partnerships with Other Trades  Teamwork  Flexibility |

Source: Company documents.

EXHIBIT 3: Keystone excavating Limited—RATIO ANALYSIS, 2014–2016

|  |  |  |  |
| --- | --- | --- | --- |
|  | **2014** | **2015** | **2016** |
| **Liquidity Ratios** |  |  |  |
| Current Ratio | 0.89 | 1.22 | 1.20 |
| Receivables Turnover | 4.08 | 4.62 | 0.30 |
| **Leverage Ratios** |  |  |  |
| Debt to Equity | 0.25 | 0.10 | 0.41 |
| Total Debt to Total Assets | 0.62 | 0.39 | 0.48 |
| Leverage | 2.66 | 1.64 | 1.93 |
| **Profitability Ratios (%)** |  |  |  |
| Gross Operating Margin | 16.61 | 20.64 | 3.12 |
| Gross Operating Margin *Excluding Depreciation* | 22.38 | 25.85 | 17.13 |
| Net Operating Margin | 0.69 | 3.32 | −25.65 |
| Net Operating Margin *Excluding Depreciation* | 6.18 | 8.66 | −10.93 |
| Return on Asset | 2.12 | 20.68 | 6.76 |
| Return on Equity | −1.60 | 8.67 | 4.45 |

Source: Company documents.

EXHIBIT 4: KEYSTONE EXCAVATING Limited—FINANCIAL PROJECTIONS, 2017–2018

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
| **Category** | **Revenue Target**  **(%)** | **Estimate November 30, 2016–YTD (CA$)** | **Estimate 2016 (%)** | **Projected 2017 (US$)** | **Projected 2017 Revenue (%)** | **Projected 2018 Keystone (CA$)** | **Projected 2018 Revenue (%)** |
| Revenue |  | 11,354,276 |  | 14,539,924 |  | 16,060,000 |  |
| Direct Cost | 74 | 10,321,748 | 91 | 10,790,869 | 74 | 11,884,400 | 74 |
| Gross Margin | 26 | 1,032,528 | 9 | 3,749,055 | 26 | 4,175,600 | 26 |
| Administrative Expenses | 10 | 2,812,176 | 25 | 2,588,564 | 18 | 1,525,700 | 10 |
| Earnings before tax | 17 | (1,779,648) | −16 | 1,180,491 | 8 | 2,649,900 | 17 |

Note: Projections in Fall 2016, based on work with valuation companies; YTD = year to date; admin = administrative.

Source: Company documents.

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