

A black and white photograph of two hands shaking in a firm grip, symbolizing agreement or partnership. The hands are wearing suit sleeves.

ESOPs and Contractors: “Building” an Ideal Succession Plan

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Speakers



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Introduction to GBQ's Construction Services Practice

Market Leader

In 2019, GBQ was recognized by the Construction Executive as the #43 construction CPA firm. We serve over 75 construction companies.

Experienced

GBQ has a long history of providing outstanding client service to contractors. Our client list includes general contractors, specialty trade contractors, heavy highway contractors, homebuilders and residential contractors. We have a team dedicated to serving the construction industry, and therefore, we understand challenges and issues of all facets of construction.

Recognized

Our team includes recognized thought leaders in the Construction Industry. We are frequent speakers on construction accounting and financial related topics for various professional organizations (e.g., AICPA, CFMA, The BX, CICPAC, ABC and ASA, etc.) on a local, regional and national basis.

Credentialed

Our professionals have earned a variety of professional designations related to construction financial management and accounting. We hold leadership positions in various construction-related organizations.

Introduction to GBQ's ESOP Advisory Practice

Market Leader

GBQ has a national valuation and ESOP advisory practice. We complete 300+ valuation and 100+ ESOP engagements annually. Since our inception in 2005, we have been involved with 3,000+ valuation engagements and 1,000+ ESOP engagements.

Experienced

Our professionals have dedicated their careers to the valuation and ESOP advisory industries, as well as completed 10,000+ valuations and financial opinions and 2,000+ ESOP engagements during the course of their careers.

Recognized

Our team includes recognized thought leaders in the ESOP industry. We are frequent speakers on valuation and ESOP-related topics for various professional organizations and educational institutions (e.g., ESOP Association, National Center for Employee Ownership, etc.) on a local, regional and national basis.

Credentialed

Our professionals have earned a variety of professional designations related to valuation, finance and accounting. We hold leadership positions in various ESOP-related organizations.

GBQ's ESOP Advisory Services

Pre-ESOP Planning and Evaluation

- Assessment of Alternatives
- ESOP Feasibility Studies
- Preliminary Valuation
- ESOP Transaction Illustrations
- ESOP Consulting

ERISA Compliance

- Annual Valuations
- Trustee Advisory
- ESOP Transactions
- Valuation Report Review

ESOP Formation

- Initial Valuation
- Trustee Representation
- Company Representation
- Transaction Structuring & Financing
- Fairness & Solvency Opinions

Mature ESOP Planning

- ESOP Sustainability Assessments
- Transaction Advisory
- ESOP Terminations
- Fairness Opinions

Challenges of Ownership Transition Planning

And how they are magnified in the Construction Industry

- Over 50% of exits are not voluntary – Death, Divorce, Disability, Disagreement, Distress
- Owners leave money on the table as they are focused on income generation and not enterprise value – income does not automatically translate into value – many are “lifestyle” businesses
- Unreasonable valuation expectations
- Many businesses are not salable or do not make it to the second generation
- Very emotional, difficult to get owners to plan for their exit and create additional value through proper planning and execution

Challenges of Contractor Businesses and Ownership Transitions

Challenge	Explanation	How an ESOP Can Help
Owner(s) concerned about Legacy	<ul style="list-style-type: none"> Legacy matters more to contractors, as the owner may be the founder (and business may even carry his/her family name) 	
Family or management team may not be able to buy out owner(s)	<ul style="list-style-type: none"> Contractors often transition to the “next generation” Next generation may not have the capital to meet owner’s purchase price 	
Customer/referral relationships may not survive external sale (or may prevent external sale)	<ul style="list-style-type: none"> Many contractors have key referral sources/customers; buyers may not be able to talk to these important partners ahead of time Referral sources/customers may send projects elsewhere after transition 	
Owner(s) not willing to market company to competitors	<ul style="list-style-type: none"> Contractors are hesitant to market company to competitors (or let the industry know they are considering selling) It is common for competitors to wait/hope company fails rather than pursue acquisition 	
Growth is limited because profits are bonused out to reduce taxes	<ul style="list-style-type: none"> Desire to minimize tax inhibits ability to re-invest in the business No incentive to grow/increase value of the business Fewer opportunities for younger staff to grow and move up in the organization 	

Agenda

- How ESOPs Work & Unique Benefits of ESOPs
- Contractors & ESOPs
- The ESOP Transaction Process
- Case Studies
- Next Steps



A black and white photograph of a businessman in a suit and tie, holding a magnifying glass over a folder of papers. The image is partially obscured by a green horizontal bar at the bottom.

How ESOPs Work & Unique Benefits of ESOPs



ESOPs: The Big Picture

- Sale of 100% of stock (typically) to employees via the ESOP
- Sellers receive fair market value over time, plus a fair interest rate on their seller financing
- Operational control and management of the company does not change with an ESOP
- Company legacy is preserved; employees and management are protected and jobs are retained
- The ESOP structure can create a 100% income tax-free entity
- Improved ability to attract, reward and retain employees

What is an ESOP?

- ESOP stands for Employee Stock Ownership Plan
- An ESOP is a qualified retirement plan under ERISA
- Selling shareholders sell stock to the ESOP in exchange for cash (typically provided from a bank) and/or notes to the seller
- ESOP shares are allocated to participants over time
- All employees who meet eligibility requirements will receive shares
- Participants cash out ESOP shares for fair market value when they retire

Primary Benefits of ESOP

Financial

- Can create income tax free company (if 100% ESOP owned)
- Tax-deductible financing (including principal)
- Tax savings finance large portion of transaction
- Stock sale (favorable tax treatment)
- Potential for tax-free rollover
- Sellers can participate in ESOP
- Opportunity for additional return through interest, warrants, SARs

Non-Financial

- Unique ownership transition alternative tool that preserves a company's legacy
- Sellers can retain operational control of the business
- Reward, attract, retain and motivate employees
- Flexible; can customize ESOP
- Low "transaction risk"; ESOP transactions almost always close
- Productivity gains are likely
- Tax/cash flow savings can facilitate growth

ESOPs Help Business Owners Achieve Various Goals

<u>Owner Objective</u>	<u>Third Party Sale</u>	<u>MBO</u>	<u>ESOP</u>
Build/Preserve Legacy	??	YES	YES
Assure Financial Security	YES	??	YES
Flexibility/Control Timing of Transaction	??	YES	YES
Maintain Operational Control	NO	??	YES
Build Ownership Culture	??	??	YES
Retain and Reward Employees	??	??	YES
Minimize Taxes	??	??	YES

Key Financial Benefit

S Corporation ESOP Tax Savings

	<u>Non-ESOP Company</u>	<u>ESOP Company</u>
Revenue	\$ 31,500,000	\$ 31,500,000
Operating Expenses	<u>(27,870,000)</u>	<u>(27,870,000)</u>
Pre-Tax Income	3,630,000	3,630,000
<i>Less: Effective Income Tax Burden</i>	<u>(1,270,500)</u>	<u>-</u>
Income Retained in Business	2,359,500	3,630,000
<i>Improvement in Cash Flow</i>	<i>1,270,500</i>	<i>53.8%</i>

Key Financial Benefit

Practical applications of ESOP tax savings

What could annual savings of \$1.3 million do for your business...

Opportunity	Cost	Benefits
Add 5 new senior tradespersons	\$ 500,000	<ul style="list-style-type: none">• Increased revenue potential• Bolster expertise in different specialties/markets
Add large piece of equipment	300,000	<ul style="list-style-type: none">• Improved operating efficiency• Potential for new engagements
Add dedicated HR/recruiting director	100,000	<ul style="list-style-type: none">• Better identify/attract to talent• Free up existing staff for other opportunities
Increased Raise/Bonus Pool for Existing Employees	400,000	<ul style="list-style-type: none">• Improve staff satisfaction/retention• Competitive hiring advantage• Foster an "ownership" culture
Total	\$1,300,000	<ul style="list-style-type: none">• These savings are <u>annual</u>, allowing for increased re-investment in the business over time

Common ESOP Transaction Structures

One-Time Sale of Minority Ownership Interest to ESOP

- Common when there is a desire for some employee ownership, but family or key executives require controlling ownership
- Allows seller to “take chips off the table” and diversify wealth while maintaining voting control of the business

Multiple Transactions to Eventually Achieve 100% ESOP Ownership

- Common with owners that want to gradually exit the business
- Common with owners that want to participate in “upside” of business

Sale of 100% to the ESOP

- More common than ever
- Company immediately benefits from being income-tax free
- Selling shareholders often receive notes as part of their consideration
- Seller notes can be attractive investments for sellers

Parties Involved in an ESOP Transaction

ESOP's Advisors

- ESOP Trustee
- Independent Valuator *
- Trustee's Counsel

Company's Advisors

- ESOP Deal Quarterback / Financial Advisor *
- ESOP Attorney
- Third-Party Administrator
- CPA Firm

**Note: GBQ often serves in one of these two roles*

How Valuations Work in ESOPs

- ERISA prohibits ESOPs from paying more than (or receiving less than) adequate consideration (i.e., fair market value) for company stock
- ESOP transactions are negotiated between the sellers(s) and the ESOP trustee. As the buyer, the trustee (with help from an ESOP valuation firm), ultimately determines how much an ESOP can pay (by determining their opinion of fair market value)
- Selling shareholders will not see the ESOP trustee's valuation analysis, nor will they know the maximum price the ESOP can pay. As such, it is helpful for selling shareholders to have an experienced ESOP financial advisor "on their side"
- The DOL has repeatedly and aggressively challenged prices paid (and other financial terms) in ESOP transactions
- ESOP companies are valued every year. The annual ESOP valuations determine the value of participants' accounts and any payouts

Typical ESOP Characteristics

Participation

- ESOPs are inclusive; generally, everyone participates
- Typical ERISA rules apply (18 years of age, 1,000 hours of service)

Allocation

- Shares may be allocated based on compensation or combination of compensation & tenure
- Plan cannot be “top-heavy” or discriminatory

Vesting

- Can have a maximum of three-year cliff or 6-year graded vesting schedule
- Can give “credit” for service-to-date

Repurchase

- Shares must be purchased on a non-discriminatory basis
- Can defer payments until ESOP loan is repaid and pay out over 5 years

Checklist: Are you a good ESOP candidate?

- ✓ Desire to preserve legacy as independent company
- ✓ Shareholders have interest in company's future success
- ✓ Desire to reward employees with ownership, opportunity and job security
- ✓ Strong management team
- ✓ Strong cash flows and debt capacity
- ✓ Shareholders are willing to accept Fair Market Value
- ✓ Desire to control timing of succession or sell a portion of the company
- ✓ Open-book management style; healthy corporate culture

Deal-Breakers for ESOP Transactions

- X Poor management team
- X Financially struggling / No additional debt capacity
- X Unwilling to provide broad ownership to employees

Abundant Data Shows that ESOPs Outperform

Sources: Various Studies and Surveys on Employee Ownership & ESOPs

78%

of ESOPs report increased revenue last year

Company Performance Before and After ESOP

Measure	Before ESOP	After ESOP	ESOP Advantage
Employment Growth	1.21%	5.05%	4.2x
Sales Growth	1.89%	5.40%	2.9x

Workers with employee ownership had layoffs

6X less often

than those without employee ownership

72% of workers want to work for employee owned companies

Employee turnover can be **3X lower** in ESOP companies

70% of ESOP company employees are heavily involved or somewhat involved in expense reduction initiatives

70%

of ESOPs report increased net profit last year

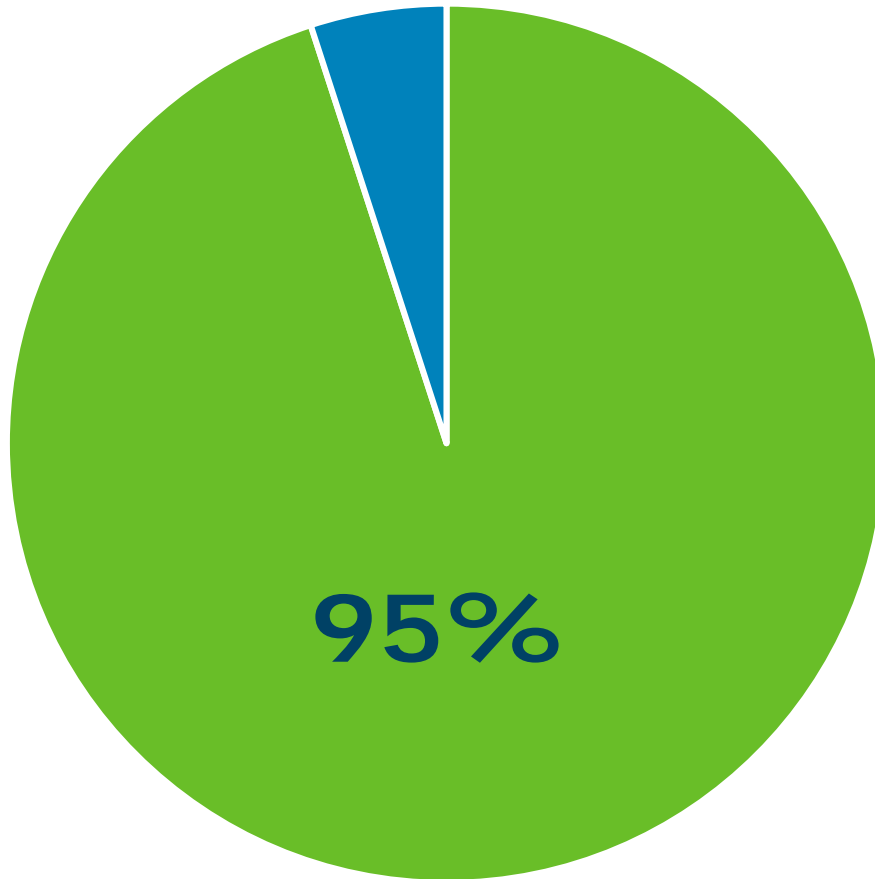
Avg. Retirement Savings: ESOP vs. Non-ESOP Employees

Employee Age	ESOP Employee	Non-ESOP Employee	ESOP Advantage
Under 25	\$ 5,617	\$ 2,740	105%
25-34	\$ 50,722	\$ 12,405	309%
35-44	\$ 179,716	\$ 37,039	385%
45-54	\$ 373,940	\$ 91,054	311%
55-64	\$ 426,098	\$ 142,124	200%
65 and Older	\$ 325,641	\$ 108,363	201%

38% of customers say they are more likely to buy from employee-owned companies

Bottom Line: ESOPs are Usually Successful

Source: Employee Ownership Foundation Annual Performance Survey



95% of ESOP companies report that creating employee ownership through an ESOP “was a good business decision that has helped the company”



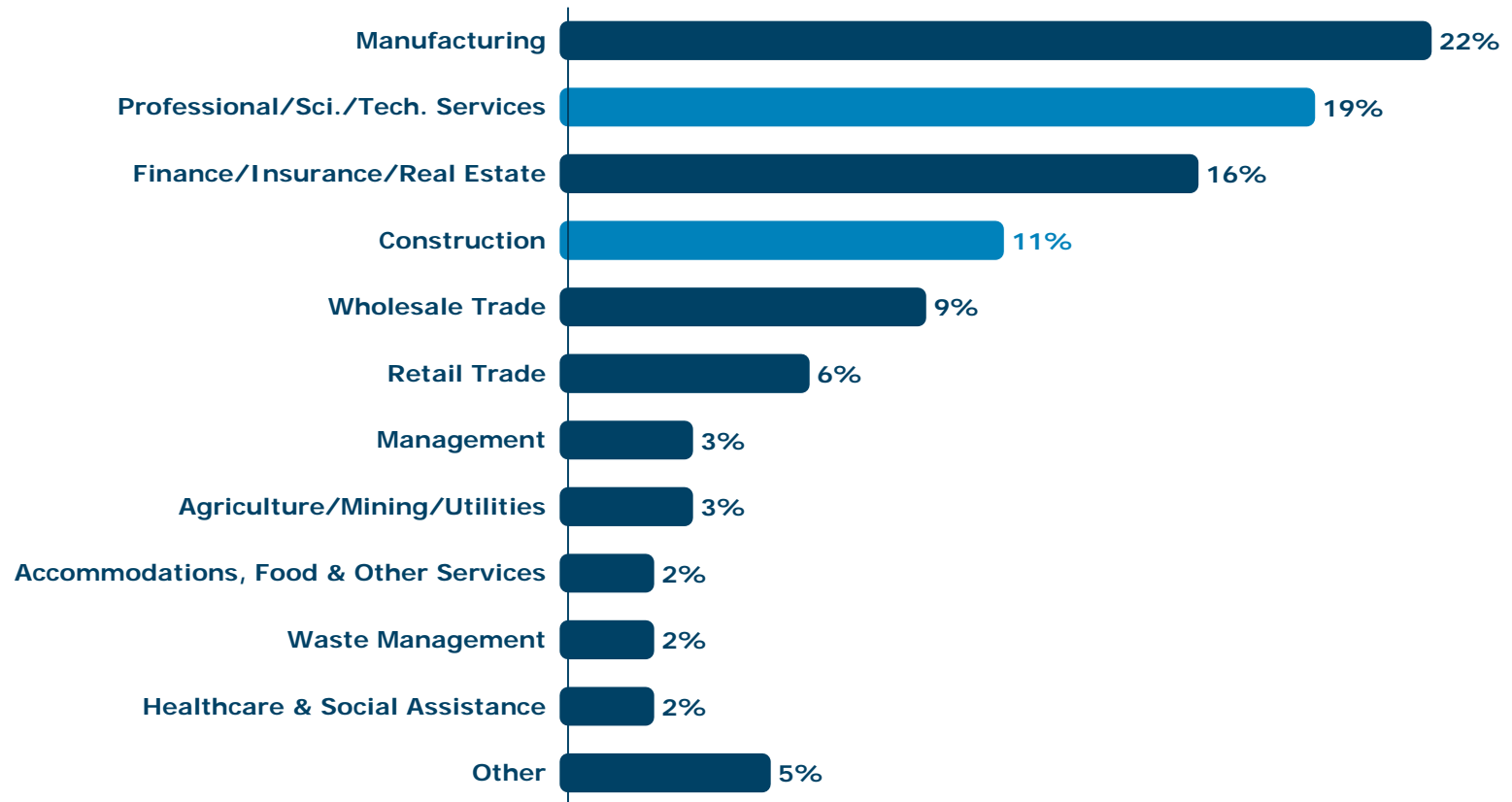
Contractors & ESOPs

Challenges of Contractor Businesses and Ownership Transitions

Challenge	Explanation	How an ESOP Can Help
Owner(s) concerned about Legacy	<ul style="list-style-type: none"> Legacy matters more to contractors, as the owner may be the founder (and business may even carry his/her family name) 	<ul style="list-style-type: none"> ESOP allows the company to remain independent indefinitely
Family or management team may not be able to buy out owner(s)	<ul style="list-style-type: none"> Contractors often transition to the “next generation” Next generation may not have the capital to meet owner’s purchase price 	<ul style="list-style-type: none"> ESOP provides tax savings, allowing for a more efficient ownership succession Next generation can still transition to leadership, receive equity incentives
Customer/referral relationships may not survive external sale (or may prevent external sale)	<ul style="list-style-type: none"> Many contractors have key referral sources/customers; buyers may not be able to talk to these important partners ahead of time Referral sources/customers may send projects elsewhere after transition 	<ul style="list-style-type: none"> ESOP is an “internal sale”, so nothing has to change from the viewpoint of customers or referral sources
Owner(s) not willing to market company to competitors	<ul style="list-style-type: none"> Contractors are hesitant to market company to competitors (or let the industry know they are considering selling) It is common for competitors to wait/hope company fails rather than pursue acquisition 	<ul style="list-style-type: none"> ESOP is an “internal sale”, so confidential financial information is not shared with competitors Competitors often do not know ownership has changed until ESOP is announced ESOP ownership may give company competitive advantage in the future
Growth is limited because profits are bonused out to reduce taxes	<ul style="list-style-type: none"> Desire to minimize tax inhibits ability to re-invest in the business No incentive to grow/increase value of the business Fewer opportunities for younger staff to grow and move up in the organization 	<ul style="list-style-type: none"> With no shareholder/corporate tax liability, company can retain more cash flow to grow business through capital investment, M&A activity and talent acquisition

ESOP Companies, By Industry

ESOP Companies By Industry*



* Source: National Center for Employee Ownership (NCEO)

GBQ's ESOP Client Base, By the Numbers

100 – ESOP Engagements Annually

80 – Ongoing ESOP Clients

30 – Ongoing **A/E/C** ESOP Clients

50% – **A/E/C** in Recent ESOP Formations

GBQ's Recent ESOP Formations - Contractors

Summary of GBQ's Recent ESOP Formations - Contractors

	<u>Lower Quartile</u>	<u>Median</u>	<u>Upper Quartile</u>
Enterprise Value (\$000s)	12,925	16,100	26,600
Revenue (\$000s)	22,250	40,750	76,250
Revenue Multiple	0.31x	0.41x	0.63x
EBITDA Multiple	4.98x	5.49x	6.37x
EBIT Multiple	5.70x	7.08x	8.52x

Contractors – Multiples By Industry Niche

Contractors - Transaction Multiples By Industry Niche (2000-2019)

Industry Niche	SIC#	# Trans.	Median Multiples	
			Revenue	EBITDA
General Contractor - Residential	152	185	0.39x	5.23x
General Contractor - Nonresidential	154	58	0.59x	7.88x
General Contractor - Heavy Construction	161	33	0.75x	6.23x
Plumbing, Heating and Air-Conditioning	171	364	0.40x	4.07x
Painting and Paper Hanging	172	40	0.45x	3.07x
Electrical Work	173	157	0.39x	4.10x
Masonry, Stone Setting, and Other Stone Work	174	44	0.37x	2.82x
Carpentry and Floor Work	175	96	0.36x	3.86x
Roofing, Siding, and Sheet Metal Work	176	79	0.36x	4.16x
Concrete Work	177	69	0.46x	3.40x
Water Well Drilling	178	12	0.99x	7.38x
Miscellaneous Specialty Contractors	179	335	0.49x	3.83x
Overall		1,607	0.43x	4.32x

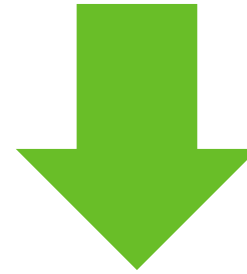
Source: Deal Stats, Mergerstat/BVR Control Premium Study

Contractor Characteristics & Value Impact



Raises Multiple/Value

- Service Diversification
- Higher Growth Rate
- Larger Size



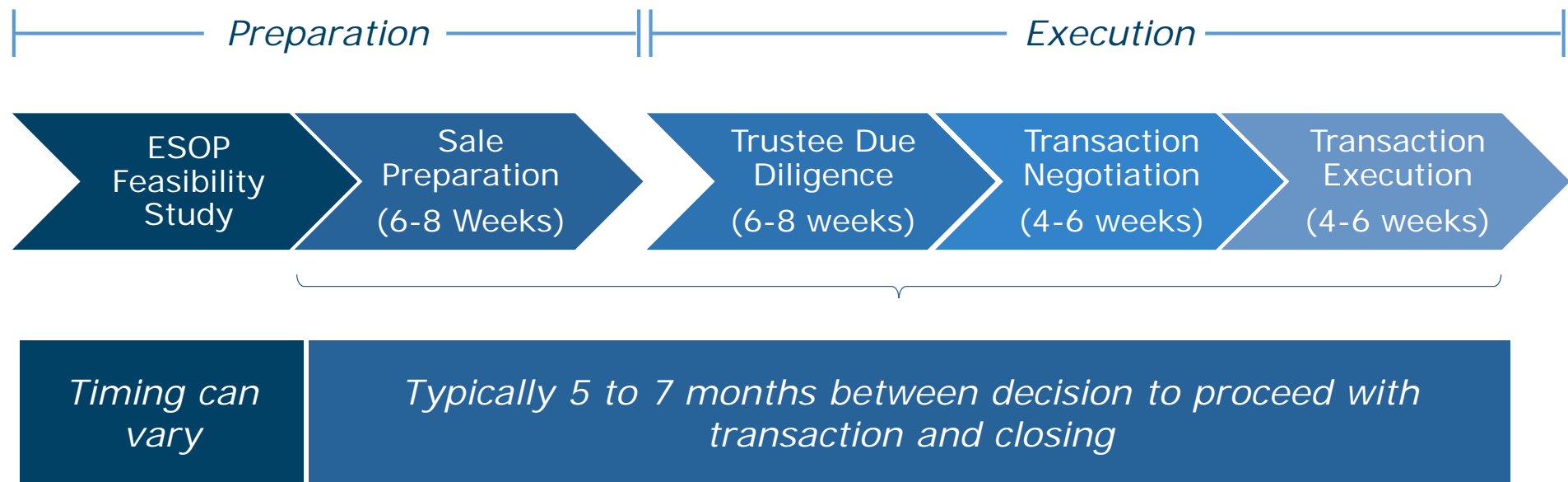
Lowers Multiple/Value

- Construction Dependent
- High % Bid
- Customer Concentration



ESOP Transaction Process

Sample ESOP Transaction Timeline



Sample ESOP Transaction Timeline

ESOP
Feasibility
Study

Sale
Preparation
(6-8 Weeks)

Trustee Due
Diligence
(6-8 weeks)

Transaction
Negotiation
(4-6 weeks)

Transaction
Execution
(4-6 weeks)

- Comprehensive valuation analysis
- Evaluate transaction financing alternatives
- Evaluate synthetic equity or management incentive plans
- Post-transaction cash flow analysis
- Illustration of seller proceeds
- Illustrations of benefit levels to management and employee
- Make decision to proceed

Benefits of GBQ's ESOP Feasibility Studies

- GBQ will conduct a valuation analysis with the same rigor and approach as the ESOP Trustee's valuation firm
- This approach: (a) produces realistic indications of value that a trustee is likely to accept, and (b) maximizes value by identifying and communicating factors that enhance and drive value and mitigate risk
- Solidify and evaluate forward-looking financial forecast
- Offer suggestions/insights on value drivers and how to maximize value (within the context of FMV) in an ESOP transaction
- Quantify impact of various factors on valuation (e.g., comp, SARs)
- Assess if timing is right for an ESOP (from a valuation perspective)

Sample ESOP Transaction Timeline

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Feasibility
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Preparation
(6-8 Weeks)

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Transaction
Execution
(4-6 weeks)

- Draft confidential information memorandum
- Help management finalize financial forecast
- Update valuation analysis
- Design plan features
- Discuss/interview/engage trustee team
- Interview/engage ESOP attorney
- Legal sale prep work
- Draft initial letter of intent

Sample ESOP Transaction Timeline

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Feasibility
Study

Sale
Preparation
(6-8 Weeks)

Trustee Due
Diligence
(6-8 weeks)

Transaction
Negotiation
(4-6 weeks)

Transaction
Execution
(4-6 weeks)

- Deliver confidential information memorandum to trustee team for review
- Trustee team document and information gathering
- On-site due diligence meeting with management and trustee team
- Assist trustee team with responses to their questions

Sample ESOP Transaction Timeline

ESOP
Feasibility
Study

Sale
Preparation
(6-8 Weeks)

Trustee Due
Diligence
(6-8 weeks)

Transaction
Negotiation
(4-6 weeks)

Transaction
Execution
(4-6 weeks)

- Present letter of intent to trustee team
- Negotiate purchase price and other terms of transaction (synthetic equity, MIPs, SARs, etc.)
- Negotiate terms of bank financing
- Agree to transaction terms
- Finalize letter of intent

Sample ESOP Transaction Timeline

ESOP
Feasibility
Study

Sale
Preparation
(6-8 Weeks)

Trustee Due
Diligence
(6-8 weeks)

Transaction
Negotiation
(4-6 weeks)

Transaction
Execution
(4-6 weeks)

- Draft transaction documents
- Execute bank financing
- Draft/execute plan documents
- Close transaction
- Communicate/roll-out ESOP to employees

Case Studies

1. Specialty Contractor Becomes 100% ESOP:

- Attempt to sell company failed due to (a) inability for buyer to talk to key customers, and (b) incompatible cultures with buyer
- Sold to ESOP for comparable net proceeds to third party sale to a strategic buyer (price was lower, but favorable ESOP tax treatment largely offset)
- Management and employees are now owners; company culture is preserved and company continues as an independent enterprise

2. Specialty Contractor Currently Implementing 100% ESOP:

- Had offer to acquire company for \$14.5 million (i.e., 5.5x LTM EBITDA)
- In April 2020, buyer reduced offer to \$7.5 million (due to temporary decline in EBITDA)
- Company is currently pursuing an ESOP; we believe purchase price will be in the \$12-14 million range and will close by 12/31/20

3. General Contractor Sells 49% to ESOP:

- Family business; parents wanted control of business to remain in family, but also diversify wealth and reward employees
- ESOP purchased 49% interest; remaining interest being gifted/sold to next generation

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Takeaways and Next Steps

ESOP Transactions in the Current Environment

- Valuations are currently volatile...
 - Tough to predict future cash flows
 - Market factors (industry growth rates, public company stock prices, interest rates, etc.) are fluctuating
- Difficult to **close** transactions in current environment (but some are still closing)
- Ideal time to begin **planning** for ESOP transaction, especially if targeting close in 2020/2021

Is Your Company in this Situation?

- ✓ Seeking a more sustainable ownership model
- ✓ Desire to reward employees and provide growth opportunities
- ✓ Shareholders want to receive fair market value for the business
- ✓ Wish to preserve the company's legacy

Then it could be time to pursue one of two options...

If you're unfamiliar with the ESOP concept and want to learn more, then contact us for a **complimentary consultation**

If you've done some initial research and found an ESOP may be a viable choice for your business, a logical next step is an **ESOP Feasibility Study**.

Questions?

GBQ ESOP Advisory



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- Management Consulting