

A black and white photograph of two hands shaking in a firm grip, symbolizing a business deal or agreement. The hands are wearing white shirt cuffs and dark suit sleeves.

Engineering a Better Ownership Model: ESOPs in the A&E Industry

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Speakers



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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 and have 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

Common Attributes of A&E Ownership Model and Potential Complications

Characteristic	Potential Complications	How an ESOP Can Address These Potential Complications
Multiple Shareholders With a Buy/Sell Formula (Often Based on a Formula) to Facilitate Ownership Transfers	<ul style="list-style-type: none"> • Formula doesn't reflect market value • Seller may not be motivated to sell if formula undervalues shares • Formulas often "break", which can create unintended swings in value • Effectively operating as an ESOP (broad ownership) without the tax benefits 	
Minimizing Taxes through Bonuses	<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 	
Senior/Outgoing Staff Sell Shares to Younger Employees	<ul style="list-style-type: none"> • May have a mismatch in the timing of available buyers and sellers • Younger staff may not have funds necessary to acquire shares, may need to seek bank financing to acquire shares 	

Agenda

- How ESOPs Work & Unique Benefits of ESOPs
- A&E Firms and ESOPs
- The ESOP Transaction Process
- A&E Case Study
- Next Steps





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?

- An ESOP is an Employee Stock Ownership Plan
- An ESOP is a vehicle, in the form of a qualified ERISA plan, that allows business owners to sell their ownership to their employees, and allows employees to enjoy ownership in the companies where they work
- The 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
- 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

Key Financial Benefit

S Corporation ESOP Tax Savings

	Non-ESOP Company	ESOP Company
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 engineers	\$ 500,000	<ul style="list-style-type: none">• Increased revenue potential• Bolster expertise in different specialties/markets
Add fleet of drones for aerial surveying	300,000	<ul style="list-style-type: none">• Improved operating efficiency• Re-purpose staff into more profitable 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

ESOPs Help Business Owners Achieve Various Goals

<u>Owner Objective</u>	<u>3rd 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

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 six-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 five years

Attributes of a Good Candidate for an ESOP

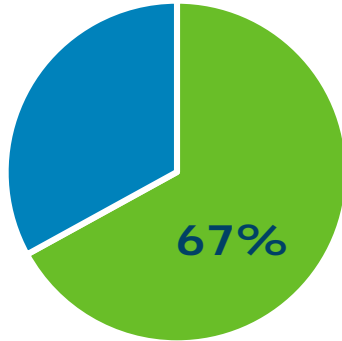
- Desire to preserve legacy as independent company
- Shareholders have interest in company's future success
- Desire to reward employees with ownership, opportunity and job security
- Strong management team
- Strong cash flows and debt capacity
- Shareholders are willing to accept Fair Market Value
-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

The Three Deal-Breakers for ESOP Transactions

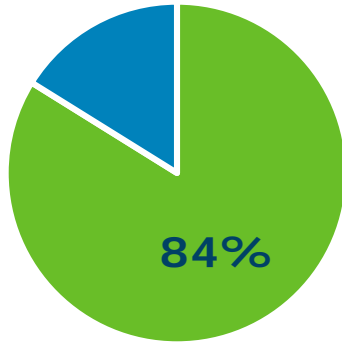
- Poor management team
- Financially struggling / No additional debt capacity
- Unwilling to provide broad ownership to employees

ESOPs are Usually Successful

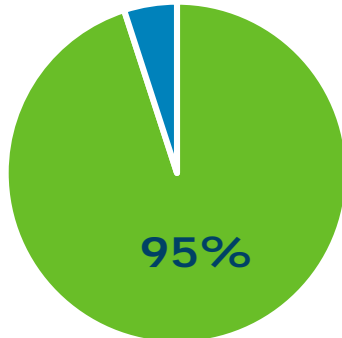
Source: Employee Ownership Foundation Annual Performance Survey



- **67%** of ESOP companies report that their ESOP improved employee productivity



- **84%** of ESOP companies report that their ESOP stock value increased in the past year



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

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



A&E Firms and ESOPs

Attributes of A&E Ownership Model Revisited

Potential Complications and ESOP-Created Solutions

Characteristic	Potential Complications	How an ESOP Can Address These Potential Complications
Multiple Shareholders With a Buy/Sell Formula (Often Based on a Formula) to Facilitate Ownership Transfers	<ul style="list-style-type: none"> • Formula doesn't reflect market value • Seller may not be motivated to sell if formula undervalues shares • Formulas often "break", which can create unintended swings in value • Effectively operating as an ESOP (broad ownership) without the tax benefits 	<ul style="list-style-type: none"> • At initial transaction, current owners receive fair market value for their shares • Shares are valued every year • The Company/ESOP buys shares at fair market value when they leave • Company can take advantage of tax benefits associated with ESOP ownership
Minimizing Taxes through Bonuses	<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 though capital investment, M&A activity, talent acquisition
Senior/Outgoing Staff Sell Shares to Younger Employees	<ul style="list-style-type: none"> • May have a mismatch in the timing of available buyers and sellers • Younger staff may not have funds necessary to acquire shares, may need to seek bank financing to acquire shares 	<ul style="list-style-type: none"> • ESOP creates a perpetual ownership model • Shares are allocated annually • All employees participate in the ESOP • No cost to employees to participate in ESOP

ESOP Companies, By Industry

ESOP Companies By Industry*



* Source: National Center for Employee Ownership (NCEO)

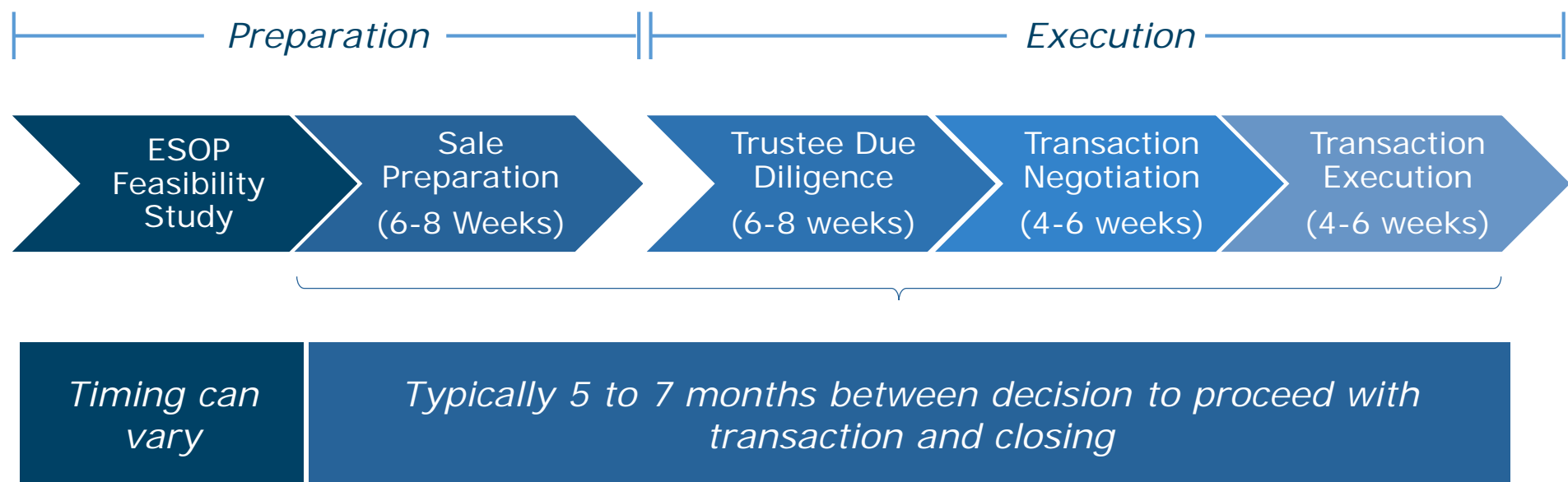
GBQ's ESOP Client Base, By the Numbers

- **100** – ESOP Engagements Annually
- **80** – Ongoing ESOP Clients
- **30** – Ongoing A/E/C ESOP Clients
- **50%** – A/E/C in Recent ESOP Formations




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 & employees
- Comparison to third party sale
- 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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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

ESOP
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



- 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

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Case Study – Arkansas A&E Firm

Client Profile

- Engineering firm with offices in Arkansas & Oklahoma
- 25 shareholders; 200+ employees
- \$30 million in revenue; \$4 million in EBITDA
- Internal formula valued shares (resulted in undervaluation)
- Number of shareholders had to personally borrow to facilitate their buy-in
- Seeking a long-term ownership transition model
- No desire to sell to third party; wanted to preserve legacy, remain independent and reward employees/management

Solution: 100% ESOP Transaction

Solution:

- After GBQ's feasibility study, company decided to proceed with ESOP
- Sold 100% of ownership to newly-formed ESOP for \$22 million (a significant premium over formula price)
- Sellers financed entire transaction

How Company/Shareholders/Employees Benefit:

- Sustainable ownership solution to remain independent
- Shareholders will receive payments (+ market interest) for 10 years
- Company eliminated ~\$3 million of taxable income & will never pay income tax again as a 100% ESOP-owned S corporation
- Key management is thrilled since they can keep running the firm
- Employees have new a benefit (improving employee attraction & retention)



Takeaways and Next Steps

Is Your A&E Firm 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?



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