Liberty Mutual SURETY

Are ESOPs a suitable form of ownership in construction? Understand the risks.

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Proper succession planning has long been of paramount importance to both construction company owners and their sureties. With the aging ownership population in this industry, solving for this risk while keeping in mind the best interests of all parties is an ever-increasing challenge. The lack of proper succession planning and the improper execution of succession plans have historically proven to be risk factors that lead to contractor difficulties and, often, to failure. If executed correctly, however, employee stock ownership plans (ESOPs) can be a viable vehicle to facilitate ownership transfer and perpetuate a company.

This paper outlines characteristics of this ownership structure and identifies considerations to factor into a surety underwriter's decision-making. The information within should not be construed as all-encompassing on the topic, because this ownership structure is far too complex to cover comprehensively in a single white paper. The focus will be on privately held construction companies that are either ESOP-owned or pursuing an ESOP ownership structure.

Basic ESOP Description

- At its core, an ESOP is a means for owners to sell their company to an ESOP trust and to engage employees by providing them with a share of ownership. Because an ESOP invests its assets in the stock of the sponsoring company, the success of the plan relies on the success of the sponsoring company.
- An ESOP retirement plan is designed to provide retiring shareholders with a way to get their investment out of the company while providing remaining employees with an ownership interest in the company by investing in the company's stock.
- Like 401(k)s and profit-sharing plans, ESOPs are tax-qualified retirement plans under ERISA that must invest in company stock.
- When an ESOP is established, the company establishes a *trust* that operates under the direction of a *trustee*. The trustee becomes the shareholder of record for the company and is appointed by the company's board of directors. The trustee can be an officer or employee of the company, a member of the administration committee, or an independent bank or trust company. Responsibilities of the trustee include obtaining appropriate valuation of company stock, protecting the interests of plan participants, and approving the purchase and sale of company stock.
- ESOP trusts are funded with tax-deductible contributions by the employer, which can be in the form of either actual company stock or cash that is then used to buy company stock.
- A *plan administrator* is the primary responsible party for the plan administration. Unless the board appoints an individual or committee as the plan administrator, the board assumes that power.
- The ESOP trust can enable the seller to retain control of the business as long as is desired.

- The basics of *leveraged* and *non-leveraged* options are discussed later in this paper. In a leveraged transaction, the company borrows funds to buy new or existing shares, and the company makes cash contributions to the plan to enable the ESOP to pay down the loan.
- Contributions to the ESOP are the principal and interest used to retire the debt. The contributions are tax-deductible and save the company up to 40% in taxes that would otherwise be due.
- The seller must sell at least 30% of owned shares to the ESOP to receive a tax deferral on capital gains.
- Shares in the trust are allocated to individual employee retirement accounts and grow on a tax-free basis until retirement.
- Vesting of participants generally must occur in compliance with one of two minimum vesting schedules: 1) "cliff" vesting—no vesting in early years, followed by 100% vesting after no more than five years; or 2) "graded" vesting—20% vesting after three years, followed by 20% more each year until 100% is reached after no more than seven years.
- Generally, all full-time employees of a company participate in an ESOP so that management cannot pick and choose who will receive the shares.
- A qualified independent appraiser establishes the fair market value of the company upon the establishment of the ESOP. The value of the company's shares is then appraised annually.
- ESOPs were opened to S corporation ownership in 1996, and it is estimated that 70%–80% of ESOPs have moved to S corporation ownership.

Underwriting Considerations and Questions

<u>Existing or potential new accounts considering an ESOP</u>

From a theoretical vantage point, ESOPs sound like an exceptional ownership option, but the practical application can prove far different. To determine whether an ESOP is truly part of a viable succession plan for an existing or potential new account, a surety underwriter should consider several factors, which may include the following:

- Because ESOPs are highly regulated and financially complex legal entities, any contractor considering the ESOP route should involve an experienced consulting firm to help determine whether the company is a good candidate. Consulting firms are not created equal in terms of value provided, and an underwriter should consider this when doing an evaluation and should approach the job with the appropriate level of professional skepticism.

  Keep in mind that ESOP consultants have a vested interest in selling the deal and in remaining involved for the potentially lucrative annual administration of the ESOP.

- As with any form of continuity succession planning, timing of a surety's involvement with this process is also critical. It is important to bring the Surety in early to allow the opportunity to ask key questions and help identify potential impacts on surety credit.
- Consider whether the company is well established and has historically strong financials, including:

  - Substantial net worth, working capital, and liquidity. Accounting standards require that related debt be recorded as a liability and a like amount deducted from equity. Therefore, it may be advisable to hold ESOP companies to higher equity and liquidity ratios because of unique characteristics that are not present in owner-operated construction firms.
  - A history of profitability and a reasonable expectation of continued profitability.
  - Little to no long-term debt.
  - A strong cash flow. Under an ESOP purchase agreement, the company is literally buying itself with future cash flows, so adequate future cash flow is of paramount importance. Therefore, cash flow forecasting is highly recommended. Forecast assumptions should be scrutinized for reasonableness and evaluated against historical data. Projections provided by outside consultants have proven to be optimistic, so it is important to do our own analysis.
- Company Valuation
  - Stock valuation should be done by a reputable independent firm. This is key, as the valuation should not be unrealistically high based on the estimated future performance of the company.
  - Is the valuation considered conservative; realistic, or aggressive? Frequently a consultant will secure different valuations based on various revenue and profit margin assumptions. Given the volatility of a construction company's results we would like to see a more conservation valuation utilized when determining the sales price.
  - What assumptions went into this valuation? The components and expectations applied to arrive at a valuation should be understood, including when in the economic cycle valuation occurs.
  - Were we presented with pro-forma financial statements? Oftentimes, ten years of forecasted financials are provided including a balance sheet, income statement, and cash flow forecast.
- How will the ESOP be financed?
  - <u>Leveraged plan</u>: The company borrows money, either from a bank or from the selling shareholders, to purchase shares of the company's stock.
    - If the ESOP is financed by a bank, the company borrows enough money to cover the amount of stock to be sold to the ESOP, then re-loans money to the ESOP. The ESOP then pays the shareholders/owners and receives the stock, and the shareholders/owners exit/retire with the cash value of the stock. This "cash-out" can be done all at once or in phases over time. The company then makes contributions (from its earnings) to the ESOP trust, and the ESOP returns money to the company so it can cover its debt service to the lender(s).
    - If the ESOP is financed by the selling shareholders, the mechanism works much the same as above, except the note is held by the selling shareholders and is usually paid back over several years to prevent the company balance sheet from taking the full hit of a cash-out all at once.
    - Typically, we see leveraged ESOP conversions with 100% selling stockholder debt vs. bank financing. This is a key variable as selling shareholders are often willing to be flexible with repayment terms (if needed) and interest rates. Banks offer no flexibility, and we are forced to allow the full bank debt amount as a liability.

        - If it's a leveraged plan, sureties generally prefer that the selling shareholders hold the note so that a bank does not have control.
        - On most occasions, shareholder note(s) can be subordinated to the surety and therefore be counted as soft equity.
    - Non-leveraged plan: Instead of borrowing money, the ESOP is generally funded in one of two different ways:
        - The company contributes shares of its stock.
        - The company makes cash contributions, which are used to buy stock from the company or the selling shareholders.

      Sureties generally prefer the non-leveraged method because establishing a leveraged plan may negatively impact the company's net worth, working capital, and debt-to-equity ratios, thereby reducing the company's ability to pursue bonded work.
    - Regardless of the method used to finance the ESOP, it is important to know the financing composition and terms, including the proposed payment and debt structure and the components of consideration to the selling shareholders.
- Legal interpretation of the ESOP documents and CPA consultation on a correct financial analysis are a must. It is especially important to consider:
    - The balance sheet impact of the transaction.
    - The company's and the ESOP's ability to meet share-repurchase obligations to ESOP participants/shareholders. Most ESOPs own the stock of privately owned firms, and as a result, no public market exists for sale of the company stock. Because of this limitation, ESOP provisions require the trust to purchase *vested* shares upon retirement, death, disability, or termination (under certain circumstances) of the participants. The degree and timing of the repurchase obligations of vested shares demand detailed cash-flow and overall organizational-impact forecasting. Age diversification will lessen the financial strain and risk associated with repurchase obligations.
    - Upon leaving the company, the employee owners have the right to request payment of their retirement assets or a rollover into a qualified retirement plan.
- Will the ESOP transfer occur in phases? Instead of a full 100% ESOP transition, starting with 30% or 60% reduces risk and allows for other potential advantages. What percentage of equity will the ESOP comprise, and over what time period will that amount of stock be redeemed or paid for? Some benefits of a partially owned ESOP and phasing of ownership transfer include:
    - Enables the seller to sell additional shares later at a potentially higher value.
    - May be beneficial to the surety, as it promotes continued vested interest of the seller(s).
    - Enables selling shareholders to play a role in the ongoing plan administration.

- Will the company be able to maintain a strong culture, leadership, and management team?
    - Are the sellers and/or the current management team remaining involved and in control of the company, at least while the management transition occurs? Make sure there's no disconnect between old and new management regarding ESOP ownership. Ideally any new executive leadership will have been actively involved with the ESOP from the beginning of the process. Maintaining the highest level of transparency and including the employee owners in the process promotes the best engagement and alignment.
    - Is there a solid management team to take the company forward after the departure of the selling owners?
    - Who controls the key business relationships—the selling shareholders?
    - Has the company culture promoted strong leadership and ambition to succeed among its employees? Do the remaining employees value the opportunity to become owners? The importance of strong leadership to the success of an ESOP cannot be overstated. Good stewardship leads to high employee-owner engagement, motivation, productivity, and ultimately, profitability. Just as strong leadership guidance can drive success, weak and/or misaligned leadership can have dire implications for these ownership structures.
- Does the company have a relatively large employee base with adequate talent and age diversity to maintain continuity for the ongoing entity?
- Make sure you know the costs. The costs to complete the transaction and the ongoing administrative fees can be expensive, particularly for smaller companies.
- Know whether the sellers offer some level of personal indemnity.
- Surety underwriters' relationship with and depth of organizational knowledge of their ESOP-owned (or potentially ESOP-owned) contractor partners should be at least as strong as, and preferably stronger than, those that exist for the rest of their book.
    - Stay abreast of changes in organizational control and the related impacts. Trust your instincts, and do not wait too long to respond to changes in the risk dynamics.
    - Constantly gauge the level of employee-owner engagement.

<u>Potential new accounts currently owned by an ESOP</u>

Since the construction industry is cyclical in nature, construction companies generally have cyclical business activity. They also operate in highly competitive markets. Therefore, there may be challenges in generating enough earnings to pay down the debt associated with an ESOP year after year. To determine whether to extend surety credit to a potential new account that is currently owned by an ESOP, a surety underwriter needs to first gain an understanding of all the above factors that pertain to how this particular ESOP was established. Then, particular attention should be paid to the following factors:

- How long the ESOP has been in existence.
- Whether the sellers of the company are still employed by the company.
- Whether there has been a smooth transition to the new management team.
- How successful the company has been at servicing the debt and repurchasing the shares related to the ESOP. How strong are company financials, and how have they trended since inception of the ESOP? This information should include:

    - Net worth, working capital, and liquidity
    - History of profitability and expectation of continued profitability
    - Amount of long-term debt
    - Strength of cash flow
- Age diversity of the employee group (e.g., whether a large number are retiring soon).
    - How large are near-term repurchase obligations?
    - Can these near-term obligations be covered with near-term projected earnings?
- Whether the required annual valuation of company stock has shown any significant fluctuations.
    - Consider the impact on the morale of the employee owners when the stock of the firm decreases in value. Not only their jobs but also their retirement savings are at risk.

<u>Among the documents a surety should review are the following:</u>

- ESOP plan document
- Pro-forma financial statements, including the appearance of the balance sheet directly following ESOP inception and multiyear projections for the balance sheet, P&L, and cash flow
- Trust agreement
- Bank loan documents and covenants (if applicable)
- ESOP/shareholder promissory notes (if applicable)
- Shareholder Redemption Agreement and authorizing Corporate Resolution
- ESOP Stock Pledge Agreement
- ESOP Stock Purchase Agreement
- Shareholder employment agreements (if applicable)

Some Advantages of an ESOP

- Allows the owner of a closely held business to sell interest by creating a market for company shares that might not otherwise exist.
- Creates the incentive of ownership for remaining (non-seller) employees.
- Provides remaining (non-seller) employees with retirement benefits.
- Offers tax benefits for the seller.
    - Sellers can sell shares to the ESOP and defer recognized capital gains taxes contingent on the funds being reinvested in qualified asset classes.
- Offers tax benefits for ESOP shareholders.
    - The company's contributions to the ESOP are tax-deductible for S corporations, and S corporation income attributable to ESOP shareholders' shares is not subject to federal income tax or, in most cases, to state income tax. This can provide a huge benefit over non-ESOP-owned firms (as much as 40%), as these funds can be used to improve cash flow and shareholder value.
    - Tax-advantaged retirement.
- Offers tax benefits for both sellers and ESOP shareholders.
    - The company can realize a significant tax benefit in the form of tax deductions flowing from contributions to an ESOP, which in turn can be used to fund debt payments resulting from the ESOP's acquisition of ESOP shares with before-tax dollars.

  - The substantial tax savings by virtue of these tax deductions will also serve to build company share value and company liquidity, with cash flow that would flow directly to tax obligations in non-ESOP-owned firms.

Some Disadvantages of an ESOP

- ESOPs do not guarantee benefits, and they put plan assets at greater risk than the typical diversified ERISA-regulated plan because they generally invest solely in the company's stock.
- For private companies, the stock is not readily traded, and there can be significant fiduciary issues in valuing shares.
- Costs of ongoing plan administration can be high and even burdensome for smaller companies.
- The surety may not be able to obtain personal indemnity of the ESOP shareholders or of the ESOP itself.
- Bonding capacity could be reduced after the conversion to an ESOP.
- ESOPs are not well suited for companies with a history of volatile earnings.
- Employee-owner morale can be impacted by a company's poor performance. Both their employment and their retirement savings are potentially affected.
- Selling ESOP-owned firms is challenging because of the breadth of the ownership structure and the many regulations that govern such sales.
- Significant obstacles exist if the company requires additional capital or financing.
- Downsizing will cause repurchase obligations.
- ESOP trustees have fiduciary liability, which involves challenging obligations.
- Private owners who ask to review a contractor's financial statement as a prequalification measure may look unfavorably on the balance sheet of a leveraged ESOP-owned firm.

Characteristics of Companies for Which ESOPs Tend to Work More Effectively

- Financially successful track record, with reasonably predictable profitability and cash flow. This track record will help service the acquisition-related debt and secure support of potential lenders.
- Adequate capitalization in place to sustain future company growth.
- Little to no permanent debt.
- Reasonably large and diversified revenue base.
- Balance sheet with sufficient collateral to support additional bank financing.
- Not particularly prone to changes in the business cycle.
- Highly strategic in its business model, with a high level of sophistication.
- Solid management team to carry organization forward after the departure of selling owner(s).
- As identified earlier, the importance of strong leadership and a cohesive culture for business success cannot be emphasized enough.
- A management team that is actively involved in the ESOP planning.
- A relatively large employee group that is also age diverse.
- Employees who value the opportunity to become owners.
- An owner willing to accept less than a strategic sale value.

- An interest in good stewardship of the selling shareholders toward the organization.
- Close alignment of seller and employee-owner interests (where the company is not 100% ESOP-owned).
- Highly structured, with clear communication throughout the ranks. This leadership philosophy promotes employee engagement and empowerment.

If too many of these attributes are not present, an ESOP succession plan can be challenging. Many companies in the construction industry are highly susceptible to its cyclical nature and thus may face more challenges than companies in other industries that have a greater degree of stability and diversification in revenue streams.

Summary

Since ESOPs became available under ERISA of 1974, they have proven to be an important succession tool for a lot of industries. Does that make them the best succession vehicle for construction contractors? This paper is not intended to make that ultimate judgment. Rather, it is intended to provide a brief description of ESOP characteristics and to identify some considerations when underwriting ongoing bonding support of a firm that is considering this avenue of ownership succession, or when considering bonding an existing ESOP-owned construction firm.

Construction firms thrive on leadership, culture, focus, and discipline. Perhaps the most important component of an ESOP's success is the quality of the firm's leadership and employee-owner alignment with that leadership. Any change in this area needs to be addressed promptly with the appropriate adjustment to underwriting direction. Underwriting judgment is largely subjective and ambiguous, and as such requires constant assessment and close contact with contractor partners to assess the evolution of an ESOP-owned construction firm. Any sense of adverse post-ESOP cultural shifts should be addressed immediately, with clear action plans initiated early.

Given the highly complex and technical nature of this ownership structure it is advisable to seek specialist and/or legal consultation to interpret the numerous documents and assumptions.

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