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ESOPs: A Hotly Trending Strategy for Construction Companies

By Patrice Radogna and Kenneth J. Pia Jr. | Monday, September 30, 2019

For owner-operators of multi-generational, family-owned construction firms, remaining at the helm indefinitely is not a realistic option. An exit strategy is imperative to prepare for the continued success of the company before handing the reins to someone else—no matter how qualified or promising that person may be.

Thoughtfully consider these key factors for a successful retirement strategy and exit plan:

- options to sell (or gift) the company either to the next generation or to key employees;
- possible sale to an outside buyer who has the financial strength and expertise to profitably run the business;
- retention of key employees who are not family members;
- a "legacy" for the future of the company and its employees; and
- the criteria required by the surety company, protecting the construction firm's bonding capacity.

An employee stock ownership plan (ESOP) is often a viable solution that addresses these concerns (and others) during the complex process of transitioning construction firm ownership.

ESOP AS AN ATTRACTIVE EXIT OPTION

The "typical" options for company owners preparing to exit, such as sale to a third party or sale to a private equity, are frequently not a good fit for construction companies. Historically, construction companies have not been great take-over candidates for a strategic sale. This is due to several factors, including:

- cultural mismatch between the buying and selling firms;
- lack of recurring cash flows, resulting in low multiples;
- lack of new contracts to assure the retention of key employees and critical clients post-acquisition;
- a low barrier to entry for a construction company seeking to enter a new location; and
- the exiting owner's fear that an acquiring company will tarnish the hard-won legacy of the newly sold firm.

Private equity firms also face significant challenges when buying construction companies. Notwithstanding the above concerns, they may face an additional lack of management expertise in running a construction company and the inability to project a clear return on investment.

ADVANTAGES OF AN ESOP

An ESOP utilizes the resources of the company's balance sheet to fund either a partial or full buyout from the exiting shareholder(s). It is initiated when a trust is formed to hold stock for the benefit of employees. An owner may gain the desired liquidity from a "ready market" (the ESOP) that, through certain financing alternatives, can back its purchase of stock. Furthermore, the legacy of the firm can stay with the people who have created it.

An ESOP also provides a structure allowing for an owner to step back based on a controlled timeframe, should the owners desire to sell less than 100% of the business. This, therefore, means that instead of divesting right away, a proprietor can continue as part of the operation and assure that the company continues to operate with current, trusted personnel and protocol.

Plus, an ESOP provides significant tax breaks to the company, resulting in increased cash flows. As a sanctioned retirement plan, an ESOP is technically a tax-free trust. For S corporations, the pre-tax income of the company, attributed to the shares owned by the trust, serves as non-taxable income. At its maximum benefit, an ESOP trust that owns 100% of the company stock pays no federal income taxes.

For those companies wherein the ESOP does not hold 100% of the stock of the S corporation, there is a tax benefit related to ESOP leverage instead. With an ESOP in place, both principal and interest debt payments (related to an ESOP loan) are tax deductible.

A controlling shareholder of a construction firm has worked a lifetime to build a company that is often the most significant asset in his or her investment portfolio. Traditional exit strategies are, generally, not the best fit due to the owner's desire to leave a positive legacy and a desire to reward loyal employees with a secure future. Plus, owners may lack a qualified buyer with the desire and/or financial means to acquire the company.

The construction industry's intertwined culture of pride and longevity creates an ideal environment for employee ownership.

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