ESOPs as an Alternative Buyer for Construction Companies

An inside look at employee stock ownership plans & their advantages in a high interest rate environment

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In an economic environment defined by ever-increasing interest rates, traditional market debt financing doesn't provide liquidity to corporations as it did in the past.

Particular to the construction industry, interest rate hikes make construction projects more expensive due to the increase in material costs, which can delay or cancel projects, or place pressure on general contractors' or subcontractors' margins.

In addition, according to a Bloomberg article published at the tail end of 2022, dealmaking dropped by approximately one-third compared to 2021, buyout volumes fell faster with each passing month, and even the dulcet tones of the opening bell lost some luster, with the fewest initial public offerings on record since 2009.

Additionally, based on industry research from PwC, also known as PricewaterhouseCoopers, the merger and acquisition market in the Americas saw deal volumes and values decline by 17% and 40% between 2021 and 2022, with a decline in deal volume and values each quarter since the start of 2021.

On a more hopeful note, Bloomberg's piece highlighted the increasing creativity of the deals that are closing, specifically the increase in equity financing, agreements that take the leverage out of leveraged buyouts and the potential for spinoffs to bring value to a struggling market.

As uncertainty reigns and a gloomy outlook is forecast to darken further, ingenuity could prove a lifeline for deals through 2023.

For certain types of construction companies — specifically those with low debt, strong balance sheets, consistent earnings and a strong management team — the high cost of debt and the reduced appetite for third-party leveraged buyouts could indicate the need for an alternative exit.

With the cost of borrowing increasing at rates not seen in over a decade, observant and astute sellers are recognizing the opportunity to capitalize and accomplish a transaction by actually taking on the role of the bank for part or all of the transaction sale price.

This exit option has garnered attention in the past few years and could present a solution for many business owners seeking to sell their companies and receive liquidity for their ownership interests.

ESOPs: An Alternative Buyer

An employee stock ownership plan (ESOP) is a form of leveraged buyout established by Congress as part of the Employment Retirement Income Security Act of 1974, with the aim of boosting employees' economic power through a tax-advantaged sale of a business to its employees.

ESOPs are often an attractive alternative to traditional financing in a high-interest rate environment due to:

1. The option of lower interest rates

2. Flexibility in the transaction structure (i.e., a combination of external loan and seller notes)
3. Substantial income tax benefits compared to traditional merger and acquisition deals

ESOPs & Construction Companies

Company owners preparing to exit often sell to a third party or private equity, but those options are frequently unsuitable for construction companies. Construction companies are usually poor candidates for strategic buyers due to several factors, including:

- Cultural mismatch between the buying and selling firms
- Lack of recurring cash flows, or volatile cash flows, resulting in low valuation multiples
- Low barriers to entry for construction companies seeking to enter a new location (thus reducing the appeal of an acquisition)
- The exiting owner's fear that an acquiring company will tarnish the hard-won legacy of the newly sold firm, or the fear that loyal employees may be terminated post-acquisition

Private equity firms also face significant challenges when buying construction companies. They typically lack expertise in managing a construction company and, therefore, struggle to confidently project a clear return on investment (ROI). In addition, as mentioned above, today's high interest rates are altering the economics of potential deals.

Advantages of an ESOP

An ESOP utilizes the company's balance sheet to fund a partial or full buyout from the exiting shareholder(s).

To initiate an ESOP, a trust is formed to purchase and hold a company's stock for the benefit of its employees. A selling shareholder may thus gain the desired liquidity of their owned company shares from a "ready market" (i.e., the ESOP trust).

The purchase is then funded through certain financing alternatives (bank financing, seller financing, company cash or a combination of these).

The legacy and management of the firm remain with the people who built and maintained it over the years, which preserves company culture and leadership structure, and can be an improvement for employee morale.

From the company's viewpoint, an ESOP provides significant tax benefits at the corporate level.

Depending on the structure of the transaction, all or a portion of a company's income is tax-free, allowing it to more flexibly service the debt associated with the leveraged buyout of the selling shareholders.

Additionally, ESOPs provide significant tax benefits to the selling shareholder(s). For example, the selling shareholder can defer and/or eliminate all related capital gains tax with a 1042 rollover, a process by which owners elect to purchase qualifying U.S. securities in exchange for deferring or eliminating the capital gains tax.

With persistent labor challenges and rising material costs challenging the industry, coupled with a reduction in deal activity and escalating interest rates, ESOPs are an effective tool to create liquidity in a market that is becoming more risk averse.

Financing an ESOP Transaction Using Seller Notes

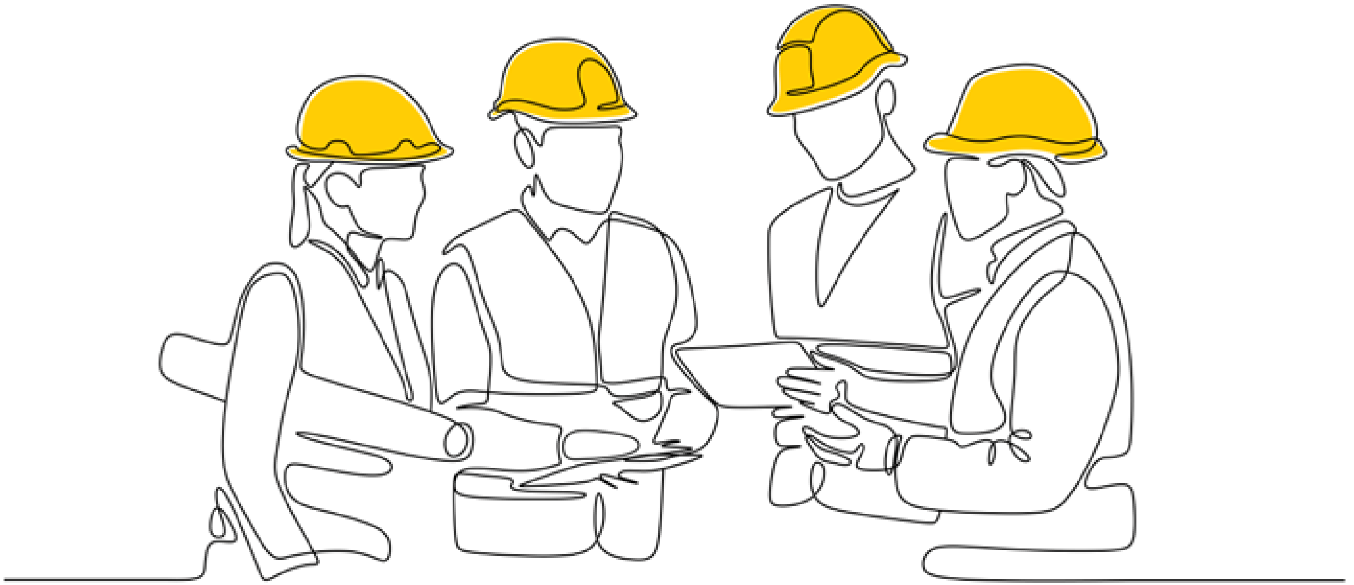
Seller notes are a form of debt financing structured as an interest-bearing loan. Seller notes are typically subordinated to any existing or new bank loans ("senior debt") used to finance a transaction. If there is no senior debt, the seller note will not be subordinated.

Financing an ESOP through seller notes can make a transaction more viable in today's economic environment. Advantages include:

- The selling shareholder(s) may receive a higher ROI compared to the ROI generated from outside financing. This is due to payment-in-kind interest or warrants (equity participation rights) attached to seller notes.
- There is a higher degree of flexibility with seller note payments. At times, a company may need to use cash flow for other purposes. Thus, seller debt payments may be temporarily deferred, and this makes them "company friendly."
- There are typically no prepayment penalties if a corporation decides to accelerate payments (selling shareholders are paid sooner than prescribed by the structured seller note). The lack of prepayment penalties is helpful if the company chooses to exchange bank financing for seller notes at a later date, when bank financing may be more attractive. In this scenario, the seller(s) would receive the rest of their note balances (again, sooner than dictated by the original seller notes).
- Importantly for construction companies, if bonding is necessary, seller notes are at times regarded as equity rather than debt for the bonding company's debt-to-equity ratio requirement.

However, seller financing also presents some risks:

- Most seller notes are unsecured. If the business fails and the seller note



defaults, any collateral is unlikely to cover the obligation.
- The future performance of any business is unpredictable. Like any lender, the seller must understand there is a risk that the seller note may not be repaid if the company's financial performance suffers.
- Seller notes are subordinated to any senior debt. If the business is not producing enough free cash to cover its secured debt obligations, the senior lender will not permit repayments of the principal on the seller notes.
- Seller notes do not provide liquidity as quickly as bank financing, as the balance of the bank note is paid to shareholders as a structured note over the loan time period.

Warrants

The seller may receive warrants attached to the seller notes as an additional benefit. As discussed, seller notes are subordinate to senior debt and deserve a market rate of return for the risk inherent in this type of debt.

Warrants guarantee the holder's right to buy a certain number of shares of stock at a later date and at a set price ("exercise price")*.

The advantage to the selling shareholder is that when the value of the ESOP shares rises, so does the value of the warrants. Additionally, the longer until expiration, the greater the value the warrant holds. Since the exercise price of a warrant is set on a post-leveraged basis**, as the ESOP debt balances are paid, the warrants often present significant value to the holders.

Capital Gains Tax

As mentioned above, an additional benefit to any ESOP transaction under a variety of financing scenarios (not just with seller financing) is that Section 1042 of the Internal Revenue Code allows for a tax-free rollover for qualified shareholders in an ESOP transaction. This provides selling shareholders the ability to defer and/or eliminate any capital gains tax resulting from the sale.

Summary

Construction company owners face a unique and difficult environment in 2023. With persistent labor challenges and rising material costs challenging the industry, coupled with a reduction in deal activity and escalating interest rates, ESOPs are an effective tool to create liquidity in a market that is becoming more risk averse. Like any specialized financial structure, ESOPs may not be the right fit for every company or every business owner. But they have proven to be a great exit option for owners whose companies meet certain criteria, especially for sellers looking for a tax-efficient way to sell their business while rewarding employees and maintaining the culture and legacy of the company they worked so diligently to create. ▲

**The set price, known as the exercise (or strike) price, is based on the fair market value of the stock of the company immediately after the ESOP transaction. The exercise price is typically at an all-time low for the company as it is set immediately after a leveraged buyout. When warrants are exercised at a fair market value in the future, the "equity kicker" is determined based on the difference between the fair market of the stock upon exercise and the pre-set strike price.*

***The exercise or strike price of any synthetic equity instrument, including warrants or stock appreciation rights, are set based on a per share price post-ESOP transaction debt. Thus, the exercise of these instruments are typically very low.*