ESOPs: The Emerging Ownership Model for Heavy Civil and General Contractors

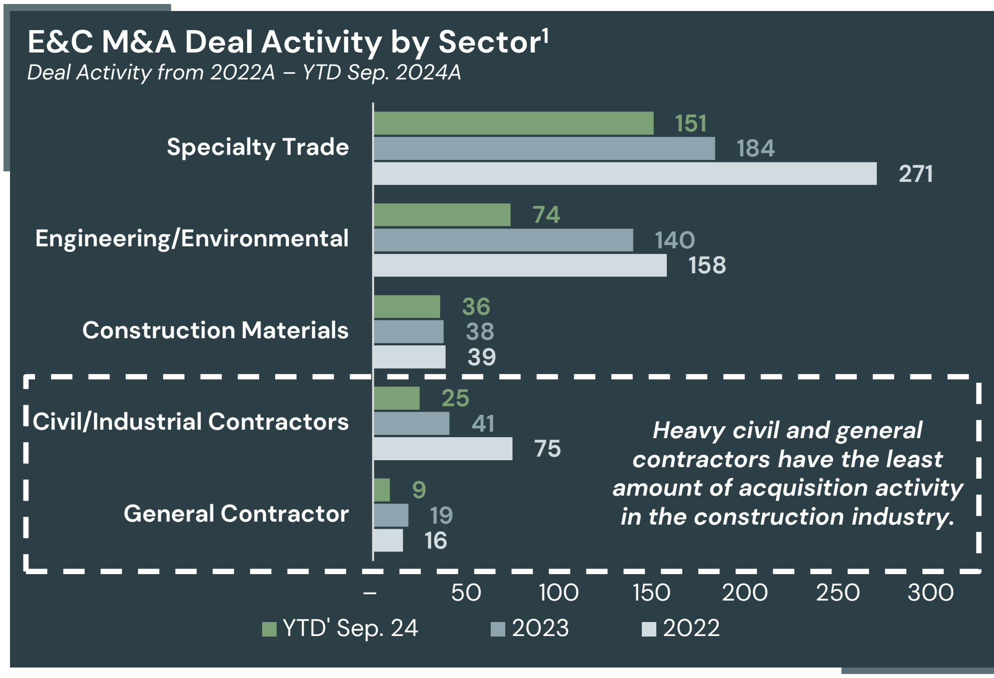
Are you thinking about selling your heavy civil construction or general contracting company? If so, you may be wondering what your best options are for succession and transition. In the majority of industries, business owners are often confronted with one of two options– **a sale to a strategic acquirer or to a financial buyer** (e.g., private equity).

However, **for heavy civil and general contractors, the buyer pool is often more limited, primarily consisting of large, well-capitalized public strategics**. This is because heavy civil and general contractors don't align well with the leveraged acquisition strategies that financial buyers typically employ.

M&A Realities

While public strategics may have significant reserves of cash, they are often reluctant to pursue acquisitions proactively, preferring to maintain liquidity in case of industry downturns.

Even when acquisition opportunities do arise, these large players tend to be slow to act, adopting increasingly conservative approaches to both valuation and the transaction process.



Adding to the complexity, surety bond obligations make M&A in this industry more challenging, which further diminishes private equity interest in the sector.

A surety company's underwriters evaluate the business's financial health by examining its capital position, liquidity, and the stability of the management team.

If a proposed acquisition results in excessive debt on the balance sheet or leads to the departure of key leadership, the surety company may be unwilling to underwrite bonds. This reluctance stems from concerns about the business's financial viability and the continuity of its management, both of which are critical to securing bonding.

(1) CapitalQ; BaseRock Analysis

ESOPs by the Numbers

As a result, the M&A market in the heavy civil and general contracting industry tends to be sluggish, with owners looking to sell often relying on favorable timing and circumstances.

> *These conditions have **led heavy civil and general contractor owners to identify Employee Stock Ownership Plans (ESOPs)** as a compelling solution, with significant advantages for both owners and employees.*

- Over the past decade, contractors have become the fastest-growing ESOP segment.
- **Construction companies account for 16%–17% of ESOPs** in the US.
- As of 2021, approximately **30% of newly formed ESOPs in the US are in the construction sector.**
- Across all industries, ~15 million employees participate in ESOPs, with 250+ plans established annually.

Segmentation of ESOP-Owned Companies[1]

ESOP-Owned Companies

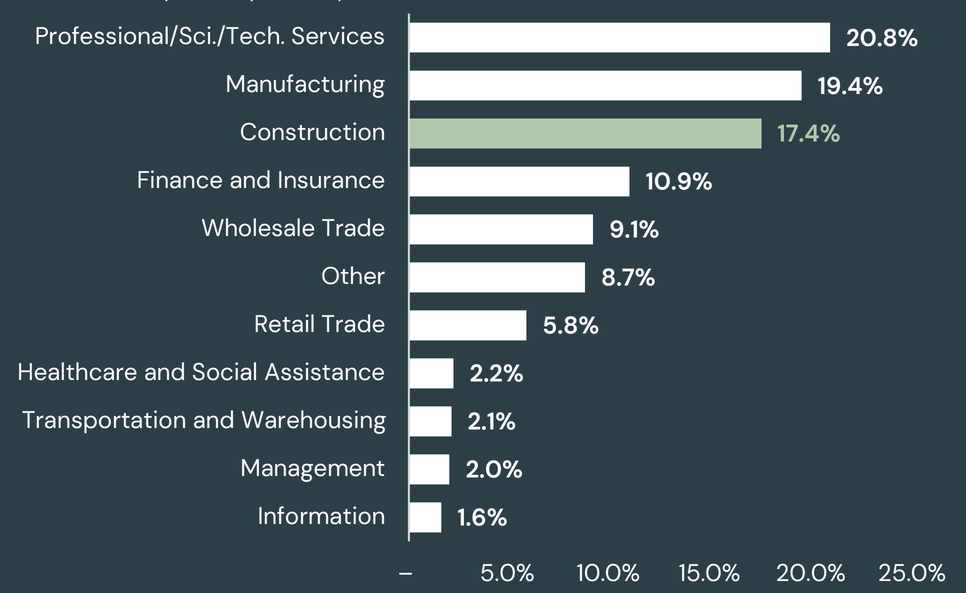
6,257 companies have an employee stock ownership plan (ESOP).

5,764 Privately held companies

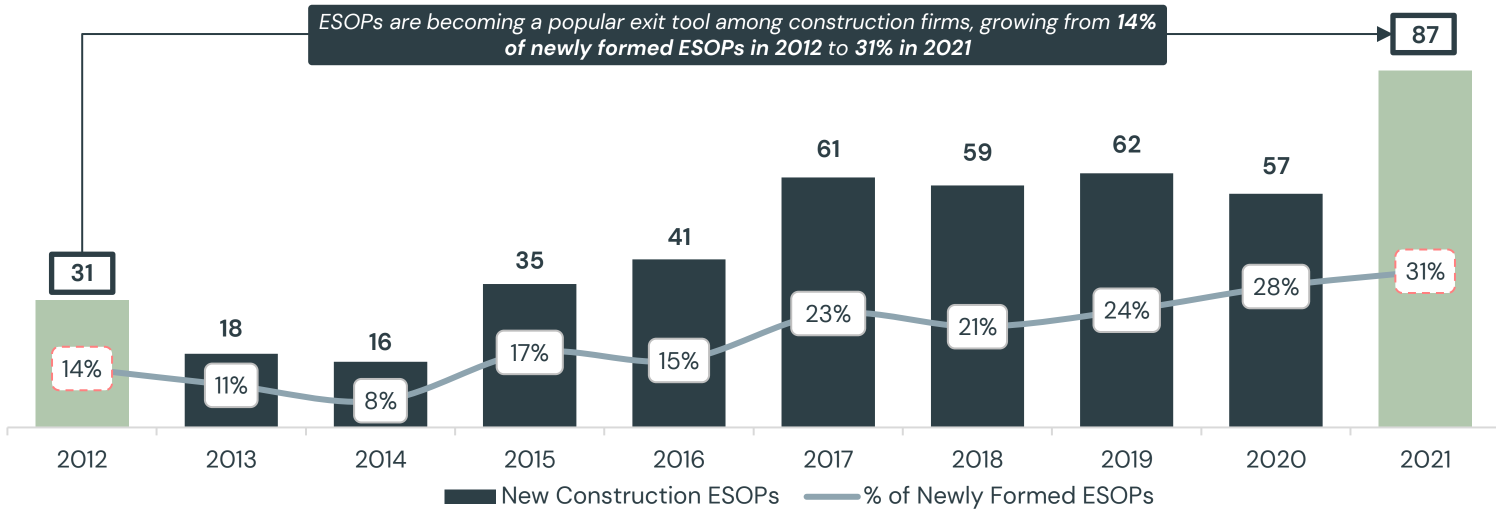
493 Publicly traded companies

At least 2,355 100% employee-owned companies

ESOP-Owned Companies by Industry (%)



Construction Firm Owners are Increasingly Choosing ESOPs Nationally[1]



(1) NCEO; BaseRock Analysis

What is an Employee Stock Ownership Plan, and Why are they an Attractive Option?

Given the various mechanics of an ESOP transaction, it's crucial to understand why these plans are gaining popularity in the heavy civil and general contracting industry and how they can be a valuable component of a company's succession planning strategy.

> *An ESOP is a type of qualified retirement plan, similar to a 401(k) or profit-sharing plan, designed to provide employees with retirement income over time.* ***What makes an ESOP unique is its dual function, not only offering retirement benefits but also facilitating the transfer of business ownership to future leaders.***

In an ESOP, the current owner sells either a portion or all of their ownership interest in the business to the plan, allowing employees to become participants in the ownership structure.

Importantly, the owner is not obligated to divest their entire stake at once; there is no minimum percentage of company stock an ESOP must hold when established.

In the construction industry, owners typically structure ESOPs to include between 30% and 100% of the company's shares.

While most new ESOP transactions involve a 100% sale, it's also common for owners to transition ownership gradually through a series of smaller sales over time.

For sellers, an ESOP also affords value built over decades, enables tax-efficient estate planning, and helps preserve the company's culture and legacy.

Advantages of the ESOP Structure[1]

- **Tax Benefits:** ESOPs can offer selling shareholders the opportunity to defer or even eliminate capital gains taxes on the proceeds from the sale. Additionally, 100% ESOP-owned S-Corporations are exempt from most if not all state and federal income taxes, which can significantly boost cash flow.
- **Preserve Continuity and Legacy:** ESOPs maintain the existing management and operational structures, minimizing disruptions for employees and customers while helping to secure the company's legacy.
- **Bolster Employee Recruitment:** ESOPs provide employees with additional retirement benefits at no extra cost to the company, making them a valuable tool for attracting and retaining talent.
- **Strengthen Business Resilience**: Data from the NCEO shows that companies with ESOPs are 25% more likely to remain in business, highlighting their role in fostering long-term stability.
- **Promote Employee Wealth-Creation**: Employees in ESOP-owned companies typically have 2.5 times more retirement savings compared to workers in non-ESOP firms, driving significant wealth creation for the workforce.

(1) NCEO

Is an ESOP Right for You and Your Construction Business?

While an ESOP offers numerous benefits, it's essential to assess whether this ownership transition method is a good fit for your heavy civil construction or general contracting business.

The following considerations are critical to keep in mind:

Strong Company Culture: ESOPs are designed to enhance employee alignment and engagement, but they can't create cohesion where it doesn't already exist. For an ESOP to succeed, employee engagement is critical. In companies with high turnover or strained employee relations, this can be a significant challenge.

Established Business with Stable Cash Flows: Since ESOPs are often financed through debt, companies with unstable cash flows may face heightened risks. Heavy civil and general contractors with consistent, stable cash flow are better positioned for successful ESOP transactions. An experienced advisor can help structure the deal to safeguard the company through industry cycles, ensuring a smoother transition.

Bonding Requirements: Surety bonds may introduce financial covenants or conditions that can complicate ESOP transactions. While bonding requirements don't necessarily exclude a company from pursuing an ESOP, those with significant bonding needs must carefully structure the transaction and communicate proactively with sureties to avoid any disruptions in coverage that could affect business performance.

Patient Capital: Sellers in an ESOP transaction typically receive a combination of cash, seller notes, and equity in the form of warrants. Depending on the company's ability to secure external senior debt, a significant portion of the proceeds may come from seller notes, with repayment terms extending over 7–10 years. A long-term perspective is crucial for sellers in this type of transaction.

Estate Planning Opportunities: There are many estate planning opportunities for ESOPs, including leveraging Section 1042 for deferral of capital gains and potential step-up in basis for permanent tax avoidance, as well as gifting warrants at a reduced price for future economic benefit.

Choose BaseRock Partners as Your ESOP Advisor for Your Construction Company

For construction company owners considering an ESOP as a transition strategy, BaseRock Partners is a recognized, trusted advisor. **With extensive expertise in the heavy civil construction and general contracting industries, we design sustainable ESOPs that provide lasting benefits for both owners and employees.**

Our team is well-versed in the unique challenges of the construction industry, including surety, licensing, bonding, lending requirements, and M&A complexities. We leverage this knowledge to:

1. **Guide business owners through the decision-making process,** helping determine whether an ESOP is the best path to achieving their personal and business goals.
2. **Design tailored ESOP transactions** that align with the unique needs of all parties involved, ensuring an optimal outcome for the owner, the company, and its employees.

We also collaborate closely with the essential partners in the ESOP process, including CPAs, attorneys, and trustees. We understand the critical role each party plays in structuring the deal to maximize advantages for everyone involved.

About BaseRock Partners

BaseRock Partners is an investment bank built to serve the engineering and construction industry. BaseRock advises clients using a team-oriented approach that combines decades of industry expertise, deep industry relationships, and unique transaction capabilities specifically designed to meet the needs of engineering and construction companies.

Contact Us to Learn More

Matthew Drake
Partner
mdrake@baserockpartners.com
312.882.7649

Jay Rolader
Associate
jrolader@baserockpartners.com
314.399.6073