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Why Architecture and Engineering Firms Make Great ESOP Candidates

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Government statistics estimate that approximately every eight seconds another individual born during the baby-boomer generation passes the age of 55 – one step closer to retirement. The explosion of births between the years of 1946 and 1964 in the United States has resulted in a major demographic group that is referenced consistently by trade groups and companies globally. The aging of this baby-boomer generation, combined with the gradual improvement in equity pricing multiples since the financial crisis, have recently led to an amplified interest among owners of privately held architectural and engineering ("A/E") businesses in pursuing exit strategies. However, like many privately held businesses, A/E firms often struggle with implementing long-term succession planning strategies in connection with an owner's exit plan. While there are several liquidity alternatives for owners of mid-size companies in the A/E industry, selling to an Employee Stock Ownership Plan ("ESOP") can result in numerous advantages compared to others.

Management Buyout / Leveraged Redemption

Many owners initially explore selling directly to the next tier of management. However, this strategy can be complicated by a number of factors. First, most employees do not have the financial wherewithal to fund such a transaction. Second, selecting the members of management to include in the ownership transition can be challenging and may result in a selection bias. In many instances, key managers who are not included in this investment opportunity or cannot afford to participate may lose interest in the long-term success of the firm because they lack the same motivations as an owner. Third, in circumstances where one of the owners is interested in an exit strategy, a leveraged redemption may be an alternative. A leveraged redemption, commonly referred to as a leveraged recapitalization, is when a company takes out a loan to pay a special dividend or redeem shares of a business owner, leaving the remaining owners with a higher ownership percentage. While this type of transaction typically does not result in a change in management control or the day-to-day operations of a business, the structure does increase leverage and may create additional risks for the remaining shareholders. If a founder or a current group of owners of the firm is interested in transitioning ownership to a broader group of the firm's employees, the tax and operational consequences should be carefully considered.

Sale of Company to a Strategic or Financial Buyer

When exploring exit strategy alternatives in many industries, owners can consider selling the business outright to a strategic acquirer since such a sale typically results in the highest price to the seller. However, A/E firms have historically not been great takeover targets for strategic buyers since other A/E firms generally cannot realize many synergies from the acquisition of a competitor. Additionally, founders of A/E firms are often hesitant to relinquish control of their firm out of fear that a new owner may tarnish their legacy by changing the firm name and implementing cost-cutting measures, resulting in a reduction in workforce and office closures. Also, most financial buyers (e.g., private equity funds) are not interested in acquiring A/E firms given their service-based business model because financial buyers typically do not have the necessary expertise nor the ability to obtain enough debt due to lack of collateral to generate sufficient returns on their investment. While a complete sale of the business may result in the highest price, there is often not a logical third-party buyer for mid-size A/E firms.

Employee Stock Ownership Plan

A third exit strategy for A/E firm owners is using an Employee Stock Ownership Plan to transition ownership of the firm. An ESOP is a tax-advantaged ownership transition vehicle that provides indirect employee ownership while offering the shareholder(s) a flexible structure to exit the business under their desired timeline. According to the ESOP Association, there are over 11,500 ESOP companies in the United States covering approximately 10 million employees with more than $600 billion in employee asset value. What makes an ESOP unique compared to other retirement plans is that the ESOP can use leverage to acquire the employer stock. In a leveraged ESOP, the company makes contributions to the ESOP which it uses to repay the loan with the company and shares are released to participants. The shares are (1) purchased from the seller at a price up to full Fair Market Value; (2) owned by the ESOP trust (in which each employee holds a beneficial interest); and (3) allocated to employees on a non-discriminatory basis. Although ESOPs have been around for decades, favorable tax laws and numerous success stories have increased their popularity among A/E owners, executives, and advisors. The ESOP structure has numerous benefits for A/E firm founders compared to other exit alternatives. In particular, an ESOP can (1) create partial liquidity; (2) minimize taxes for the seller(s) and company post-transaction; and (3) foster a corporate environment that could increase productivity.

Flexibility in Structuring and Financing

When a shareholder is exploring exit strategies, the flexibility of the ESOP alternative is attractive in many respects. For instance, the ESOP does not have to purchase all of the company's stock in a single transaction. If a firm happens to be lagging in the general economic recovery, the firm's current owners may want to consider a multi-stage transaction whereby he or she sells a minority interest today to the ESOP and the remainder at a later date when the firm is performing better. However, ESOPs are often the only viable option for A/E firm owners seeking partial liquidity since most strategic buyers will only want to acquire a controlling interest in the firm. Therefore, a common deal structure for A/E firms involves selling a minority interest (typically between 30% and 50%) to an ESOP with the remaining portion retained by the founder or a few members of the management team, which then allows the ESOP to acquire the remainder of the firm's equity over time. More important, the ESOP alternative also provides the firm's current owners with a level of certainty that a transaction will be completed that does not exist when there is a third-party buyer.

Compared with traditional exit strategies, ESOP transactions have more flexible financing structures. If necessary, ESOP transactions can be structured without any outside financing at closing. In situations where a shareholder is selling an amount of stock in excess of what a bank will lend the company, the selling shareholder can finance the transaction by issuing a seller note. The terms of the seller note are negotiated to represent prevailing market conditions as if the company obtained financing from an outside third party. Recently, these rates of return have been in the mid-to-high teens range, depending on the facts and circumstances, which are attractive rates of return to a selling shareholder compared to the historical performance of the public equity markets.

Seller Tax Advantages

Perhaps the most unique benefit of establishing an ESOP to purchase the selling shareholder's stock is that the seller may be able to permanently defer all capital gains taxes on the transaction. Under section 1042 of the Internal Revenue Code, a qualified seller of C corporation stock can defer capital gains taxes of the sale of stock to an ESOP if the ESOP purchases at least 30% of the outstanding common stock and the seller reinvests the sale proceeds into qualified replacement property ("QRP") within 12 months of the transaction. QRP primarily consists of stock and bonds of U.S. operating companies. If the seller retains the QRP until death, the QRP transfers to that person's heirs at a stepped-up cost basis, thereby eliminating all capital gains on the original sale of stock. If the firm is not operated as a C corporation, the firm can be converted into a C corporation prior to the transaction to permit the current owners of the firm to take advantage of the tax deferral opportunity. In comparison to other liquidity alternatives, the ESOP structure is often the most tax efficient structure for the selling shareholder.

Benefits to A/E Firms

While we have primarily outlined why ESOPs are common from a seller's point of view, there are several overlapping themes that make ESOPs attractive for A/E firms and their employees as well. The primary advantages include the (1) cultural fit; (2) increased ability to attract and retain talent; and (3) corporate tax advantages that can lead to material retirement savings. These advantages are illustrated by many successful companies in the A/E industry, such as HNTB Inc., Weston Solutions, Inc., HDR Inc., DLR Group, CH2M Hill, Inc., and Parson Corporation. In fact, nearly 20 of the 100 largest majority-owned ESOP firms in the United States are in the A/E industry based on data from the National Center of Employee Ownership. While the benefits of ESOPs apply to all size A/E companies, the benefits are especially noteworthy for mid-size firms without readily available liquidity alternatives. Under the right circumstances, the ESOP structure can not only benefit the selling shareholder, but can also create a sustainable employee-owned firm with certain tax, recruiting, and operational advantages over industry peers.

Cultural Fit

The proto-typical architect or engineer is hard working, type-A personality, well-educated and precise. These characteristics make it difficult for a business owner considering exit strategies to walk away from his or her company abruptly by selling to a competitor. As previously described, the ESOP structure provides shareholders the flexibility to exit the business in a gradual manner. Since employees are typically well educated and highly compensated, it is often easy for them to understand how their individual performance may impact the overall firm value and their retirement assets directly, which creates a positive incentive. Additionally, architects and engineers are often familiar with working in close groups and collaborating with one another. This team-based mentality fits nicely with the ESOP structure since everyone will have a common goal. Numerous recent studies have been completed which suggest ESOP companies have outperformed non-ESOP companies in terms of revenue, employment, and profitability. In fact, a new study from Georgetown University showed that in the recent recession, ESOP firms' revenue increased an average of 15%, compared to a decline of approximately 3% for all private industry revenue. If management properly communicates and educates employees on the benefits of employee ownership, the results inherently tie all stakeholders (e.g., founder, management, ESOP participants, etc.) together so that everyone is focusing on profitability and increasing firm value.

Improved Recruiting and Retention

An ongoing challenge for A/E firms is the shortage of qualified engineers in the United States. Due to the service-based nature of the industry, A/E company executives and selling shareholders realize their employees are clearly the most valuable assets of the firm. ESOPs have been used by A/E firms as a competitive edge to attract and retain top talent. From a new employee's stand point, the ESOP is typically set up so that there is no initial cost to the employee. The employees are only taxed on their benefits when they receive a distribution, which most often occurs when the employees retire or leave the company. A good industry example of how the ESOP structure can help add talent and grow a business is HDR Inc., a 7,800 person A/E firm with more than 185 locations worldwide, which has been an ESOP since 1996 and a 100% S corporation ESOP since 2002. According to Terry Cox, Chief Financial Officer of HDR, Inc.:

> *"We have been able to use the ESOP culture to our advantage when it comes to successfully negotiating and integrating acquisitions. Most firms in the industry are private and closely held, so the process of managing who gets ownership and how much is difficult. The ESOP allows new employees to see the huge opportunities of ownership, especially when people can relate their performance to firm value."*

For ESOP-owned companies, recruiting young and qualified architects and engineers is made simpler by providing a direct incentive through a beneficial ownership stake in the company.

Company Tax Advantages

The ESOP structure can significantly reduce or even eliminate a company's corporate tax burden. For instance, since annual contributions to the ESOP are a fully tax-deductible expense, an ESOP company can fund both the principal and the interest payments on an ESOP's debt service with pre-tax dollars. Generally, these contributions are limited to 25% of total qualified payroll. However, as a service business, payroll often represents a significant portion of the cost structure so annual contribution limits are rarely a constraint for A/E firms. Furthermore, while the annual contributions to the ESOP are tax deductible for all companies, the most significant tax benefits are accomplished when an ESOP owns 100% of the common stock of an S corporation. Income from an S corporation is passed through to the shareholders of the entity, but since an ESOP is a qualified retirement plan that is exempt from all federal and most state income taxes, the benefit creates significant savings. Therefore, A/E firms that are structured as 100% S corporation ESOPs have a significant competitive advantage because such firms can use the enhanced cash flow to be more cost competitive on bids, accelerate debt repayment, expand through acquisitions, and attract new talent. According to Dennis Wiederholt, Chief Financial Officer of DLR Group, a 520-person architecture and engineering firm with 22 offices across the United States and China that has been an ESOP since 2004:

> *"The [100% S corporation ESOP] transaction allowed for an orderly transition of ownership of the company of the voting shares of two senior executives to a new leadership team. The [100% owned S corporation ESOP] structure provided the capability to build cash reserves because of deferrals of federal and state corporate income taxes for expansion of company operations through acquisitions, procurement of equipment, software, and personnel, as well as the capability to build cash reserves for shareholder buyback upon departure from the firm, which in turn gave employees a comfort level their shareholder value was partly maintained in cash and liquid investments."*

While it is important to consult with advisors on the legal limitations related to establishing and maintaining 100% S corporation ESOP status, the long-term benefits can lead to tangible increases in company value, which translate directly into material retirement saving for employees.

Conclusion

In the A/E industry, many firms are still owned by original founders of the firm or a small group of firm management. Many of these founders and senior members of management, as they approach retirement age, are beginning to consider exit strategies, some of which have undesirable tax and operational impacts on the ongoing business. As professional service firms with a high payroll and a well-educated work force, A/E firms also have unique characteristics that make them well suited for employee ownership. While there are certain hurdles A/E firms must address while establishing an ESOP, such as the cyclical nature of the construction industry, state licensing requirements, or leverage concerns raised by bonding providers, the benefits of ESOPs may outweigh the risks. Specifically, founders are more frequently interested in the financing flexibility, tax savings, and the opportunity to exit the business over time. The culture an ESOP instills through employee-ownership can lead to a greater attachment, loyalty, and willingness to work hard, all while giving the company a tax-efficient tool to attract and retain employees.

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