

***Employee Ownership in Construction:  
A Foundation for Success?***

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## **Employee Ownership in General Contracting: A Foundation for Success?**

The risks and complexities facing general contractors have magnified in recent years. Higher levels of legislation, the war for talent in the workplace, new project delivery and contracting methods, among other things, have increased the competitive intensity of the industry. Confronted with these new realities, owners must constantly strive to maintain and enhance their firm's competitive advantages. For general contractors remaining competitive is in large measure dependent on hiring and retaining the best people which has clear implications for how ownership succession is planned and implemented.

Canada's general contracting industry has traditionally been the domain of privately held companies. While some of the largest companies have gone public (Bird Construction, Aecon and Churchill Corporation) the vast majority remain privately held. Among the most vexing questions facing the owners of these privately held companies are:

- How to attract and maintain the talent that will ensure growth and profitability?
- How to ensure business continuity should the owner/founder suddenly leave the business?
- How to achieve liquidity and reduce the risk of having too much net worth tied up in the business?

### ***Succession Roulette: Where to place your bet?***

When it comes to ownership succession, there are four alternatives to choose from: sale to family; sale to employees, sale to an arm's length third party, or an orderly wind-up of the business. As a practical matter, general contracting businesses don't lend themselves to family succession or third party sales as readily as say, an insurance brokerage business which offers standardized products and an income stream that has a predictable, recurring nature. Still, there are always exceptions to these conventional ownership succession rules. My family's general contracting business nearly made it to the fourth generation of family ownership. And from time to time, you will hear about arm's length sales such as Bird Construction's acquisition of Rideau Construction in 2008. But no matter which option is chosen, dealing effectively with ownership succession issues requires the owner-operator to view the process as a financial decision, as much as a personal one. To the extent that a succession is approached in the manner of an arm's length transaction (as opposed to say, a gifting of shares to the next generation of family) the owner-manager stands a better chance of achieving:

- A reduction of the investment risk by obtaining some measure of liquidity;
- The transfer of control of the business in proportion with the transfer of monetary risk;
- The realization of a fair price for the business;
- Availability of funds for retirement.

## ***Why is Employee Ownership Well Suited for Construction?***

Given the inherent complexities of general contracting, it is particularly suited to employee ownership in some form. This is because success on a given project is heavily dependent on the skills and competencies of the staff and employees on that project. The intellectual property of a construction company arguably rests less in methods and processes and more in the knowledge and decision making people on the front lines. As such, long term success is more likely where there is an element of self management, knowledge retention and continuity of practices. This is less likely to occur on a consistent basis where a business is overly dependent on the decisions of one or just a few key people, or where the objective is to maintain family control no matter what the circumstances.

Given the competitive nature of the construction market and the fact that success in construction is highly dependent on the skills and abilities of people, the importance of employee motivation to a company's long term success cannot be overstated. As such, I believe that for many established general contractors some element of employee share ownership is desirable. Notable advantages associated with this form of ownership include:

- **Flexibility & timing:** employee share ownership programs (ESOP) can be tailored to meet the liquidity and ownership objectives of the retiring shareholder over any time horizon. The shareholder can thus retain the desired degree of ownership and management control while withdrawing funds from the business. Control can eventually be passed to employees, or to other family members, as circumstances dictate. In this way, employee ownership can be used as a flexible tool in managing the succession process;
- **Motivation & performance:** ESOPS have been shown to enhance productivity and increase employee loyalty. A UK study released in 2008 indicates that performance benefits are most likely to be found in workplaces where the employees are involved in the decision making process, such as construction projects. (Source: Industrial Relations Journal, Volume 39, Issue 3, March 2008);
- **Shared Goals and Culture:** ESOPs are generally undertaken by owners who wish to reward and motivate key employees, and who wish to realize liquidity over a period of time. These factors will help ensure that the negotiations are carried out in the spirit of mutual respect;
- **Tax savings on sale proceeds:** by selling shares of a qualifying small business corporation, owners will qualify for a lifetime capital gains exemption of up to \$750,000 per shareholder;
- **Valuation:** as a fair market value must be established for purposes of any share sale, the ESOP creates a valuation framework for the succession process. As such, it should help to satisfy parties related to the selling shareholder (such as beneficiaries of an estate) that a market price is being paid for the shares. Experience indicates that in some non-arms length situations (ie sale to family), the agreed price can be contentious because family members outside of the business may feel that a family member is buying at a discount from 'fair market value'. An ESOP helps to alleviate this concern.

## ***Perspectives from the Front Lines***

In March and April of 2009 I conducted interviews with Chief Executives and Senior Officers at PCL Construction, Ellis Don, Buttcon, Eastern Construction, Ball Brothers, Kenaiden Construction and Birmingham Foundation Solutions. Each of these companies has an element of employee ownership and each offered insights into the strategies and structures used in establishing their employee share ownership program. The following is a summary of some key findings.

### **Eligibility for Ownership**

Six of the seven companies surveyed offered share ownership by invitation only. Three of these six offered ownership only to invited senior managers, while the remaining three offered ownership to salaried employees as well as senior managers. Only one of the seven companies surveyed offered shares to all employees without exception (including hourly paid field personnel). In terms of minimum service to qualify, three had no minimum service period and four had minimum service periods ranging from eighteen months to three years.

### **Buying In: Price & Terms**

Six of the seven companies surveyed used 'book value' as the basis for the buying and selling of shares. These six companies seemed to share the view that the principal of 'in at book, out at book' was simple, understandable and fair. Two of the six companies incorporated an element of 'goodwill' into the share price to account for the understated asset values and to act as a disincentive to the notion of going public. Typically, shares were offered once annually following the delivery of the audited financial statements. The one company from the survey that did not use the 'in at book, out at book' approach chose to use a valuation formula based on a multiple of average after tax earnings.

In terms of paying for the acquired shares, two of seven required full payment on purchase, two required a payment of 50% of the balance on purchase and the remaining three allowed for payment to come from future dividends or bonuses. Two of seven companies arranged financing for new shareholders through facilities offered by the company's bank.

### **Rules & Conditions**

All of the companies surveyed maintained tight control over the trading and ownership of shares via the shareholders agreement. In six of the seven companies, shares had to be sold back to the company on exit. In one case, trading amongst employees was permitted but only upon approval from the Board of Directors. One of the companies permitted certain retirees to hold shares, but for all others only active employees could own shares. In several cases, pledging of the shares was not allowed in order to avoid the prospect of having shares fall under the control of outside parties.

## **Selling Out: Price & Terms**

As noted previously, six of seven companies surveyed adopted the principal of 'in at book, out at book' as the valuation basis for the trading of shares. The one company that chose to use a valuation formula based on a multiple of after tax earnings paid the departing shareholder based on a multiple that varied depending on the circumstances of departure. As such, a higher multiple would be paid to those leaving on the most favourable terms (retirement), and a lower multiple would be paid to those leaving on less favourable terms (joining a competitor). It is my view that this valuation formula could lead people to leave the business following an uptick in profits, or when business was expected to decline.

Of particular note, all of the seven companies had a clause in their shareholder agreements stipulating that the buyback of shares was at the company's option. Of course this is of particular importance to general contractors who must protect against a run on their balance sheet and preserve their ability to bid and win contracts.

## ***In Their Words***

To conclude, all of the decision makers I surveyed felt that employee share ownership had a highly positive effect on how the business performed. While establishing the structure involved a commitment of time, resources and money, all were of the view that the benefits realized have far outweighed the costs.

As a note of caution, two of those interviewed related that they had received incomplete advice during the formative period of their ESOP leading to some unnecessary complications. They emphasized the need to invest in expert advice on ownership structure to ensure that Small Business Corporation status is preserved, and to avoid the prospect of becoming a reporting issuer under provincial securities regulation.

The following comments from those surveyed reflect how employee share ownership has benefitted their organizations.

## **Self Management**

'In an employee owned business, there is still an incentive to make your project or division as profitable as it can be, but not to the detriment of the business as a whole which can occur with profit sharing. Where employees are the owners, interests are aligned. Managing an employee owned construction business is much easier for this reason.'

## **Teamwork and Cohesiveness**

'There is a huge intangible benefit to have owners on the jobsite. One of the biggest gains for us was having 'cross ownership' between our divisions that made us more cohesive and got us away from the old internal conflicts. There have been enormous gains...and the Company is at a higher level because of this co-operation. Interests are aligned.'

## **Information Sharing**

'The original shareholders need to be prepared to share information fully and openly from day 1. The ESOP needs to be flexible and build in protection for the company with regard to share redemptions for example but not to the point where the program is viewed as a sham. I would never be more conservative in my approach to sharing information and being open. This is just a better way to manage'.

## **A Bigger Pie**

'Since establishing the ESOP...we have not had a losing year and have experienced exponential growth...I think what stops most owners going this route is the belief that they are going to be giving away the profits that should be going to them. But our experience is that the more you give, the more you get. With higher growth and profitability you end up with as much or more at end of the day than what you would otherwise have with more closely held ownership'.

## **Getting Buy In**

'If ownership is too concentrated then you don't get the input to better manage and find the synergies... You need enough people to understand the business plan and strategy... to spread the gospel...and make it more likely to be realized. Bringing senior management and senior site people into this realm helped us achieve the needed clarity to really contribute to the achievement of our long terms goals'.

## ***In Closing***

The foregoing experiences related by construction executives who have implemented employee share ownership programs indicate that they have found the impact of these programs to be very positive on a number of fronts. As challenges facing the construction sector heighten due to economic uncertainty, maintaining and attracting the best and brightest people will take on added importance. Those companies who implement an employee share ownership program will create the environment needed to ensure the loyalty of their single most important asset, and will be positioned for superior long term performance and wealth creation.