MARCH
2024

EMPLOYEE STOCK OWNERSHIP PLANS: HOW TO SET UP YOUR BOARD FOR SUCCESS

THE IMPORTANCE OF GETTING IT RIGHT FROM THE START

BY NATHAN PERKINS AND MICHAEL MANGUM

Employee stock ownership plans (ESOPs) are a fast-growing method of transferring engineering and construction (E&C) company ownership. As cited in FMI's recent ownership transfer and management succession (OTMS) industry study, 38% of companies thinking about ownership transfer are looking to implement ESOPs – an increase in the past few years.

An ESOP offers workers stock in a company as part of their compensation. Founders and shareholders can sell their ownership stakes slowly or all at once, facilitating ownership transfers. As company owners, employees are often more motivated and cost conscious than they otherwise might be, which drives better overall corporate performance over time.

"Employee ownership drives a different level of engagement and commitment," said Jason Hendricks, president and CEO of Performance Contracting Inc. (PCI), a specialty contracting group with offices across the U.S. Of note, ESOPs can also hold significant tax benefits for owners and shareholders.

Yet despite being a requirement in most ESOP transactions, too few companies take the opportunity to establish solid, independent boards of directors. This is a missed chance to put the newly employee-owned company on a foundation for future success by maximizing the value of the board from the start.

In an ESOP transition, a company will select a trustee to oversee the interests of the new company shareholders. Additionally, a new board of directors will be elected with at least one independent (or outside) director. Thus, the board becomes an extension of the trustee in protecting the shareholders.

At this critical juncture, a company has the potential to create a strategic board responsible for growing shareholder value, supporting business continuity and advising the CEO and management team. It can't be overstated: building a smart, diverse, well-led and well-informed board is a tremendous opportunity to build long-term success. Effective boards with strong dynamics and processes in place are linked with the improved financial performance of companies. What's more, diverse boards are associated with better company results overall.

For many leaders of closely held or family-run companies, this concept is new. Many have operated without an active board for years, with their board existing only on paper, meeting the bare minimum to fulfill legal requirements. And because leadership of these companies doesn't know where to start, building an effective board drops off the priority list. As a result, newly minted ESOP-owned companies often don't fully leverage the benefits a board can provide.

ADAPTING CLOSELY HELD COMPANIES TO THE ESOP ENVIRONMENT

In family-run or closely held companies, it's common for ownership and management roles to be held by the same people. Company control and decision making stay with these individuals—and, as a result, the boards of the companies are often sidelined. Getting boards to a point where they're truly adding value for an ESOP requires diligence and thoughtful planning.

FMI's study conducted with the Construction Industry Round Table (CIRT) found that E&C boards typically face four main challenges:

- **Less than optimal leadership.** As with any organization, strong leadership makes for a highly effective board. Yet heading a board is quite different from leading a business. A strong board chair keeps conversations strategic, holds company executives accountable and creates a culture that balances inclusion with accomplishments.
- **Homogenous membership.** The best-designed boards are diverse. Their members boast complementary knowledge, skills and abilities. Members should ideally represent a range of ages, geographic locations, races and genders since individual life experience plays a huge role in one's perspective and contribution.
- **Insufficient training and evaluation.** Like everyone, board members perform better when they're trained and given feedback. Yet only one in 10 E&C companies offers board training, and just one in five evaluates directors. Great boards invest in director development as a strategy to improve both individual and group performance.
- **The wrong focus.** Boards ought to focus on the horizon, not the details of daily affairs. Yet our survey respondents said they spend more time looking backward, reflecting on and explaining performance, than looking forward. The ideal time split is an 80/20 ratio of looking to the future versus reflecting on past results.

"We are looking for smart businesspeople who can help us grow our organization strategically," said Tom Sorley, former CEO of Rosendin Electric, the largest employee-owned electrical contractor in the U.S. Given the accelerating pace of change in the built environment, it is critical that an ESOP board be able to effectively navigate uncertainty and ambiguity. People who bring different perspectives can identify risks and spot opportunities that might otherwise go unexplored. Directors with some distance from a business often notice patterns and can bring new problem-solving approaches.

> "We are looking for smart businesspeople who can help us grow our organization strategically."
>
> — TOM SORLEY, FORMER CEO OF ROSENDIN ELECTRIC, THE LARGEST EMPLOYEE-OWNED ELECTRICAL CONTRACTOR IN THE U.S.

BUILDING A SOLID FOUNDATION

To counter the referenced challenges, there are several best practices that company leadership can implement to build an effective ESOP board.

STEP ONE: GET GROUNDED IN YOUR VISION

Prior to appointing the ESOP board, leaders should spend time identifying and communicating the company vision, including “who” the company is and what it seeks to accomplish in the next 20 to 30 years. Remember, there is tremendous potential that comes with employee ownership. As part of the transition process, it’s important to create buy-in with new employee owners and ensure everyone is working toward the same vision.

Believe in your mission, purpose and values, and stay true to them,” said PCI’s Hendricks. “Ultimately, that’s what defines your company and leads to success.”

Working to define this vision before building a new corporate board reassures employees and owners that the board will not fundamentally change the company’s identity and gives new board members direction for steering the business.

Finally, a clear vision will help shareholders select the right board members, ones whose values and attributes align with the company’s.

Three key components of a company vision:

CORE PURPOSE

Define why the organization exists, beyond making money.

CORE VALUES

Outline how everyone is expected to behave and what criteria to use when making decisions.

CORE MISSION

Determine the 15-20-year overarching strategic goals coupled with specific descriptions of what the organization will look like once it has accomplished those objectives.

STEP TWO: CONSTRUCT THE BOARD

For an ESOP to do things correctly, they need to be strategic in how directors are chosen," advises Rosendin's Sorley. "We are trying to surround the executive management team with a group of people that can help them."

A company's ESOP organization documents typically include board and trustee governance charters that detail how board members are selected. The documents also describe board-related processes, including how the board and ESOP trustee oversee each other.

Although there's no size requirement, most ESOP company boards have three to seven members. In most cases at least one board member must be independent, defined as neither an employee nor family member nor someone who has provided material services to the company in the past year.

While an ESOP trustee generally wants to stay aware of important activities in the company, most expect the board to provide high-level strategic oversight—which underscores the importance of FMI's recommendation that companies take a deliberate and thoughtful approach to filling board seats.

At the heart of building a diverse board is the need to rethink board recruitment. Board members are often recruited through peer endorsements, drawn from similar organizations or C-suite networks. As a result, the boardroom becomes a club of like-minded individuals with similar backgrounds.

To avoid this situation, successful boards include more than the minimum number of external directors. Because while it may be reassuring to include former employees who know the business, these people may be too steeped in tradition and common practices to see things strategically. External directors, on the other hand, bring outside experience, provide objectivity, mix up conversational dynamics and fill internal competency gaps. FMI's survey findings reveal that the greater the number of external directors, the higher a board's self-rated overall effectiveness.

Every organization can invest in a myriad of projects and directions. As the highest decision-making body in an organization, the board may be called upon to prioritize, accept or reject such directions or projects. **Strategic thinkers** focus on big picture questions like "what is the outcome we're looking to achieve?" and "how do these activities align with our three- and five-year plans?"

STEP THREE: LEAD THE BOARD

Just as the ESOP trustee and shareholders should carefully craft a board, so too should they seek to appoint a strong board chair. A good chair is a master facilitator, strategic thinker, organizational advocate, and authentic and caring leader who can increase overall board effectiveness.

"A good chair knows when to let discussions flow and when to shut them off," said one survey participant. "If you can get to a point where you're prioritizing and really hearing everyone's voice and getting everyone's input – and those voices have enough variety – then you've got some real effectiveness."

> "A good chair knows when to let discussions flow and when to shut them off."

One complicated role of the board chair is serving as an advocate for the organization, rather than for the management team. The board chair may oversee senior executives' performance and thus get involved in hiring and firing a CEO. A good chair remains impartial and makes decisions based on the organization's needs and long-term shareholder value.

Finally, the best board chairs are excellent listeners who authentically care about the company and the board. A leader who fosters open dialogue is essential if board members are to effectively challenge one another in the process of moving toward consensus.

A NEW BEGINNING
WITH NEW LEADERSHIP

Transitioning to an ESOP means a period of big change for a company. It's also the best time to rethink the company board. Just like other aspects of employee stock ownership, this is new for owners and can be daunting.

Geoff Wormer, CEO of Catamount Constructors, says his company's ESOP board, built on the strength of independent directors, has provided "tremendous" value to the company.

An effective board serves a vital role by helping company leadership keep an eye on the horizon and think about its vision and long-term business objectives. Encouraging innovative thinking throughout the organization, driving strategy, assessing and mitigating risk, and fostering financial health are all within the purview of an effective board that applies forward-looking perspectives of individual directors driven by a strategic agenda.

With our deep experience helping E&C companies set up successful ESOP boards, FMI can equip you to take your company to the next level.

AUTHORS

MICHAEL MANGUM brings more than 35 years of experience in the construction industry to his work with FMI's Leadership & Organizational Development practice. He is committed to guiding organizations and their leaders through transformational change, especially the challenges of management succession and business continuity.

He is deeply involved in corporate governance, organizing and launching three independent boards of directors, and speaking at National Association of Corporate Director events. Michael is past chairman of the National Asphalt Pavement Association and led its health and safety initiative for more than a decade. During those years, he developed close working relationships with members of organized labor, regulatory agencies and academia in the U.S. and Europe.

Michael can be reached at *michael.mangum@fmicorp.com*.

NATHAN PERKINS is an expert in employee stock ownership plans (ESOPs). He regularly speaks to industry groups about the value of these transactions for employees and as a liquidity strategy for business owners. He has advised on more than 300 ESOP M&A deals representing billions in value during his more than 20-year career.

Prior to joining FMI in 2022, Nathan was a managing director at CSG Partners where he focused on ESOP strategies for middle market companies. Nathan began his career as a financial advisor with Morgan Stanley in Washington, DC, and held a similar position at Bank of America Merrill Lynch.

Nathan can be reached at *nathan.perkins@fmicorp.com*.

CONTACT US

RALEIGH HEADQUARTERS
223 S. West Street
Suite 1200
Raleigh, NC 27603

919.787.8400

FMI is a leading consulting and investment banking firm dedicated to serving companies working within the built environment. Our professionals are industry insiders who understand your operating environment, challenges and opportunities. FMI's sector expertise and broad range of solutions help our clients discover value drivers, build resilient teams, streamline operations, grow with confidence and sell with optimal results.

OFFICES

Denver
44 Cook Street
Suite 900
Denver, CO 80206
303.377.4740

Houston
1301 McKinney Street
Suite 2000
Houston, TX 77010
713.936.5400

fmicorp.com