OWNERSHIP TRANSITION:

Build Bridges for Future Success

NECA PHILADELPHIA
SEPT 29-OCT 2, 2023

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What are The 3 Choices for Transition?

- Management Buyout (MBO: The Internal Sale) – Growing the firm from within.
- Merger & Acquisition (M&A) – Selling to an outside buyer.
- Employee Stock Ownership Plan (ESOP).
- Combination of strategies:
  - MBO + ESOP
  - MBO leading to M&A

The Ownership Transition Process – How to Plan Your Transition

- Owners meet with their professional team (attorney, consultant and CPA) and develop program, through Road Map Sessions (see next slide).
- Owners identify candidates and have them vetted by outside source (Owners are too close to be objective).
- Financial projections are prepared to confirm economic feasibility of program.
- Prepare and present program in “Term Sheet” form to candidates.

The Road Map Topics

- Identify Objectives of the program (What do the owners want?)
- Valuation – How to value the firm.
- Matching the Rate of Sell down by Founders to Buy In by candidates
- Identify candidates for Ownership.
- Compensation.
- Base Salary Increase, Owners' Bonus Pool, Other Owner Benefits ("The Perks").
- Governance – create an Executive Committee made up of all owners
- Set a timetable for closing.

The Ownership Transition Process – Start to Finish

- Present legal documents to candidates.
- Candidates review documents with legal counsel.
- Resolve questions and comments.
- Close and celebrate – This is Phase 1 of the program.

Timing: 4 to 9 months from time you start to develop your program. (It always takes longer than you think).

Examples of How Valuation Works
Balance Sheet

Assets		**Liabilities and Net Worth**	
Cash	$10,000	Notes payable - short term	$50,000
Accounts Rec.	800,000	Consultants payable	250,000
Work-in-Process	40,000	Accounts payable	20,000
Prepaid Expenses	10,000	Accrued exp.	30,000
Total Current Assets	$860,000	Total Current Liab.	$350,000
Furniture & Equip.	90,000	Notes payable – long term	$90,000
Lease improvements	50,000		
(Dept. & Amortization)	(80,000)	Total Liabilities	$440,000
Net Fix Assets	$60,000		
Total Assets	$920,000	Stockholders Equity	$480,000

Valuation for MBO

The Purpose Dictates the Method

- Must be affordable.
- The values are discounted for:
  - Lack of Control.
  - Lack of Marketability.
  - Affordability.
- Often based on firm's Stockholders Equity plus Goodwill based on a % of Equity.

Goodwill Factors for the MBO

- Goodwill Is Not Recognized on Balance Sheet
- Client relationships
- Expertise in particular sectors
- Firm's reputation in marketplace
- Bench strength
- Contract backlog

Comments:

- High profit margins
- Goodwill range is usually 0 for a new firm and up to 50% of Equity for a seasoned firm
- The upper limit of goodwill is governed by affordability for candidates

Internal Valuation

1. Multiple of Stockholders Equity

Stockholders Equity (from Balance Sheet)	$480,000
1.25 Times Net Worth	$600,000
1.50 Times Net Worth	$720,000

1.25 and 1.50: The Goodwill Multipliers for Internal Valuation

Valuation for Merger & Acquisition

- Almost always starts with the firm's most recent Income Statement
- Buyers have money.
- Buyers are buying control, so no minority discount.
- Marketability is not an issue, so no lack of marketability discount.
- Value will almost always be based on a multiple of firm's Earnings before Interest, Taxes, Depreciation and Excess Owners compensation (EBITDA).
- Multipliers currently range between 5 and 8 times EBITDA.

Income Statement

Revenue	
Gross Revenue	$3,200,000
Consultants Exp.	(900,000)
Other Direct Exp.	(100,000)
Net Revenue	$2,200,000
Expenses	
Direct Salary Exp.	$750,000
Indirect Salary Exp.	600,000
Other Indirect Exp.	775,000
Total Expenses:	$2,125,000
Operating Profit	$75,000
Add back: Excess Owners Compensation	$50,000
Interest, Taxes and Depreciation	$150,000
EBITDA	$275,000

External Valuation

2. Multiple of EBITDA

Example: EBITDA (from income statement)	$275,000
Multiply by metrics for external sale.	
5 Times EBITDA	$1,375,000
8 Times EBITDA	$2,200,000

ESOP Valuation

3. External Valuation Discounted for: Lack of marketability and lack of control

External Value:	$2,200,000
Discount for lack of marketability and minority interest (40%)	$1,320,000

What's an ESOP?

- A pension plan invested primarily in company's stock.
- All employees become participants (just like a 401k pension plan).
- A very tax beneficial device for owners.
- Company borrows from a bank and loans to ESOP.
- ESOP buys stock form departing owners.
- Company contributes money to ESOP to enable ESOP to repay loan to company.

What's an ESOP? (Cont'd)

- Company can deduct both principal and interest it pays for bank loan plus contributions to the ESOP…Very tax efficient!
- For C Corporation, if selling shareholders invest the proceeds of their stock sale in domestic stock, they can defer gain much like a section 1031 real estate exchange.
- For C Corporation, if seller holds the stock until death, they get stepped up basis resulting in no taxes

What the Candidates Want:

Answering the 3 "C's"

- Cost: What is it going to cost me?
- Compensation: How will my compensation change?
- Control: Will I have a say in the control and governance of the firm?

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How to Compensate New Owners

- Immediate Increase in Base Salary.
- The Owners' Bonus Pool
  - Is often based on two factors: Return on Investment (ROI) and Performance.
    - ROI is based on % of stock ownership (like a "Dividend").
    - Performance is based on established criteria – See next slide.
  - Best practice is to communicate expected performance criteria at the beginning of each year for each owner and evaluate performance at year-end with the resulting share of the "Performance Pool".
  - Best to keep it simple and transparent!

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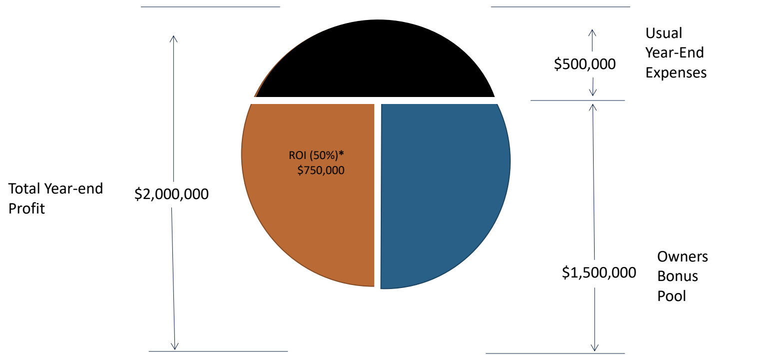
The Owners' Bonus Pool: How It Works



* The allocation between ROI and Performance may vary depending on firms needs. It is usually determined at the beginning of the program and rarely modified.

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What are Possible Performance Criteria?

- Business Generation.
- Client and project management skills.
- Compatibility of Values.
- Ethics.
- Governance and relationship skills.
- Leadership skills.
- Marketing and selling skills.
- Mentoring.

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Documenting the Program and Legal Considerations

THE DOCUMENTS

A. Term Sheet. A non-binding document that contains the essential terms of the Ownership Program, including:

- Number of Shares offered.
- Sellers: The Company or the Founders.
- Purchase Price and Method of Valuation.
- Payment Method: All Cash vs. Deferred Payments
- Summary of Buy Sell Agreement Terms.
- Titles and Positions.
- Compensation
  - Base Salary
  - Owners' Bonus Pool
- List of Legal Documents.
- Timetable.

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Documenting the Program and Legal Considerations (Cont'd)

B. The Offering Memorandum (Full Disclosure is the Goal).
- Historical Background
- Description of Business, Clients and Markets
- Projected Operations
- Financial Information
- Certain Liabilities
- Claims and/or Litigation
- Interested Party Transactions / Personal Guarantees
- Risk Factors

C. Stock Purchase Agreement.

D. Promissory Note (if payments are deferred).

E. Stock Pledge Agreement.

F. Buy Sell Agreement.

G. Indemnification Agreement - All for one and one for all.

H. Corporate Resolutions to:
- Adopt the Ownership Program;
- Authorize the Stock Issuance; and
- Adopt the Owners' Bonus Pool

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Buy-Sell Agreement Top Points to Remember

1. Restriction on transfers of shares.
2. Triggering Events.
   - Death, disability, termination of employment.
   - Other possible triggering events:
     - Bankruptcy.
     - Failure to indemnify (Shareholder Indemnification Agreement).
     - By vote of other shareholders.
3. Valuation: State the formula. When to value?
4. Method of Payment: All cash vs. down payment plus installment with interest. (usually 3 to 5 years)
5. Annual limits on payments.
6. Bring along/tag along.

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Buy-Sell Agreement Top Points to Remember (Cont'd)

7. Non-solicitation of clients and employees.
8. Purchase of spouse's interest upon marital dissolution.
9. Special shareholder voting rights – high threshold:
   - Issue or sale of shares.
   - Amendment or termination of this agreement.
   - Repurchase of existing shareholder's shares.

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Departure of Founders

- Consider involvement with company after selling last shares
  - Transitioning
  - Business Development
    - Mentoring
  - More?
- Founder Agreements
  - Consultant or Employment Agreement
  - Departure Agreement
- Use of Name
- Professional Liability Insurance

Trends in Ownership Transition

- Mandatory age-related sell down
  - Frees up stock for new owners.
  - Does not mean employment termination for the sellers.
  - Firms are extending the sell down age.
  - People are working longer.
  - Common to start at 60 or 65 and sell over 3 to 5 years
- Combining MBOs and ESOPs

Trends in Ownership Transition (Cont'd)

- Candidate skepticism about value of being an owner (Generations X,Y and Z).
- Founders work longer: potential concern for next generation leadership group. When will the reins be turned over?
- Bank Financing
  - Bank loans money to buyers to buy stock.
  - Keeps sellers out of the financing business.
  - Sellers get their money quicker.
  - Buyers will have to qualify with bank.
  - Company will have to guarantee loans and move their business to the Bank.

Q&A

Laura T. Howard

- Partner in the Corporate Department
- Represents variety of corporate clients, including architecture, engineering and environmental firms
- Corporate counseling, mergers and acquisitions and corporate finance
- Employment, contract and ownership transition

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Bill Mandel

- Partner in the Corporate Department
- Co-Chair of Firm's Business Succession Practice
- Represents a number of the leading architecture, engineering, environmental and design firms in California and nationwide
- Bill has helped more than 100 firms develop successful and sustaining ownership transition programs
- Bill has also represented both buy-side and sell-side firms in connection with merger acquisition transactions

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