D|A|DAVIDSON

NATIONAL ASSOCIATION OF SURETY BOND PRODUCERS

APRIL 2019

AUSTIN, TX

D.A. Davidson Engineering & Construction Practice

SELECT RECENT EXPERIENCE

WALKER ENGINEERING has been acquired by COMFORT SYSTEMS USA — SELL-SIDE ADVISOR

- Family-owned commercial electrical, network, end-user, industrial, and related services provider throughout Texas

EYP/ has divested THE WEIDT GROUP to WILLDAN — SELL-SIDE ADVISOR

- Provides design and engineering services to efficiently monitor and reduce energy usage

CONSTRUCTION PARTNERS INC. a portfolio company of SUNTX has completed an initial public offering of common stock $135,000,000 — CO-MANAGER

- Leading infrastructure and road construction company operating in the Southeastern U.S.

DAN COPP CRUSHING has been acquired by North American Recycling and Crushing, LLC a subsidiary of Vulcan Materials Company — SELL-SIDE ADVISOR

- Provides construction aggregates recycling and custom crushing services in Southern California

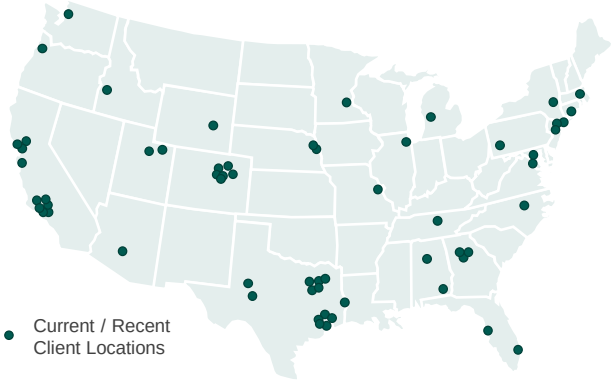
SUMMIT Materials has sold GJ Pipe to FERGUSON — SELL-SIDE ADVISOR

- Provides irrigation and utility water pipe, valve fittings, and accessory items in Western Colorado

CHC CONSULTING has been acquired by CONGRUEX a portfolio company of Crestview — SELL-SIDE ADVISOR

- Provides telecommunication engineering services for both fiber and wireless networks

NATIONAL ENGINEERING & CONSTRUCTION PRACTICE



- Construction Services
- Construction Products & Equipment
- Engineering, Design, & Professional Services
- Building Products & Construction Materials

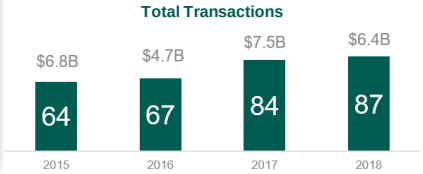
SIGNIFICANT DEAL ACTIVITY & EXPERTISE

M&A
PUBLIC OFFERINGS
PRIVATE PLACEMENT
ADVISORY

475+
COMPLETED M&A TRANSACTIONS OVER PAST 10 YEARS

$24B+
RAISED FOR PUBLIC COMPANY CLIENTS OVER PAST 10 YEARS

$ Total Deal Value ($ in Billions)



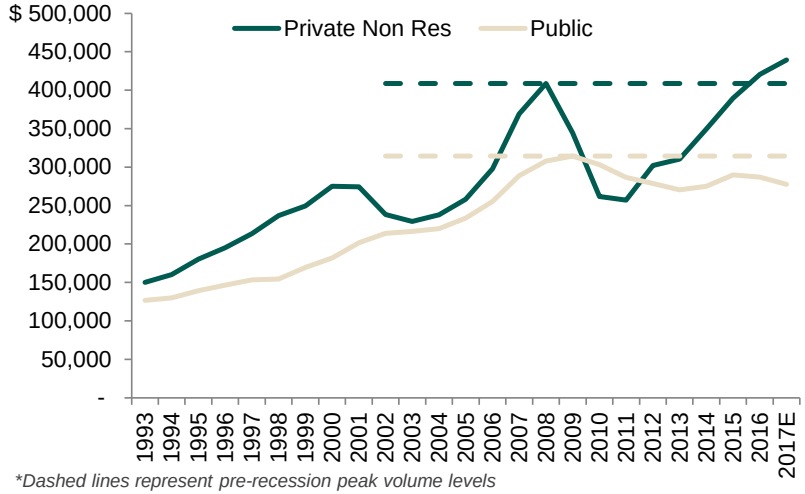
Experienced Advisor Across Five Industries:

- Consumer
- Diversified Industrials
- Financial Institutions
- Real Estate
- Technology

Engineering & Construction Macro-Economic Overview

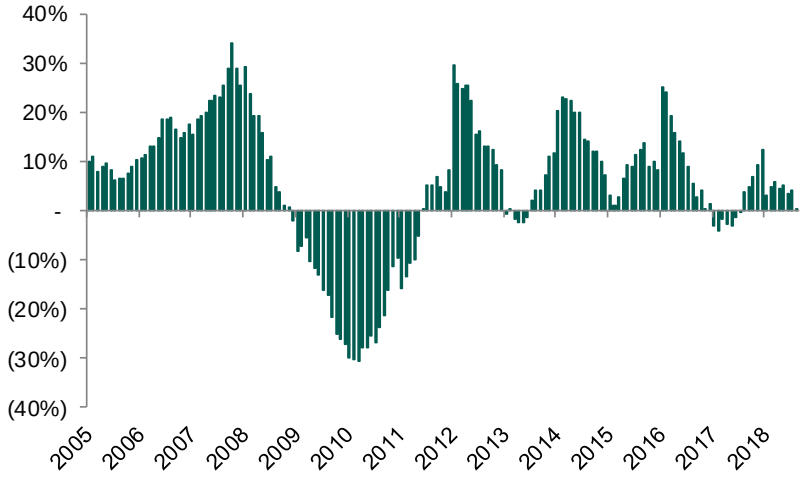
($ in millions)

HISTORIC U.S. NON-RESIDENTIAL & PUBLIC CONSTRUCTION SPENDING



**Dashed lines represent pre-recession peak volume levels*

PERCENT CHANGE IN NON-RESIDENTIAL CONSTRUCTION PUT IN PLACE



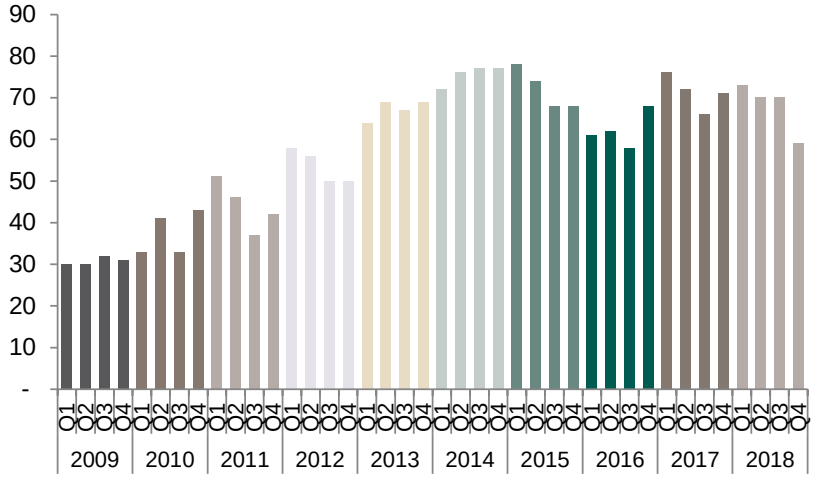
COMMENTS

- Overall construction growth has continued in 2019 after brisk increases from 2014-2018. Lagging industry data demonstrates that contractors have strong backlog levels, and expectations for continued healthy building levels across the industry continues. Industry confidence levels remain strong overall
- Rising input costs (materials, interest rates, labor) pose the greatest threat to the sustained recovery at this point in time
- Public construction demand, particularly transportation spending, continues to experience sluggishness based on a lack of federal funding certainty. New York metro appears poised for growth based upon recent public funding initiatives and the New York State budget recently passed
- Single-family home building remains solid nationally, with healthy activity in nearly all regions. The markets which experienced the deepest trough during the Global Financial Crisis have finally recovered. Residential construction growth overall is constrained, due primarily to the fading volumes of multi-family unit growth
- There is limited discussion from the White House or Capitol Hill regarding a federal infrastructure spending plan. Prior dialogue has centered around water and transportation. Potential that post-midterm election environment will bring about a solution for increased funding and programmatic focus at the federal level

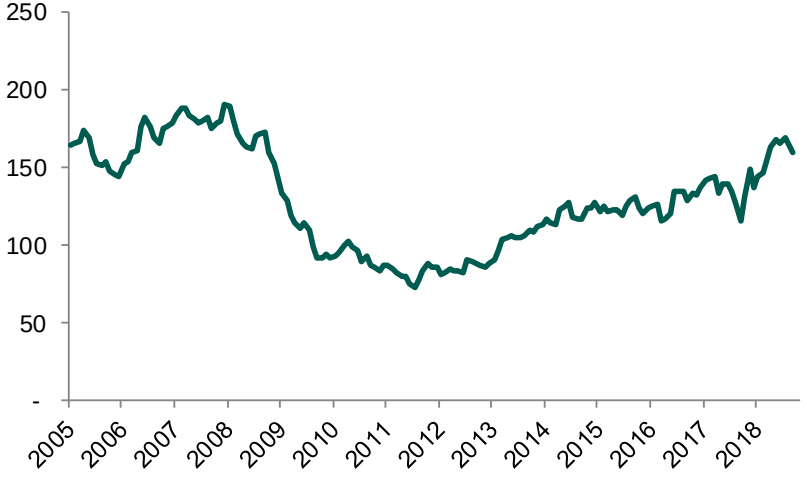
Sources: *Capital IQ and Census Bureau*

Market Indicators & Data

BUILDER CONFIDENCE

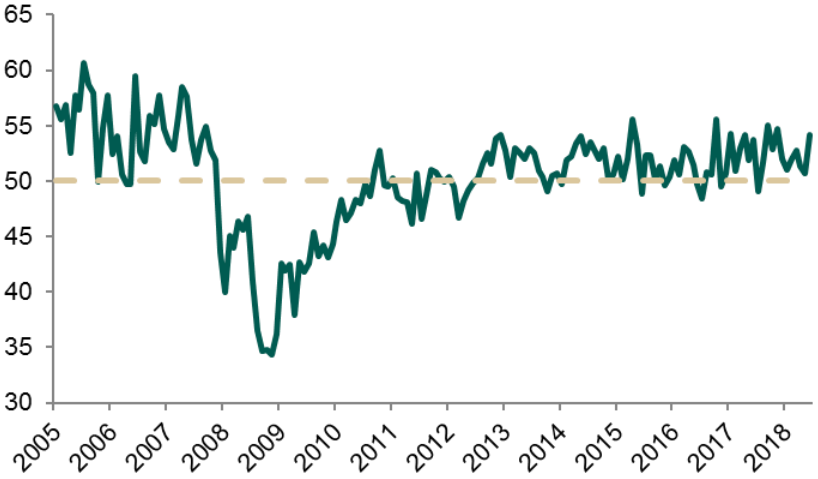


DODGE MOMENTUM INDEX



U.S. CONSTRUCTION PUT IN PLACE

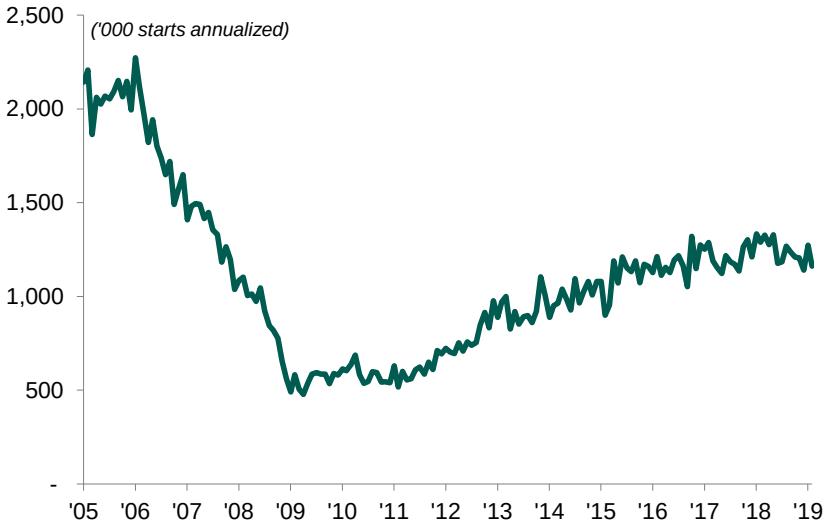
ARCHITECTURAL BILLINGS INDEX



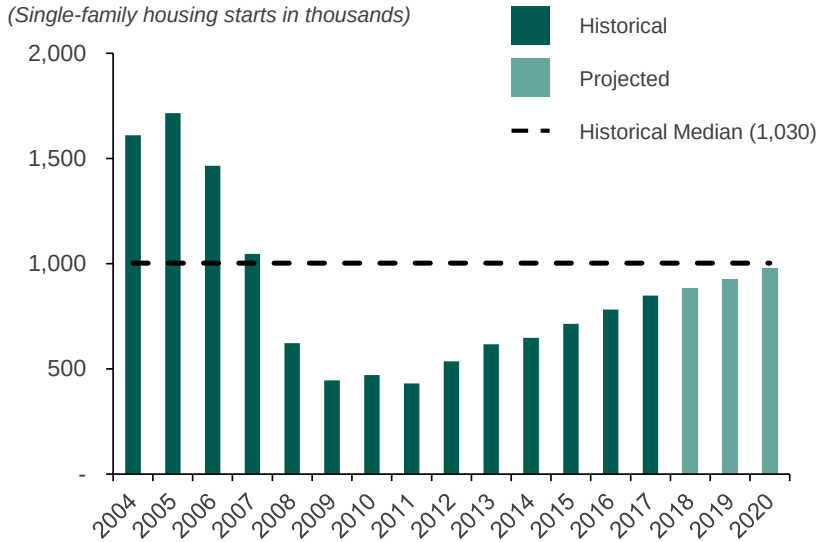
Sources: *The American Bureau of Architects, McGraw Hill Construction, FMI, and Capital IQ.*

Residential Construction Backdrop

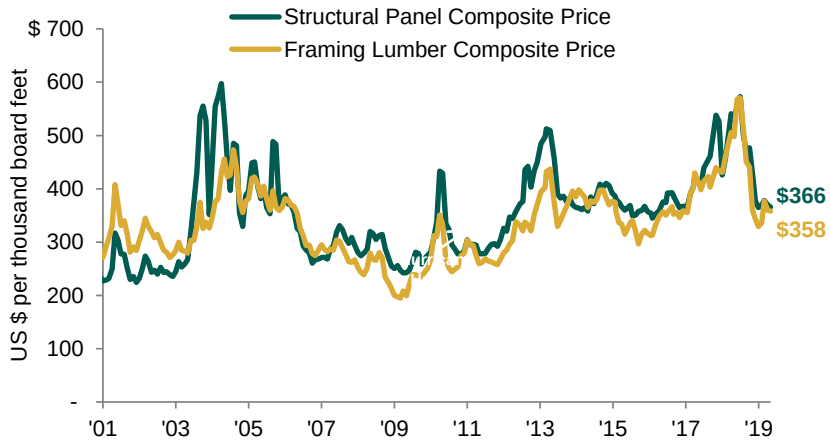
RESIDENTIAL HOUSING STARTS



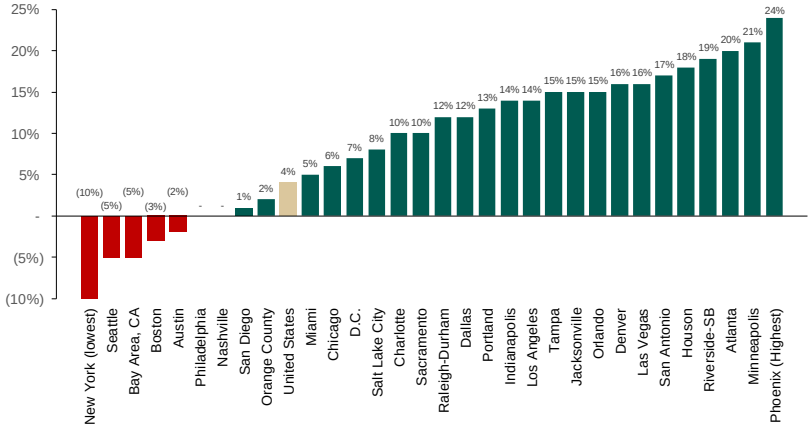
SINGLE-FAMILY HOUSING STARTS SINCE 2004



LUMBER & PANEL COMPOSITE PRICES



FORECASTED 2019-2021 ANNUAL SINGLE FAMILY PERMIT GROWTH



Sources: *U.S. Census Bureau, D.A. Davidson Equity Research and Capital IQ as of 4/15/19.*

Distant Past: 1970s to 1990s

- Extraordinarily fragmented domestic market with barbell-like structure
  - Limited number of large mega-firms with remaining landscape dominated by family / private businesses focused on local markets
- Limited merger & acquisition activity, with selective & infrequent “large” transactions driving bulk of all activity
  - Fluor – Daniel
  - UK, Australian, and U.S. conglomerates dominating acquisitions
    - Lend-Lease, Balfour Beatty, Alfred McAlpine, etc.
- Internal sale to key employees or transfers to family members the dominant form of exit for private / family businesses
  - ESOP, asset sales, or “brother-sister” structures
- Wind-down & liquidations fairly routine due to tax laws, lack of alternatives, etc.

Recent Past: 1990s to 2010

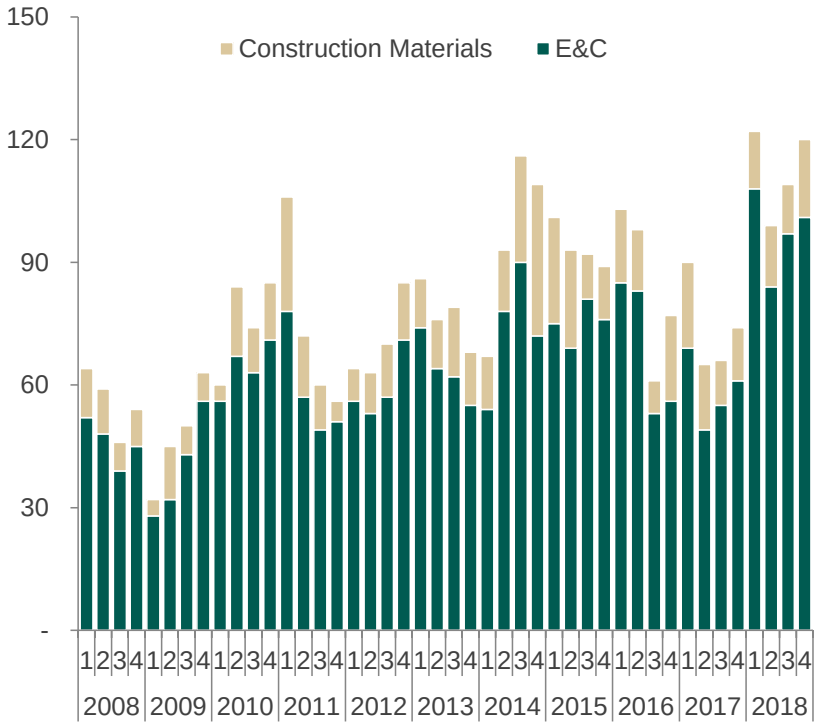
- Dramatic expansion of exit alternatives for industry participants
  - Public equities markets supportive of Engineering & Construction sector
    - Proliferation of the roll-up (Building One, Group Maintenance America, Nationwide Electric, Encompass, etc.)
    - Regular way IPOs for traditionally privately-held businesses (AECOM, Jacobs, Fluor, Stantec, etc.)
  - Institutionalization of M&A
    - 5,000+ middle-market transactions annually across multiple industries
    - Foreign buyers very active in using M&A to establish market share (Skanska, Obayashi, ACS Dragados, etc.)
  - Limited emergence of private equity
    - Focus initially on larger corporate “buy-outs” or “take privates” of public companies
    - Middle-market ($100M-$500M transactions) private equity investment quickly accelerates
- Internal transfer options vastly expanded
  - Corporate entity forms drive innovation in available techniques – S-Corps, LLCs, etc.
  - Broad expansion of ESOPs (leveraged & unleveraged)

Present Day: 2010 to 2019

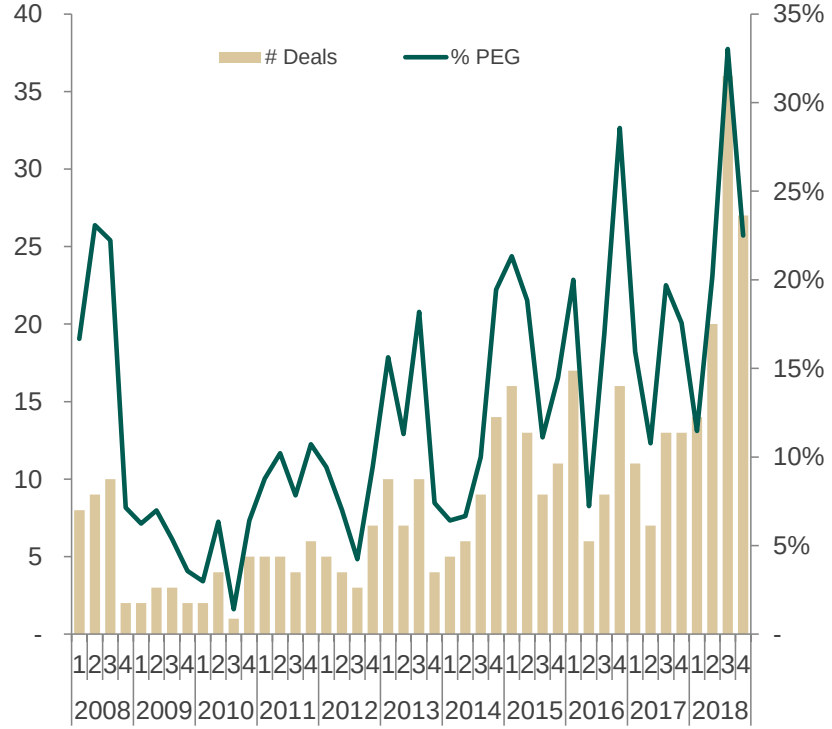
- Sustained and relatively liquid market for industry M&A
  - Current day: seller backlog and profits have recovered; buyers view market expansion optimistically
  - Sustained healthy stock market valuations for industry's public companies has led to healthy acquisition programs (e.g. Stantec, NV5, Comfort Systems, EMCOR, Willdan, etc.)
  - SPACs an increasingly accepted form of exit vehicle; consistent with previous market crest(s)
  - Significant focus by acquirers upon craft labor providers in the skilled trades – mechanical, electrical, plumbing – given labor scarcity and increased fixed costs for technology
  - Reduced level of international buyers driving the market
- Certain construction industry sectors remain difficult to transact (site preparation, non self-performing general building firms, significant multi-family exposure, etc.)
- Dramatic emergence of private equity – see following pages
- Increasing need for internal ownership transition
  - Baby boomer retirements
  - Broad ownership an increasingly common expectation for management
  - Size of companies prohibits single party internal transactions
  - Deep lending / liquidity available to support ESOPs and other form of equity transfer

Engineering & Construction Transaction Activity

OVERALL E&C TRANSACTION ACTIVITY



E&C PRIVATE EQUITY ACTIVITY

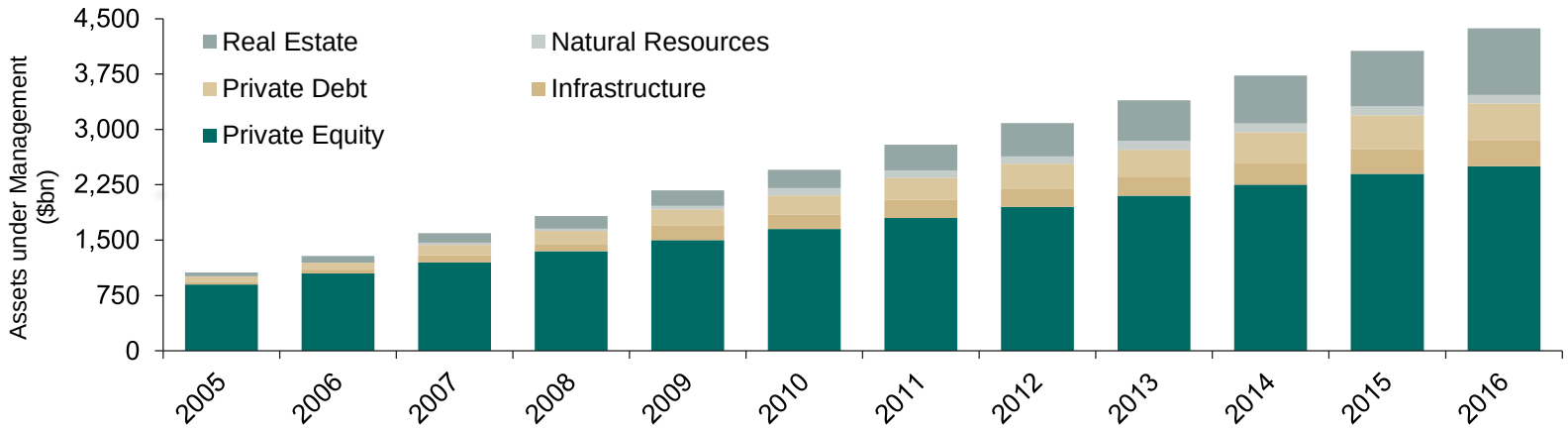


Source: *Capital IQ.*

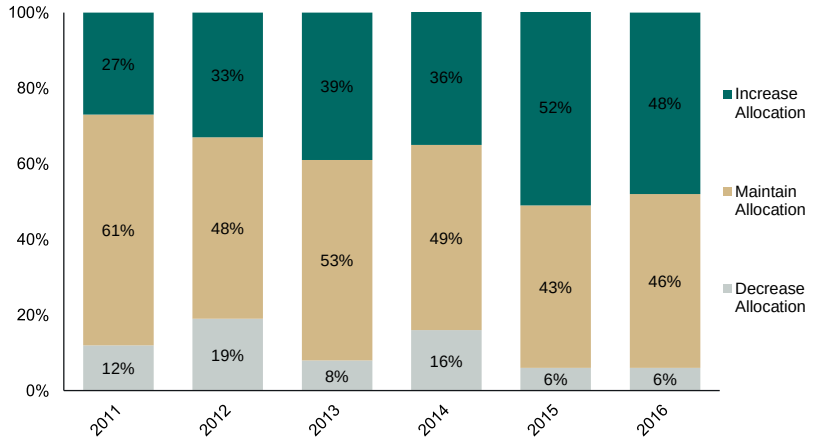
Private Equity in Context

Institutional investors increasingly lean on private equity to generate returns for their long term obligations

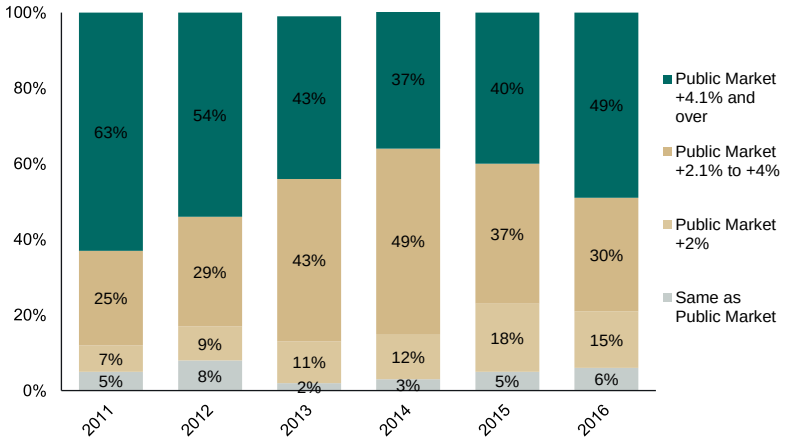
Private Capital Assets Under Management by Asset Class, 2005 - 2016



Investor's Intentions for Their Private Equity Allocations



Return Expectations for Private Equity Portfolios

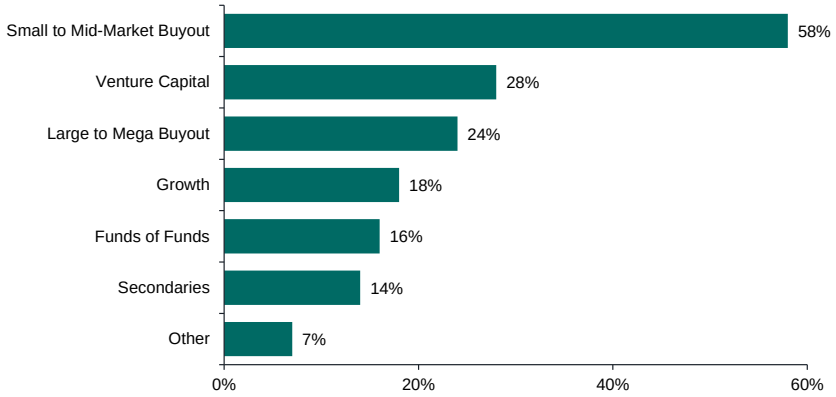


Source: *The Preqin 2016 PE report.*

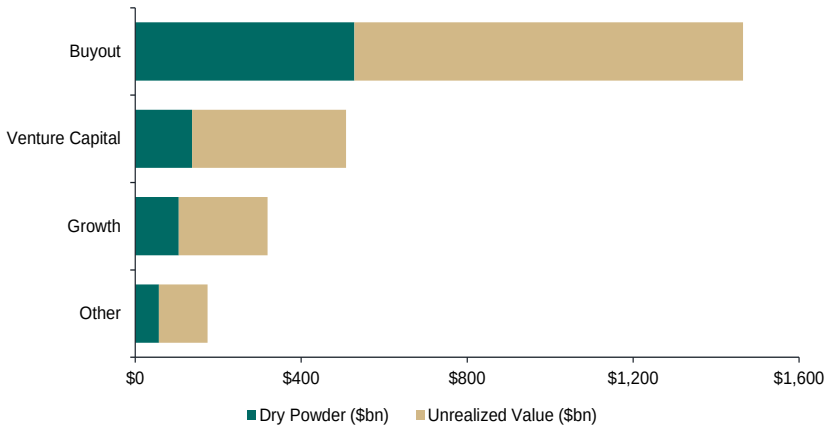
Private Equity in Context (Cont'd)

Traditional buyout funds remain the core of the asset class, with smaller funds generating increasing interest

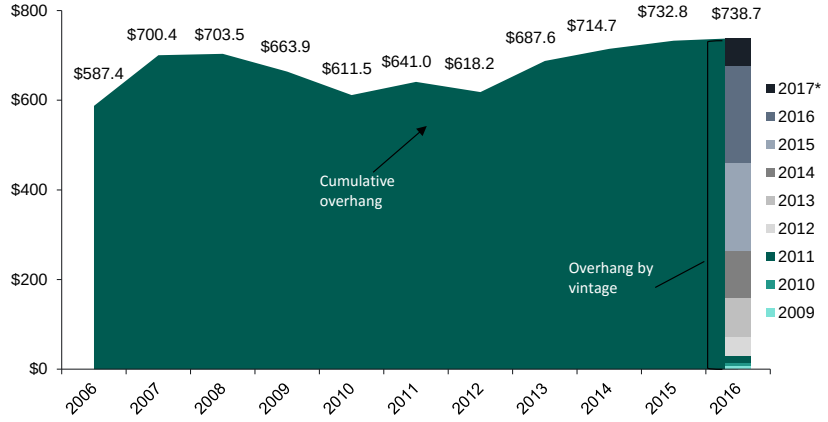
FUND TYPES INVESTORS VIEW AS PRESENTING THE BEST OPPORTUNITIES



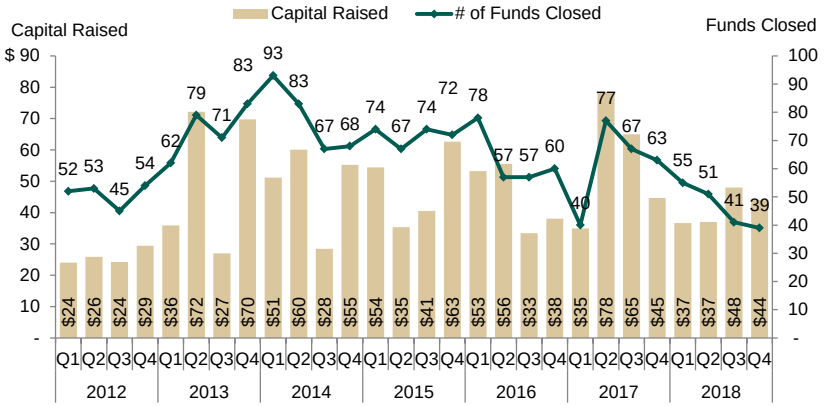
PRIVATE EQUITY ASSETS UNDER MANAGEMENT BY ASSET CLASS



NORTH AMERICA AND EUROPE PE CAPITAL OVERHANG ($BN) BY YEAR



U.S. PE FUNDRAISING BY YEAR

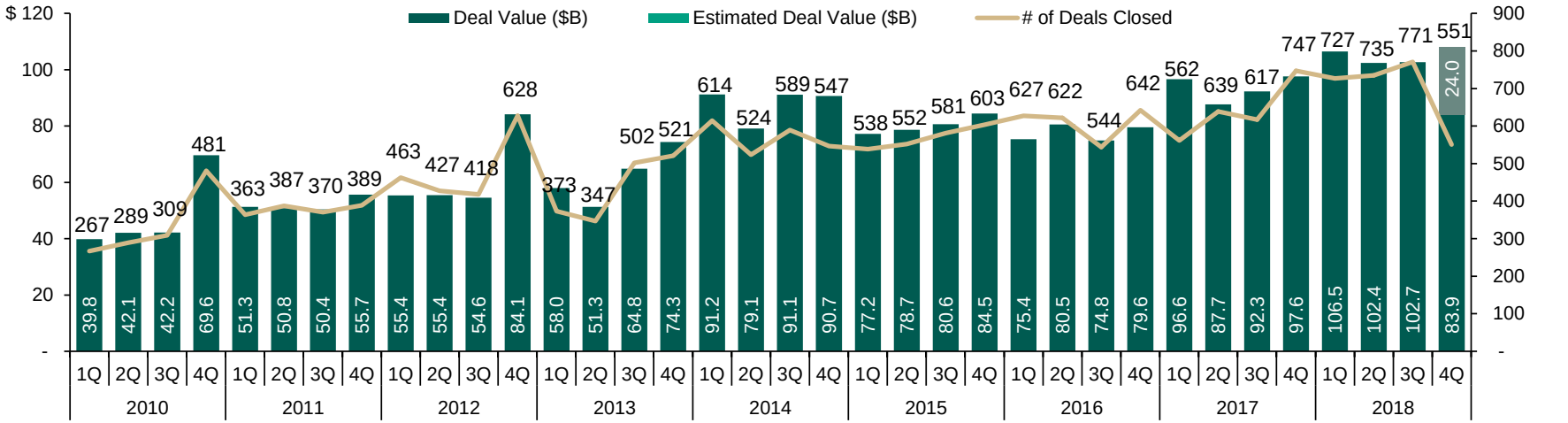


Source: *The Preqin 2016 PE report; 2017 PE VC Fundraising Report, and 2Q 2018 US PE Breakdown report.*

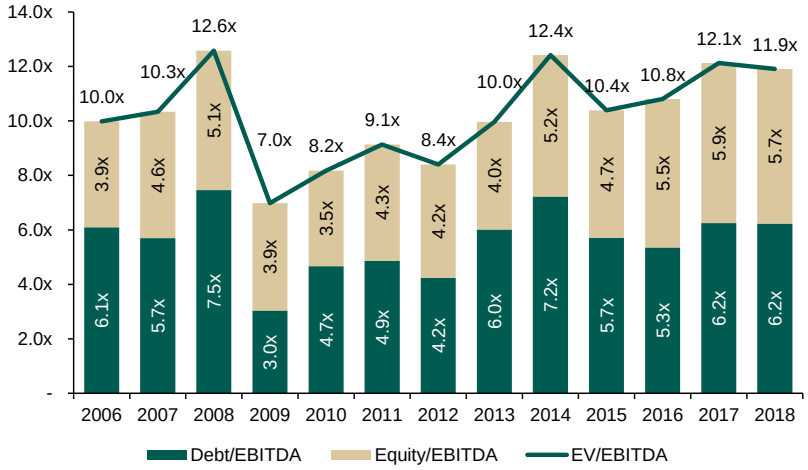
Private Equity Market Trends - Acquisitions

Sustained liquidity and strong M&A market have driven multiples to a ten year high

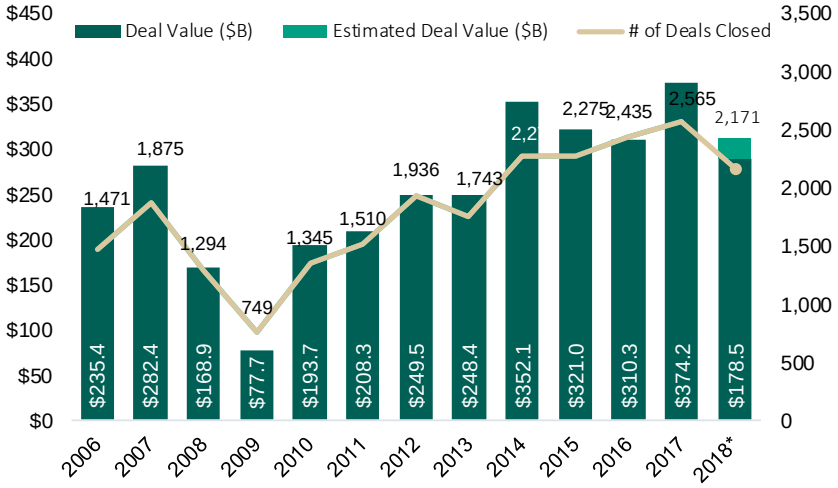
U.S. PRIVATE EQUITY MIDDLE MARKET ACTIVITY



U.S. MIDDLE MARKET PRIVATE EQUITY M&A TRANSACTION MULTIPLES



U.S. MIDDLE MARKET ACTIVITY



Source: *U.S. PE Middle Market report 2018.*

Presentation: Liquidity and Exit Strategies

2019

Susan Scherbel
Timothy Sznewajs

Overview

- Owners of a private businesses face challenges when considering how to ‘transition’ their companies and gain cash/liquidity while preserving the company’s culture and keeping their companies financially strong.
- There are various alternatives; the next several slides cover numerous approaches, discussing advantages, disadvantages and trends.

Sale to an Internal Group

- **Sale to Insiders: A natural solution, but…**
  - As an alternative, many owners consider selling to an internal group, consisting of family, employees or a managers. The problem is that these groups frequently cannot obtain adequate financing.
  - If an internal group can get financing, they will have to pay back the debt with after-tax dollars. (This means if the seller has a note for $10M, the company has to make $18-20M—depending upon state tax—to repay the debt.) This is expensive.
  - Also, if they finance via outside debt, the internal group will have substantial long-term debt risk. NOBODY LIKES RISK!

Making an Internal Sale Work: ESOP

- **An ESOP can be created that requires *no cash payment by employees and no personal debt obligations.***
  - After selling 100% of the Sub S Company stock to an ESOP, the Company is free of Federal and State income.
  - The saved tax money can be used to pay for the Company's purchase of the owner's shares. Since there is no tax any more, debt payments are made with pre-tax dollars—which makes the acquisition painless.
  - When structured this way, the ESOP facilitates a sale of stock to the employees and the government picks up the cost!
  - This structure gives the benefit of stock ownership without the cost.

So What is an ESOP?

- An Employee Stock Ownership Plan ("ESOP") is a defined contribution (DC) plan--just like a 401(k) or profit sharing plan. The main difference between a regular DC plan and an ESOP is that an ESOP invests in employer stock and can be 'leveraged.'

- An ESOP is 'leveraged' when it acquires all of the Company's stock upfront. The stock is put into a special account; each year, small amounts of stock are removed from the special account and allocated to each employee's individual account. When an employee with more than 3 years of service terminates, he receives the cash value of his stock and his stock is returned to the special account. (Employees leaving before 3 years of service receive nothing.)

How to Structure an ESOP

- There are right ways and wrong ways to structure an ESOP.
  - Many ESOPs have been created that put companies in a very bad position.
    - Taking on too much outside (bank) debt!
    - Not being 100% owned as an S-corporation.
    - Allocating shares to employees too rapidly.
  - Some companies have even failed as a result of the structure imposed by the ESOP.
  - This right ESOP structure <u>improves</u> cash flow even after accounting for the costs associated with the ESOP.

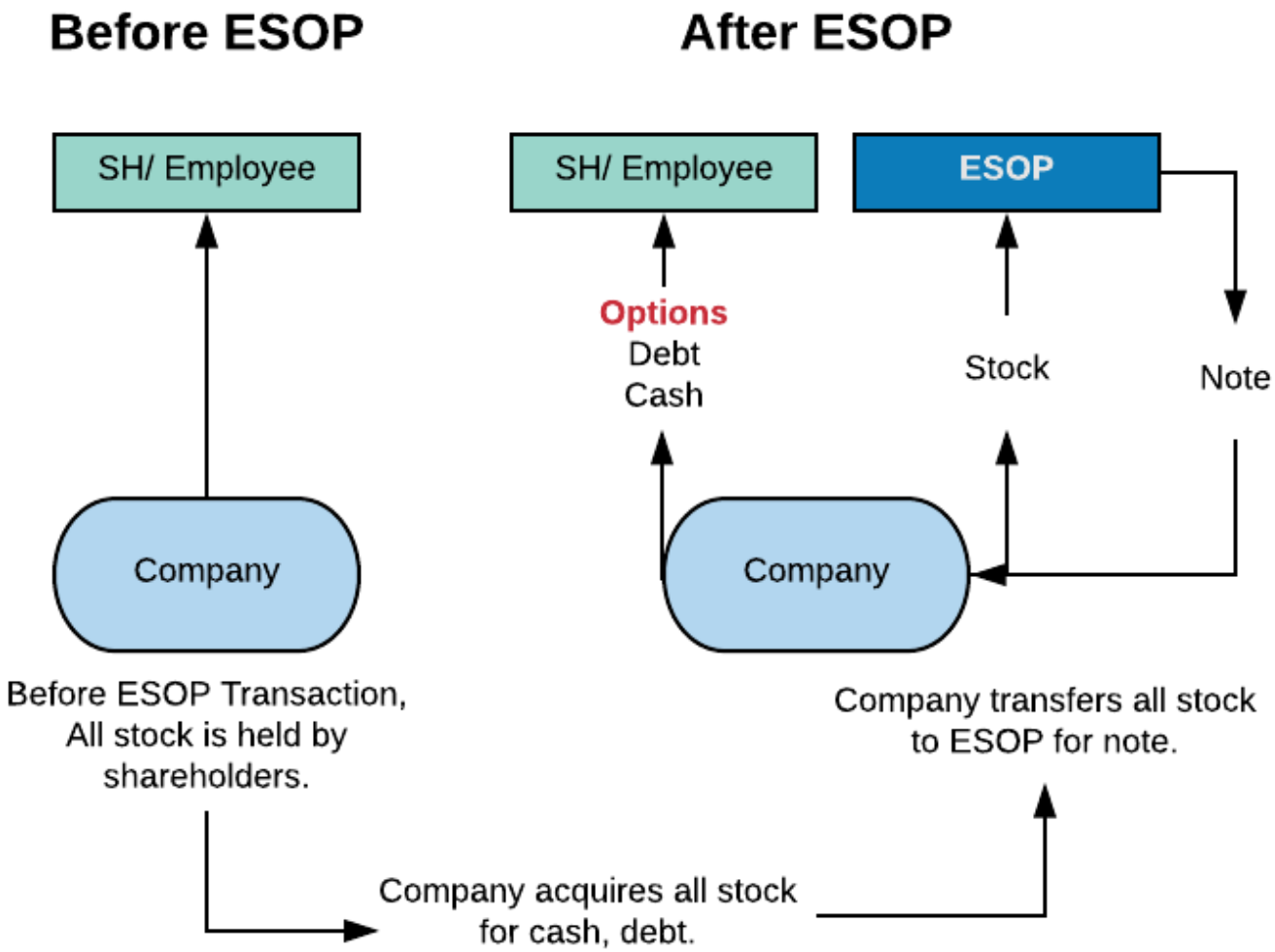
The Law

- In 1998, Congress enacted legislation to give an incentive to business owners to transfer their businesses to their employees.
  - S Corps "pass through" tax liability to the owners on a pro rata basis.
  - If an S Corp sells 100% of its shares to an ESOP, the ESOP (as the sole owner) is exempt from Federal and State taxes.
  - The Company uses the tax savings to pay off the shareholder note and to provide additional cash flow to the Company.
  - The ESOP-owned shares are held in a trust for the benefit of the employees.

A Typical Transaction

- Our transactions are done in two steps:
  - Step 1: The Company redeems the owners' shares in exchange for a note equal to the value of the Company as determined by an independent third party valuation firm.
  - Step 2: The Company then sells the shares to an ESOP trust for a much smaller value as the Company is now fully levered.

Stock Sale Where Proceeds Include Synthetic Ownership



The Result

- The Company now has a single shareholder – the ESOP Trust.
- The owners' obtain liquidity in the form of cash and notes.
- The Company continues to be managed by the current management team.
- The Company is now not subject to Federal or State income tax – even after all of the debt is repaid.
- The ESOP structure permits the Company to hold and accumulate cash free of tax.
- The ESOP permits a smooth ownership transition and gives employees a stake in the Company (funded with saved taxes).
- The employees have an incentive to stay as they are partners in the Company's future growth and success.

The Mechanics

- Each year, employees are allocated shares from the trust.
- If the company continues to be profitable, the value per share increases each year.
- The overall return for an employee is exponential – equivalent of an LBO return.
- Employees are rewarded for tenure.
- When employees leave the company for any reason (retirement, disability, etc.), the shares held in their accounts are purchased for cash.

The ESOP Landscape

- Since Congress enacted the legislation in 1998, over 11,000 Sub-S corporations have created ESOPs for their employees.

- ESOP-owned companies outperform their peer group by greater than 2-3%/yr.
  - Employees have an extra incentive to perform.
  - ESOP companies have lower turnover.
  - ESOP companies can compete favorably against companies in their industry that are subject to tax.

Common Concerns/Questions

- Can management stay in place?
  - *Yes. The current executive team may stay in place for as long as they would like – subject to the approval of the Board of Directors (same as before the ESOP).*

- Will the decision-making process change as compared to today?
  - *No. The shares are held in a trust that is managed by trustees (typically the existing owners/executive team) on behalf of the employees. The Company will operate just as it does today. Employees never own the shares—the trust owns the shares on their behalf.*

Common Concerns/Questions (cont'd)

- What about banks and bonding companies—how do they react to ESOPs?
  - *Banks and bonding companies like this ESOP structure.*
  - *CASH FLOW: After a 100% ESOP transaction, the Company is not subject to tax; this increases its cashflow and means that debt principal is repaid using pre-tax dollars.*
  - *SUCCESSION PLANNING: An ESOP answers the problem of succession planning—death will not destroy the company.*
  - *SUBORDINATION: Because selling shareholders subordinate their notes to lenders and bonding companies, their debt 'effectively' remains equity to them.*

  If properly explained, the ESOP transaction should be viewed as a positive by banks and rating agencies.

Bellview Experience

- The principals in Bellview have been structuring ESOP transactions for almost three decades.
- The majority of ESOP transactions that have been done in New England in the past 3 years have been designed and implemented by Bellview.
- Bellview has also been responsible for restructuring ESOPs that were not thoughtfully designed.

Perspectives on Ownership Transfer

- How can NASBP members best engage on helping your construction industry clients think about the issue of ownership transfer?
  - Engage early and often – planning for ownership transfer is complicated, time-consuming, and dependent on many external factors
  - Be informed about sale-ability of your client – not all companies in this industry can be transacted to a third party. Must understand if an external sale is an option or only the internal transaction is available
  - Be informed about valuation – difficult but necessary conversations to private business owners about realistic valuations for the Company
  - Know additional resources who can be an honest broker – ESOP experts, CPAs, Investment Bankers, Transition Planning Specialists, other

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