

Best Practices

Key Strategies for Protecting Bonding Capacity During an ESOP Transaction

Bonding capacity ultimately determines the size, scope and number of projects a contracting firm can pursue, making bonding a critical driver of operational capability and long-term growth.

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Key Highlights

- Surety bonds are credit-based guarantees that depend on a contractor's financial strength, liquidity, and cash flow stability, directly impacting project capacity
- ESOP transactions reshape a company's capital structure, often increasing leverage and long-term cash obligations, which can challenge bonding capacity if not properly managed
- Proactive planning, including modeling future liabilities and maintaining balanced leverage, is essential for preserving bonding capacity during and after ESOP implementation
- Early engagement and transparent communication with surety partners help align expectations, mitigate risks, and support sustainable growth in ESOP-structured construction firms

Bonding plays a foundational role in the construction industry by providing project owners with assurance that contractors will fulfill their contractual obligations and that subcontractors and suppliers will be paid.

Surety bonds are not insurance policies, but rather credit-based guarantees that rely on a contractor's financial strength, liquidity and ability to generate consistent and predictable cash flow. A contractor's bonding capacity

ultimately determines the size, scope and number of projects it can pursue, making bonding a critical driver of operational capability and long-term growth for contractors that work on bonded-type work.

Sureties often place significant emphasis on balance sheet quality, working capital and cash flow stability. Any transaction that may alter these metrics is subject to elevated underwriting focus if the structure of the transaction is not communicated effectively.

ESOPs

An Employee Stock Ownership Plan ("ESOP") is one such transaction. While ESOPs can offer compelling tax advantages, employee alignment and an effective succession solution, they also reshape a company's capital structure, often introduce additional leverage and create long-term cash obligations.

As a result, the intersection of ESOP transactions and bonding capacity is an important consideration for construction companies evaluating employee ownership, underscoring the need for thoughtful structuring and early engagement with surety partners.

Surety underwriting is grounded in a company's capital strength, liquidity and ability to generate consistent and predictable cash flow. An ESOP transaction directly affects each of these areas by reshaping the balance sheet, increasing leverage and introducing long-term cash obligations related to debt service and share repurchases. As a result, sureties often conduct enhanced underwriting reviews of ESOP-owned companies, particularly in industries where bonding is critical to operational capacity and growth.

Key Surety Risks Associated with ESOPs

Most ESOP transactions in the construction industry are financed through a combination of senior bank debt and subordinated seller notes, increasing financial leverage and placing additional pressure on a contractor's balance sheet.

Elevated leverage can reduce a contractor's ability to absorb project losses, manage underbillings or overbillings and navigate cyclical market conditions. From a surety underwriting perspective, increased funded debt often weakens key construction-specific metrics, such as debt-to-tangible-net-worth, fixed-charge coverage and working capital relative to backlog, all of which are closely evaluated and can directly influence bonding capacity.

In addition, contractor-owned ESOP companies are required to repurchase shares from employees upon retirement or separation, creating recurring liquidity demands that can escalate as the ESOP matures. Although these repurchase obligations are typically off-balance sheet, they represent a real and ongoing use of cash that must be incorporated into long-term cash flow planning.

If not properly modeled, these obligations can erode working capital, pressure key performance metrics and limit the contractor's ability to support growing backlog, fund mobilization costs or respond to adverse job performance.

Mitigating Surety Concerns

ESOPs that sustain strong surety support are typically built on balanced financial structures and supported by proactive, long-term strategic planning initiatives. Successful ESOP companies emphasize liquidity and working capital strength, while carefully balancing bank leverage at the time of transaction close to maintain operational flexibility. This disciplined approach helps ensure the Company retains the financial capacity and wherewithal required to support bonded work and execute its strategic initiatives.

Equally important is advance planning for future share repurchase obligations. Companies that model these liabilities early and understand their long-term cash flow implications are better positioned to maintain stability as the ESOP matures.

Ongoing, transparent communication with sureties and lenders throughout the ESOP transaction and beyond further reinforces confidence, particularly when experienced management remains in place following the transition.

Engaging surety partners early in the ESOP process, ideally before the transaction is finalized, can meaningfully improve outcomes and help preserve bonding capacity both at closing and over the life of the ESOP.

Conclusion

In conclusion, an ESOP is not inherently negative from a surety perspective, but its success depends heavily on thoughtful structuring and proactive planning.

Key Strategies for Protecting Bonding Capacity During an ESOP Transaction

When liquidity, leverage, governance and long-term repurchase obligations are addressed with surety considerations in mind, an ESOP can support employee ownership while preserving the financial strength necessary for bonded work.

Early and transparent engagement with surety partners aligns expectations, protects bonding capacity and positions the Company for sustainable growth, creating a durable, mutually beneficial outcome for the Company, its sellers, employees and surety partners.

Franco Silva joined Prairie Capital Advisors in 2007 and is a shareholder in the firm. He leads Prairie's downtown Chicago office and the ESOP Construction Advisory practice. Franco specializes in Employee Stock Ownership Plan ("ESOP") formations and capital raising engagements within the construction industry. Franco partners closely with construction clients to navigate the complexities of ownership transition. By understanding each client's unique situation and long-term goals, he designs tailored strategies that deliver the best possible outcomes for Prairie's construction clients.