CFMA NEW ENGLAND CONSTRUCTION CONFERENCE

CONSTRUCTION INDUSTRY OUTLOOK

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PPP AND ERTC

PPP

Loan questionnaires for loans in excess of $2.0M was retracted

SBA audits - only application accuracy

Non-taxable for federal; some states taxable

ERTC

2020	3 quarters	$5K per employee\per year
2021	3 quarters	$7K per employee\per quarter

- Exceptions apply
- Industries greatly benefited – contractors and manufacturers
- If don't meet the revenue test, may meet the partial\full shutdown criteria in connection with government orders
- Non-essential businesses closed, limited or no access, supply chain issues
- Expect to see many 2020 and 2021 amended tax returns
- Taxable

INFLATION REDUCTION ACT OF 2022 (IRA)

- The IRA is the biggest climate investment by the federal government in United States history
- Expansion of 179D Energy-Efficient Commercial Building Deduction

▶ $.50 per foot - maximum $1.00 per square foot ($1.88)

▶ Prevailing wages and registered apprenticeship - maximum $5.00 per square foot

▶ Expands eligibility requirements for NFP, religious, tribal, NFP schools\universities

▶ Change in energy cost savings calculations

- Qualified commercial clean vehicles
  - The credit is the lesser of

15% of the vehicle's cost (30% for vehicles not powered by a gasoline or diesel internal combustion engine); or	The incremental cost of the vehicle relative to a comparable vehicle

  - Credit limits

INFLATION REDUCTION ACT OF 2022 (IRA)

- Energy Efficient Home Credit

- Eligible contractors and home manufactures

- Beginning in 2023, the IRA provides an increased credit of $2,500 for single family and manufactured homes when constructed according to the standards set by the Energy Star Residential New Construction Program or the Manufactured Homes Program

- The IRA also provides a $5,000 credit for single family and manufactured homes when they are certified as a DOE Zero Energy Ready Home (ZERH)

- For multifamily homes constructed after 2022, the Act provides a credit of $500 when meeting the Energy Star Single Family New Homes Program or $1,000 when homes are certified as a ZERH

- Starting January 1, 2023, if homebuilders\manufacturers satisfy prevailing wage requirements
  - Multifamily credit increases to $2,500 or $5,000 for ZERH

NEW REVENUE RECOGNITION RULES

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PRIVATE COMPANIES

- Same as it ever was

DISCLOSURES

- Some CPAs continue to use old language
- Inconsistent language in the footnotes

FINANCIAL STATEMENT PRESENTATION

- Old\new\hybrid language
- Contracts receivable includes retainage if unconditional
- Contracts assets includes retainage if conditional:

The completion of future obligations under the contract	Meeting certain milestones	Performance metrics

BIG PICTURE – NEW LEASE RULES

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An entity should utilize the right-of-use model to account for leases, which requires the lessee to recognize assets and liabilities arising from a lease with a term of more than 12 months

The result is that most existing operating leases will be brought onto the balance sheet.

IN ACCORDANCE WITH THE RIGHT-OF-USE MODEL:

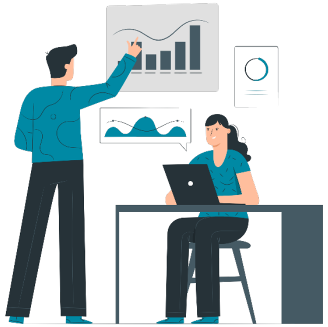
Recognize the lease liability at the present value of lease payments, discounted using the discount rate applicable at lease commencement

Recognize the right-of-use asset at the lease liability, plus any lease payments made to the lessor at or before the commencement date, plus any initial direct costs (e.g. commissions)

TWO LEASE TYPES

FINANCE LEASE

- Expectation is that the lessee will consume a major part of the lease asset
- Lease must meet criteria similar to current capital lease criteria
- Applies to most non-real estate property – equipment, vehicles, etc.
- Expense is accelerated (accelerated interest, straight line amortization)



OPERATING LEASE

- Expectation is that the lessee will NOT consume a major part of the lease asset (does not meet any of the finance lease criteria)
- Applies to most real estate property – land and buildings
- Expense is on a straight-line basis (recorded as a single lease expense)

Either way, the result is the same

THE LEASE GOES ON THE BALANCE SHEET!

NEW LEASE CONSIDERATIONS

- Effective 2022 for private companies
- Financial impact
  - Working capital and ratios
    - Current portion of lease liability
  - Debt-to-equity and debt service coverage ratios
  - Net worth – no impact
- Bank debt covenants - expect defaults
  - Update covenants
- No related party exceptions
- Option – GAAP departure, Tax Basis

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XYZ Construction, Inc.

BALANCE SHEETS

ASSETS	NEW	OLD
CURRENT ASSETS:		
Cash and cash equivalents	2,798,000	2,798,000
Contracts receivable, net	3,382,000	3,382,000
Contract assets	1,744,000	1,744,000
Inventory	1,118,000	1,118,000
Prepaid expenses and other assets	140,000	140,000
	9,182,000	9,182,000
PROPERTY AND EQUIPMENT:		
Leasehold improvements	1,309,000	1,309,000
Office furniture and fixtures	1,028,000	1,028,000
Machinery and equipment	24,929,000	28,279,000
	27,266,000	30,616,000
Less accumulated depreciation	18,453,000	18,923,000
	8,813,000	11,693,000
Right-of-use lease assets - finance leases	3,350,000	-
Less accumulated amortization	470,000	-
Total right-of-use assets	2,880,000	-
Right-of-use lease assets - operating leases	4,500,000	-
Less accumulated amortization	225,000	-
Total right-of-use assets	4,275,000	-
Net property and equipment	15,968,000	11,693,000
	25,150,000	20,875,000

XYZ Construction, Inc.

BALANCE SHEETS

LIABILITIES	NEW	OLD
CURRENT LIABILITIES:		
Current portion of long-term debt	1,255,000	1,255,000
Current portion of lease obligations	-	450,000
Current portion of lease obligations - finance leases	450,000	-
Current portion of lease obligations - operating leases	225,000	-
Accounts payable	1,078,000	1,078,000
Contract liabilities	1,019,000	1,019,000
Accrued expenses	947,000	947,000
	4,974,000	4,749,000
LONG-TERM LIABILITIES:		
Long-term debt	3,138,000	3,138,000
Long-term lease obligations	-	2,100,000
Long-term lease obligations - finance leases	2,100,000	-
Long-term lease obligations - operating leases	4,050,000	-
	9,288,000	5,238,000
STOCKHOLDERS' EQUITY:		
Common stock	1,000	1,000
Additional paid-in-capital	207,000	207,000
Retained earnings	10,680,000	10,680,000
	10,888,000	10,888,000
	25,150,000	20,875,000

XYZ Construction, Inc.

STATEMENT OF INCOME

	NEW	OLD
Net revenues	xx	xx
Contract costs	xx	xx
Gross profit	xx	xx
	xx	xx
Operating expenses:		
Interest expense	xx	xx
Lease expense	xx	xx
Interest expense - lease obligations	xx	xx
Depreciation and amortization	xx	xx
Amortization expense - right of use lease assets	xx	xx
Payroll expense	xx	xx
Utilities	xx	xx
Rent	xx	xx
Office expenses	xx	xx
Total operating expenses	xx	xx
Net operating income	xx	xx

NEW LEASE CONSIDERATIONS

FINANCE

- Same as before
- Interest and amortization

OPERATING

- No P & L impact
- Lease expense

DETAILED LEASE
PRESENTATION AVAILABLE UPON REQUEST

CONSTRUCTION OUTLOOK

INDICATORS

AIA - ABI	August, 2022	53.3
FMI Nonresidential Construction Index	2nd Qtr. 2022	53.8

Producer Price Index
PPI for construction 12.4% for 2021 (22.9% August 12 month change)

CPI 8.3 % for August 2022
construction costs rising faster than inflation

FMI – E&C 2ND QTR. OUTLOOK

Forecasted 7% growth in 2022

Growth industries – single family and multifamily, manufacturing, heavy highway, waste\sewage, water supply

Stable future despite interest rate increases, labor and material shortages, rising energy costs, recessionary indicators

CONSTRUCTION INDUSTRY CHALLENGES

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MATERIAL PRICE INCREASES AND MATERIAL SHORTAGES

- Stockpiling
- Price escalation clauses
- Alternative materials
- Waste management
- Tools and technology

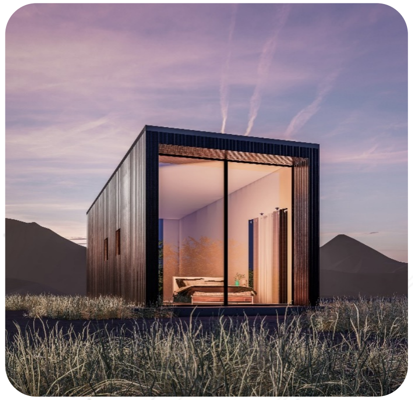
CONSTRUCTION INDUSTRY CHALLENGES

LABOR SHORTAGE STRATEGIES

- Learn While You Earn
- Cultural shifts
- Learning and development programs - upskilling, reskilling, cross-skilling
- Increase in wages and benefits
- Training facilities
- Mental and physical health

- Safety and productivity concerns for unskilled laborers
- Supply chain disruptions
- Project delays
- PLA's impact to government projects and open shop contractors
- 40 year high inflation rates
- Cyber crime

CONSTRUCTION INDUSTRY OPPORTUNITIES



- Technology advances – field and office
- Modular construction and pre-fabrication
- Green construction
- Infrastructure bill - $1.5T
- Be the employer of choice - adapting to market forces
- **"M&A Baby Boomers"**
  - Activity
  - P / E
  - Consolidations

M&A ACTIVITY

UNIQUE CONSIDERATIONS FOR CONSTRUCTION FIRMS

- Balance sheet impact
- Working capital and equity requirements
- Off-balance sheet leverage and corporate guarantees
- Indemnification agreements, guarantors and credit risk
- Assignment of contracts
- Project completion for long-term contracts
- Limited collateral for construction management firms
- Illiquid equity and highly leveraged heavy equipment construction firms
- Valuing contracts in progress and backlog
- Volatility of revenues and earnings
- Relative degree of risks compare to other industries

ESOPs ON THE RISE

- Transition ownership at fair market value while preserving legacy and culture
    - For 3rd party sales, fair market value difficult to achieve for many contractors due to intrinsic values of construction firms and assessed risk
- Added retirement benefit that can be an effective tool to both attract and retain talent.
- Tax efficiencies
    - ESOP owned S Corporations not subject to federal tax
    - Capital gain deferral afforded to sellers of C Corporation Stock (§1042)
- Flexible terms and conditions for selling shareholders
- Typically, selling shareholders and key employees participate in stock appreciation rights plans (SARs)
- Bonding considerations
    - Impact to working capital and net worth
    - Debt covenants and subordination agreements

PRIVATE EQUITY

PRIVATE EQUITY \ CONSOLIDATORS

- Strong activity in 2021 and 2022
- Drivers
    - Strong cash flow
    - Growth opportunities
    - Management depth
    - Market leader
    - Service side focused
- Strong multiples
- Favorable terms
    - Cash up front
    - Typically includes earn out incentives based on EBITDA performance
    - 2-3 year employment agreements

RECESSION PROOF?

- Fundamentals!!!
- Different time than 2007 - 2009
- Lessons learned from the last recession
- Strong demand
- Investments in technology
- Infrastructure Bill $1.5 trillion package
- Strong balance sheets
- Labor shortages – less capacity

THANK YOU!

QUESTIONS

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