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Teaching Case Study

HDR

Building a Global Employee Ownership Culture

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HDR - Building a Global Employee Ownership Culture

Teaching Case with Discussion Questions

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Abstract: This teaching case study explores the dynamics and evolution of employee ownership in HDR, a large multinational professional services firm. Broad-based employee ownership has strong affinities with professional services firms, whose success largely depends on the knowledge and capabilities their employees bring to their work. As HDR grew and expanded internationally, it had to address important issues like managing the distribution of shareholdings, cultivating and maintaining a vibrant culture of employee ownership, finding the right balance between risk and innovation, and tailoring its employee ownership model the unique institutional context of different countries. As such, its experiences are useful for understanding how employee ownership in large, multinational professional services firms evolves.

Topics: Employee ownership, multinational enterprise, cross-border collaboration, professional service firm, synthetic equity, KSOP, restricted stock

This is a teaching case study. Additional versions of this case study may appear in print. This case was developed solely as a resource to stimulate classroom discussion. It is not intended to provide management advice on how to establish or operate an employee-owned organization, or to highlight effective or ineffective management decision-making. The authors are grateful to HDR and all individuals who participated in interviews for their time and support. When requested, the authors may have disguised names or other identifying information to protect confidentiality. The authors would also like to acknowledge the generous support from Simon Pek's Social Capital Partners Fellowship from the Institute for the Study of Employee Ownership and Profit Sharing at Rutgers University, New Jersey.

Introduction

HDR is one of North America's largest employee-owned firms. With more than 200 offices worldwide, and over 11,000 employees, it is also among the world's largest architecture, engineering, and construction management companies. Founded in 1917, HDR has gone through three distinct ownership structures. Founder H.H. Henningson, along with later partners Chuck Durham and Willard Richardson, owned the company for almost 70 years before it was sold to an international conglomerate in 1983. The era of employee ownership at HDR began in 1996 when a determined group of senior managers bought the company and embraced broad-based employee ownership. Since then, the company's approach to employee ownership has evolved in important ways as it has grown and expanded internationally.

Background

Tom Sanders, Senior VP, was one of 40 managers who put it all on the line to purchase the company in 1996 and, subsequently, to prioritize broad-based employee ownership. While there are many factors that have contributed to HDR's success, Tom is adamant that employee ownership has been a central factor:

> "Employee ownership has really driven our culture. It's the idea that we all have skin in the game. What each of us does matters for everyone, so we're all in it together. In other words, while shareholdings are *valuable* for each employee, it's the shared *values* that make the difference." Tom Sanders, Senior VP

HDR is a professional services firm (PSF), which means its people are its main asset. Broad-based employee ownership – where most non-executive employees own, or have the opportunity to own, company shares[1] – has a strong affinity with knowledge-based firms like HDR that rely heavily on the capabilities of their employees. For HDR, shared ownership has been a critical factor in attracting and retaining top talent, and fostering the collaborative culture that is essential for innovative knowledge work.

Leveraging human capital to drive long-term growth requires an alignment of business strategy and ownership culture. But developing and maintaining an ownership culture takes work, especially for a multinational company like HDR that has employees in several different countries. There is no guarantee that employees from different national and cultural contexts will react the same way to common ownership incentives. Tax and regulatory issues can further complicate the development of a common share ownership model across all jurisdictions. In addition to these cross-border challenges, HDR faces several other issues common to broad-based employee-owned firms as they grow and mature, including managing share buy-back liabilities, responding to generational changes in the workforce, and finding the right risk profile in new business opportunities.

[1] Broad-based employee ownership is usually understood as situations in which non-managerial employees have the opportunity to purchase shares, or where the company grants shares widely to non-managerial employees. This does not mean that all employees own shares, although broad-based employee ownership typically refers to organizations where a significant number of employees collectively own a sizable portion of company equity (Dudley and Ruoen, 2021).

From Partnership to Subsidiary to Employee Ownership

The company was founded in 1917 by H.H. Henningson in Omaha, Nebraska, as a small engineering firm focused on local power and water infrastructure projects. Willard Richardson joined in the 1930s and was followed by Chuck Durham in 1940 … and 'HDR' was born. With Durham at the helm, HDR won its first international job in 1960, a $50M dam and irrigation project in Spain. By the 1970s, HDR had grown well beyond its roots in Omaha and had attained significant global reach.

By 1983, however, growth had slowed and the partners were approaching retirement, leading to the sale of the company to a large international conglomerate with considerable construction expertise. Over the next few years, the acquisition strengthened HDR's design-build capabilities and further expanded its global operations. But in the mid-1990s, faced with an attractive offer from another large company, the conglomerate was on the verge of selling HDR again.

Rather than go through another change of ownership, 40 senior managers decided to make a counteroffer, recognizing the intrinsic value of the company they had helped build. It was an incredibly risky decision for these individuals. They had to put significant personal assets on the line and use considerable debt to develop a competitive offer.

> "The first three years were a real financial challenge. It was like buying a house with a 1% downpayment. We had the world's worst balance sheet!" Tom Sanders, Senior VP

Thankfully, the conglomerate was willing to consider the unorthodox offer and, in 1996, the deal was closed. HDR was once again a US-domiciled company, owned by a prescient but surely apprehensive group of 40 new employee-owners.

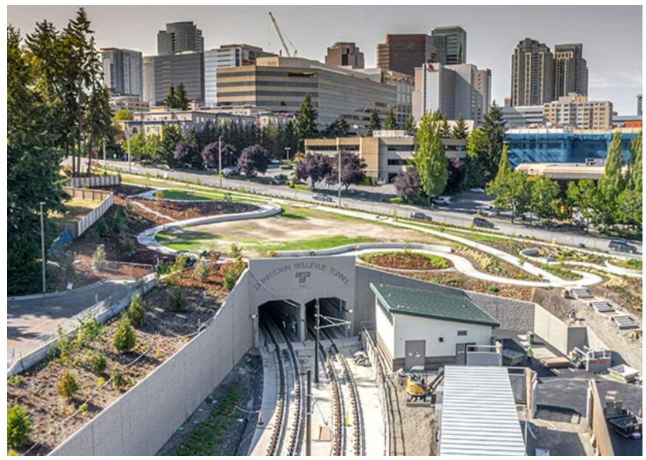
Shortly after closing the deal, the group of 40 made another pivotal decision. They decided to offer all the company's employees a chance to purchase shares. It was another remarkable strategic choice, given the risks these managers had just taken. At the time, they were unsure how many employees would take them up on the offer. But, as testament to the value of the company, almost 1200 of the 1600 employees decided to invest. Today, more than 90% of US employees own shares in the company, and most employees in other countries participate in parallel ownership plans (discussed in more detail below). Indeed, the decision to purchase the company and expand employee ownership was far more successful than perhaps anyone could have envisioned.

> "At the start, I mostly just hoped I would get my initial investment back. And if we hadn't started employee ownership, we probably wouldn't even exist today. We would have been acquired by the competing offer in 1996 and HDR would be a tiny footnote in the industry. We were approximately 1600 employees when the group of 40 managers bought the company back in 1996. Now, in 2022, we're at 11,000 employees." Tom Sanders, Senior VP

Employee Ownership Model

HDR administers an Employee Stock Ownership Plan (ESOP) on behalf of all employees in the US. The ESOP is a Trust established under the Employee Retirement Income Security Act

(ERISA) and is run by a professional external trustee and an administrative committee, both of whom have a fiduciary responsibility to make decisions and operate the Trust in the sole, best interests of employee owners. Shares that employees purchase or receive from the company are held on their behalf in the Trust. Because HDR is wholly owned by the ESOP Trust, it is a private company, which means that shares are not traded on a public stock exchange and ownership is restricted to current employees. This also means the company and the ESOP Trustee manage when and how employees buy and sell their shares within the ESOP.



East Link Light Rail Extension, Seattle

A deliberate decision was made to conduct the buy-sell period once per year. Consequently, as part of its fiduciary responsibilities, the Trustee conducts a valuation of the company and determines a share price at the end of each calendar year (which is also the fiscal year end). This valuation and the corresponding share price is announced at an Annual Meeting in early February. For an approximately two-week period following this meeting, US employees can use deferred income within their 401k plan[2] to purchase HDR stock. HDR offers approximately 15 different investment products in the 401k plan, including the option to buy HDR stock within the ESOP Trust. During the buy-sell period, employees instruct the ESOP Trustee regarding buying or selling their HDR stock allocations. This structure gives employees the convenience of having all their investments in a single 401k account, while allowing the ESOP Trust to function separately in a manner compliant with regulations. Informally, this structure is referred to as a KSOP.

To encourage broad-based employee ownership, the company matches share purchases, up to 5% of the employee's salary. In some years, there are more buyers than sellers, meaning that employees may not get all the shares they had hoped to purchase. In other years, there are more sellers than buyers, and the company must purchase the excess shares and hold them in Treasury until they can be re-sold to other employee owners in subsequent years. In recent years, this re-purchase liability has grown due to increasing retirements by senior managers, many of whom bought into the company early and have accumulated considerable share value over their careers.

Managing the distribution of shareholdings as senior employees retire and new employees join is an important consideration for privately held employee-owned firms. As discussed earlier, stock ownership is a strong contributor to talent retention, which is a considerable strategic advantage in knowledge industries like architecture and engineering. But long-term stock ownership also creates a phenomenon known as the 'golden handcuffs.' Since employees accumulate HDR

[2] 401k plans are regulated retirement savings plans which allow employees to defer a portion of their pre-tax or after-tax income for each pay period. Pre-tax contributions reduce taxable income but subsequent withdrawals from the plan are taxable. Withdrawals of after-tax contributions, on the other hand, are tax-free (for more information, see https://www.investopedia.com/terms/1/401kplan.asp).

stock while employed, a decision to leave the company and sell their holdings can have significant personal tax implications. This tax liability grows larger the longer the employee stays at HDR, especially since HDR's valuation has appreciated considerably since it became employee owned. In short, the longer an employee has been with the company, the stronger the incentive to stay.

While retaining experienced employees is obviously a key benefit of employee ownership, it can lead to an undesirable concentration of ownership by a small cohort of long-term employees, even if most employees participate in the plan. This can be exacerbated by the fact that younger employees, who may be starting families and buying their first homes, can be put off by the idea of locking in much-needed income in HDR stock.

> "If you don't deliberately tend to the business of employee ownership, with thousands of employees - even if no one owns more than 1% of the company - you can eventually find that only 100 of the employees own more than half the company. Often these are senior employees who have money to spare and can afford to purchase shares. Younger employees, starting out in their careers, don't have this financial flexibility. You have to do some deliberate things to make sure that doesn't happen." Tom Sanders, Senior VP

To mitigate these challenges, HDR has recently implemented a discretionary distribution of shares to all employees. In good years, shares are distributed, at no cost, to all employees based on a percentage of their salary, with the condition that these 'restricted' shares cannot be sold back to the company until a vesting period has passed and the employee leaves the company for one reason or another. For instance, after a successful year in 2021, every employee was given 5% of their salary in restricted shares. But there is also a cap on the total value that the most highly compensated 1/3 of employees can be granted. These practices help ensure a more equitable distribution of equity among all employees, a core tenet of broad-based employee ownership and an important factor in fostering a sense of shared ownership. Currently, in the US, approximately 75% of HDR's share equity is owned by employees who purchased their equity, with the remaining 25% allocated as discretionary share grants.

Building an Ownership Culture

The benefits of broad-based employee ownership multiply when financial incentives and employee engagement converge in a vibrant ownership culture. This culture is captured by a quote on the website from one of HDR's employees:

> "I find myself behaving differently, knowing that this is my company. When I stand in front of a client, I'm representing my own company. So I step it up a little bit, right? I'm representing myself, my company."[3]

However, finding the right balance between monetary incentives and cooperation can be a challenge in employee-owned firms. Monetary rewards can drive individualistic behaviour if not properly aligned with overall company performance. Free riders can exploit the work of others for personal gain. Ownership incentives can be diminished if employees do not feel they have voice in organizational decision-making. At HDR, considerable effort is put in place to ensure that everyone is 'rowing in the same direction.' For example, widespread employee input is a key part of the strategic planning process, which takes place every five years. During this

[3] See https://www.hdrinc.com/ca/employee-ownership.

process, employees at all levels within the organization are surveyed and each regional office undertakes a workshop with employees around key questions related to the strategic plan. Getting this input is important to ensure that the strategic values of the company align with those of its employee owners.

> "You can see the results of that feedback at the grassroots level built right into the strategic plan. It's amazing, and it's in the interest of the company to recognize that feedback because, at the end of the day, those employees are investors in the company and you have to maintain their confidence." (Jim McKay, Managing Director, Canada)

Of course, as legal shareholders, US-based employee-owners also have the right to vote for Directors of the Board.

Waldkliniken Forest Clinic, Eisenberg, Germany

Expanding an Ownership Culture across Borders

The issues discussed so far are important considerations for many employee-owned companies as they mature. However, there are unique challenges for multi-national enterprises like HDR. Key among these is how to replicate an ownership culture across national and cultural borders.

HDR is a privately-owned corporation that is incorporated in the US, and the ESOP is a registered employee benefit plan that is only available to US-based employees.[4] With no shares traded on international stock markets, it is difficult for non-US employees to hold HDR equity. However, given the strong commitment to broad-based employee ownership, HDR had to come up with an effective model that provides employees in Canada, as well as those in Europe, Asia, and Australia, with the same incentives and sense of ownership as US-based employees.

The solution was to create two synthetic equity instruments: phantom shares and Deferred Share Units (DSUs).[5] Phantom shares appreciate at the same rate as common shares, without actual legal share ownership. DSUs are like phantom shares, with the exception that they cannot be redeemed until retirement or termination of employment. Both phantom shares and DSUs are intended to simulate the incentives of share ownership where actual share ownership is not possible. Employees can purchase phantom shares. However, DSUs are granted to employees by the company as discretionary or matching contributions.

While synthetic equity is a close approximation to common shares held in the ESOP, there are

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[4] Employee Share Ownership Plans (ESOPs) are generally administered by a trust that holds share equity on behalf of all employees. Although the trust holds the shares, it maintains notional equity accounts for each employee. ESOPs are supported by favourable tax policies. For example, employee contributions are not taxed, and the distributions may be taxed at a combination of income tax rates, and more favorable capital gains rates. See https://www.nceo.org/articles/esop-employee-stock-ownership-plan for more information.

[5] See Appendix for a summary of common synthetic equity instruments.

some inherent differences. For instance, synthetic equity is not legal property; rather, it is simply a contractual agreement between the company and the employee. Therefore, synthetic equity holders do not actually have legal ownership of the company. This means that in the event of a liquidation of the company, synthetic equity holders are subordinate to common shareholders, meaning they only get the value of synthetic equity after obligations to all shareholders have been settled. This also means that they do not have the same rights as shareholders, notably voting rights for the Board of Directors. However, because HDR has been so successful, and because they put considerable effort into engaging with employees, these limitations have not been a major issue for non-US employees, as discussed below. But they do represent some important considerations for multinational enterprises that are seeking to use synthetic equity schemes to extend ownership across borders.

Shared (Synthetic) Ownership in Canada

Although the majority of HDR employees are in the US, Canada is one of its fastest growing markets. Since 2018, the number of employees in the Canadian operations has more than doubled, and more than 70% of Canadian employees participate in HDR's synthetic equity program.

Jim McKay is the Managing Director for HDR's Canadian operations. He is responsible for leading the architecture, engineering, planning, and consulting practices in the Canadian marketplace. A veteran of employee-owned companies, having worked in two employee-owned firms prior to HDR, as well as a stint with HDR earlier in his career, Jim took on this role in 2018, excited about the prospect of further developing the ownership culture in HDR Canada. He believes that employee ownership, even in a synthetic form, has played a key role in the success of the company, particularly for the recruitment and retention of experienced professional staff:

McLoughlin Point Wastewater Treatment Plant
Victoria, BC, Canada

> "I do a lot of interviews and the chance to benefit from ownership is one of the top three, perhaps even the number one reason that people choose HDR." Jim McKay, Managing Director, Canada

But employee ownership is more than just a means to attract top talent with financial incentives. Jim understands that the main benefit of employee ownership programs is a collaborative culture, which is especially valuable in a knowledge-based firm like HDR.

> "I spend a lot of time talking to new employees about the value of ownership. Most of these conversations are not just about the financial benefits; it's usually more about the culture that we're trying to achieve. By getting everyone rowing in the same direction, we all get a piece of the success." Jim McKay, Managing Director, Canada

Of course, the organizational benefits from a vibrant collaborative culture only emerge if there is widespread buy-in by most or all employees. Thus, when designing employee ownership plans, including synthetic plans, it is important to understand how the opportunity is perceived by employees at different stages in their careers. Synthetic equity does not qualify as an RRSP- or RESP-eligible investment,[6] so younger employees looking to use tax-sheltered savings plans for the purpose of purchasing a first home or saving for their children's education may be less inclined to purchase synthetic equity. For similar reasons, early-career employees may be less inclined to defer current income into locked-in investments that can only be redeemed at retirement or termination of employment.

Bryanna MacDonald started her career at HDR and has been with the company for 8 years. She is currently an Alternative Project Delivery Specialist working from the regional office in Victoria, BC, Canada, although she routinely gets involved in projects across Canada. She appreciates the chance to share in the success of the company and participates in the synthetic ownership program.

> "When I'm having a challenging day, I remind myself that I'm contributing to this company and there are other people who are benefiting along with me. I take pride in the idea that I'm contributing to the well-being of others." Bryanna MacDonald, Alternative Project Delivery Specialist

But, as a recent first-time home buyer, she acknowledges that she has only used a small portion of her paycheck to purchase HDR equity in her first eight years. She likes the idea of being an owner but is limited in her ability to lock in a significant portion of her paycheck in investments that cannot be easily liquidated. She also wants to make sure her investment portfolio is sufficiently diversified, which can be a challenge for employee ownership.

Additionally, although synthetic equity is intended to mirror the returns from share ownership, it can be perceived to be a less 'authentic' form of ownership and, as a result, may not foster the same ownership culture. Synthetic equity can also be harder for employees to understand. That said, HDR's experience with synthetic equity in Canada has been quite positive. The limitations of synthetic equity – notably the lack of voting rights – are typically not an issue when a company is doing well. However, they can become controversial if a company faces unexpected challenges and synthetic owners grow concerned about the viability of their synthetic equity. This outcome seems very unlikely in the case of HDR, but it is an important consideration in designing synthetic equity models.

Risk and Innovation

Like many professional service firms, HDR has a decentralized matrix organizational structure, with regional directors in each country having considerable autonomy to pursue business opportunities. Employee ownership aligns well with this non-hierarchical organizational

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[6] Because Registered Retirement Savings Plans (RRSPs) are tax-sheltered accounts, only qualified investments are permitted. First-time home buyers in Canada can borrow from their Registered Retirement Savings Plans (RRSPs) to make down payments without tax penalties, provided it is paid back to the RRSP within a 15 year period. Registered Education Savings Plans (RESPs) allow Canadians to save money for educational purposes in a tax-sheltered account.

structure. Because employees' personal interests are closely aligned with the company's success, there is a strong incentive to think like an owner, helping to ensure that regional autonomy does not jeopardize overall strategic direction or degrade into silo mentality.

> "I worked for a company early in my career where, because of a deep-seated silo mentality, two separate offices unknowingly submitted competing proposals to the same client! At HDR, because we're all owners, collaboration is more natural. We'll hire employees in one office in Canada to support a project being led by another office in the US, all without any formal agreements." Jim McKay, Managing Director, Canada

Employee-owners who do business development are more likely to think carefully about the risk-profile of potential opportunities, effectively balancing the desire to pursue exciting project opportunities against the need to protect the company from risk. Project staff are more likely to raise concerns about emerging problems with existing projects, helping to make course corrections earlier and avoid wasting valuable time and resources. By directly connecting personal rewards with company performance, employee ownership can help draw out the benefits of matrix structures while mitigating some of the drawbacks.

That said, the risk pendulum can swing too far in the opposite direction. A common criticism of employee-owned firms is that they are too risk averse because employees tend to focus on 'safe' revenue rather than taking on risky business development opportunities. In competitive markets, this can mean losing big projects to other firms. For companies focused on short-term profit, this can be devastating. But HDR has chosen to focus on long-term, low-risk growth.

> "We've grown a lot since we bought ourselves back in 1996. But if you look at comparable companies in our industry, there are certainly many cases of much higher growth rates. However, that's ok with us, because our emphasis is on sustainable, measured growth that doesn't impose a lot of risks." Jim McKay, Managing Director, Canada

For example, Public-Private Partnerships (P3s) are an increasingly popular model used by governments to finance large infrastructure projects. In P3s, the private sector partners agree to build *and* operate an infrastructure project. Rather than receiving full payment upon completion, the private sector partners remain involved in the operation of the project, collecting returns through user fees and sharing the financial risk over the long term. Many of HDR's competitors are actively involved in large P3 projects, but HDR has limited exposure.

> "The big P3 (public-private partnerships) work is riskier than doing traditional contract engineering services. As a partner, you're putting your profit at risk over the longer term, based on the operating success of the project. We do very little P3 work, and it's purely because of the risk profile that goes along with it." Jim McKay, Managing Director, Canada

A second issue concerning growth is the limited ability of employee-owned companies to finance mergers or acquisitions. Private broad-based employee-owned companies are less likely to borrow money than publicly traded companies, partly because of the difficulty of providing loan collateral but partly because of the conservative risk profile of employee ownership. Yet HDR has found a way to turn this limitation into a strength.

> It can be difficult for us to compete head-to-head with large publicly traded firms on mergers and acquisitions. They're willing to incur significant leverage to pay sometimes more than market value for target companies. Everything we do is self-financed; we don't take on debt to acquire companies. And we tend to focus more on

> organic growth, which can be a bit more involved in the short term as there are often some significant overhead costs associated with it. But we believe organic growth, with a strong focus on cultural alignment, can be a highly effective growth model over the long term." Jim McKay, Managing Director, Canada

Ultimately, what is clear is that broad-based employee ownership requires a long-term strategic perspective. While it can be tough to give ground to competitors, the payoffs of a careful approach to risk and growth come through consistent long-term financial performance and improved organizational resilience.

Conclusion

HDR represents a unique case of how employee ownership evolves as a large company matures. Employee ownership is an important source of competitive advantage, particularly for knowledge-based firms like HDR, but it also needs to be constantly monitored to ensure a widespread and collaborative sense of ownership as employees join and retire, and as the company grows internationally. Looking forward, the ownership culture at HDR will surely continue to be the foundation for growth and innovation.

Discussion Questions

1. As discussed in the case, collaboration and knowledge work go together. HDR is a relatively non-hierarchical firm due to its matrix organizational structure, which means collaboration must emerge from the ground-up. On the face of it, employee ownership should facilitate the collaborative benefits of matrix organization while mitigating some of the limitations. Can you think of reasons why this may or may not be the case?

2. Synthetic equity can be a cost-effective way for employee-owned multinational enterprises to extend an employee ownership culture across borders. Do you think synthetic equity plans can effectively foster a sense of ownership? Why or why not? (Review the Appendix, and some of the links provided there, to learn more about synthetic equity). What other challenges might a multi-national enterprise like HDR face in establishing and administering employee ownership across borders?

3. An increasingly important line of business for HDR is sustainable design and construction. This means creating buildings that minimize CO_2 and other air pollutants, reduce impacts on local ecosystems, add value to local communities, and provide healthy workplaces. Do you think employee ownership helps or hinders HDR in pursuing a sustainable business strategy? Why?

Appendix – Synthetic Equity

Synthetic equity comes in two basic forms: full-value and appreciation-only. Full-value synthetic equity is commonly called phantom stock (or 'shadow stock') and is a contractual agreement used to mimic the performance of common equity shares. Holders of phantom stocks are not actual shareholders; rather they simply have a contract with a company that promises to pay them the current value of the reference shares when the phantom stock is redeemed. Phantom stockholders may also be entitled to periodic payments that match dividends payable to common shareholders.

A Deferred Share Unit (DSU) is a combination of income deferral (which is typically used to defer taxes) and a full-value phantom share. Typically, employees can elect to use a portion of their pre-tax income to purchase DSUs, which then match both the performance of common shares and any dividend payments (which are usually converted into additional DSUs on behalf of the employee). Importantly, DSUs cannot be redeemed until retirement or termination of employment.

Holders of appreciation-only synthetic equity instruments like Stock Appreciation Rights (SARs) are only paid, in cash, the difference between the original and current value (i.e., the appreciation value) of the reference shares. They are not usually entitled to matching dividend payments, but holders can usually redeem SARs at any time (unlike phantom shares and DSUs which have minimum holding periods, often until retirement or termination of employment).

Employee stock options plans can also be seen as a form of synthetic equity. Options give employees the right, but not the obligation, to 'exercise' the option and purchase company shares at a specific price, called the 'strike price', on or before the expiry date of the option. Options plans may also include minimum 'vesting' periods that restrict exercise until a stipulated period has passed. When employees exercise these options, they become legal owners of company shares, although option exercise can also be cash-settled. Of course, it only makes sense to exercise options if the strike price is at or below the fair market value of shares. If the strike price remains above the market value of company shares at expiry, the options expire worthless.

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