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Wealth Planning Update

Selling Your Business in a Late-Cycle Economy

AUGUST 2018

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In this Wealth Planning Update:

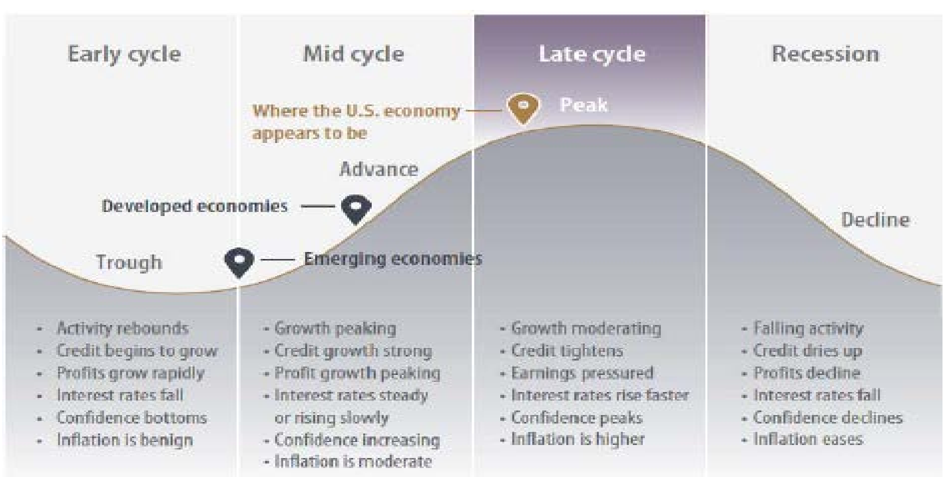
» *The economy appears to have entered the late-cycle stage, and many business owners may be viewing this as a potential opportunity to either sell their business or ride the wave of the next cycle.*

» *The sale of a business is a once-in-a-lifetime event for most owners. As such, your business, lifestyle, and financial future can be significantly impacted by the timing of a sale.*

» *Carefully consider your personal and business transition goals and timeline, review the readiness and attractiveness of your business, and discuss with your team of advisors whether you should accelerate your business sale or draft a plan to ride the wave of the next business cycle.*

Several traditional indicators have appeared that signal the U.S. economy has entered the late stage of the business cycle. One such indicator is the Federal Reserve policy rate increase in June, the second for 2018, and the prediction for two more hikes by year-end. This is likely to dampen growth, keeping inflation in check, but also slow the rate of economic expansion. These late-cycle dynamics often result in business valuations peaking, causing owners to question their transition timeline. You may wonder whether you should accelerate the sale of your business or if you should hold through another business cycle. While there are numerous factors and risks that influence this sell-versus-keep decision, predicting the “right time” to sell is difficult and perilous.

The Four Phases of the Business Cycle



Source: Wells Fargo Investment Institute, June 2018.

Business cycle timing

Although most investment professionals advise against market timing, in the case of privately held businesses, understanding the link between value and business cycles is critical to making confident decisions. This is especially true when timing the transition of your life's work and, typically, your most valuable asset.

Wells Fargo Investment Institute believes we are experiencing an "ongoing economic expansion, which appears to have room to run. In our view, the economy is in the final third of its expansion." In other words, as shown in the chart on the previous page, we may be almost to the peak of the Late Cycle. Market professionals, Association for Corporate Growth (ACG), in their 2018 Middle Market Trends Report anticipate valuations rising in 2018 buoyed by strong U.S. profits. They say, "The surplus of cash and the current phase of the economic cycle could increase buyers' willingness to bid assets higher."

Yet, you may be hesitant to consider a sale as you may be reluctant to give up the cash flow and perks of ownership, especially during a buoyant economy with a promising outlook for the business. Maintaining the status quo means postponing a near-term transition, forgoing today's attractive valuation multiples, and riding out the full business cycle until once again the economy is at an advanced stage with favorable multiples applied to healthy earnings. This is the ideal scenario. But often a downside situation develops that requires the owner to consider a sale at a less favorable time, perhaps during the Recessionary (Decline) or Early (Trough) Cycle, perhaps as a result of unforeseen health or family challenges or changes in the industry. This may result in selling at a lower multiple of, lower earnings on, or less beneficial terms. The compounding impact of that trifecta can have material effects on the outcome for a selling business owner.

While we cannot predict the peak of the current market, Darrell Cronk, President of Wells Fargo Investment Institute, wrote recently that "late cycle does not mean end of cycle." This is good news for business owners considering a sale. An extension of the economic expansion allows for more time to consider ownership changes. However, "macroeconomic research firm Gavekal Research believes a recession could be nearing as early as March 2019."[1] Yet as of June 2018, *The Wall Street Journal* recession probability index for the next 12 months remained low at 16%, and most economists don't expect a recession until 2020. Some economists currently believe we will enter recessionary territory by late 2019.[2] Additionally, while we do not know how long the next cycle will take to return to an advanced stage, the National Bureau of Economic Research shows the average length from business cycle "peak to peak" for the 1945-2009 period (which included 11 market cycles) was 68.5 months, or 5.7 years. Our current economic expansion is now 110 months long, 10 months short of the longest cycle of 120 months (1991-2001). These indicators suggest that the window is closing to make a decision to sell, if that is your plan, or prepare to hold on through the next cycle.

Because of the positive economic performance during the expansion, merger-and-acquisition (M&A) activity and valuations have displayed strong upward trends. The median deal size in the first quarter of 2018 was $47.9 million[3] with the average earnings before interest, taxes, depreciation, and amortization (EBITDA) multiple of all deals closed was 6.9x.[4] While the number of M&A deals closed in the quarter was down 18% year-over-year,[3] the deal pipeline remains strong and is expected to be up in 2018 (as compared to 2017),

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[1] *Gavekal Research Ideas, July 11, 2018*
[2] *Pitchbook 2Q 2018, PE Market Report, pitchbook.com*
[3] *Pitchbook 1Q 2018, MA Report, pitchbook.com*
[4] *MA Report, May 2018, GF Data Resources LLC, gfdata.com*

primarily due to the U.S. tax reform and a stable European economy. Many economic professionals believe the M&A market may remain strong well into 2019 before market uncertainty and potential recessionary pressures may enter the picture, but no one knows for certain.[5]

From past experience, we know that a buyer's expectation of the economy may influence their perception of economic upside in a potential acquisition, impacting what they are willing to pay for a target company. As the economy "flattens" from mid to late cycle, upside becomes more limited, resulting in a reversal in the multiple trend we have experienced recently. Strategic buyers traditionally will start to add additional requirements and look for more specific synergies to justify their acquisitions. Private equity firms may look for more favorable, performance-contingent deal terms and potentially lower multiples as they do not have the benefit of the synergies created by a strategic buyer and are often more sensitive to the availability of credit to fund acquisitions and, of course, the accompanying interest rates. Both of these factors become more challenging in the late cycle.

"Presale" planning

While a focus on the timing of the business cycle relative to a sale is important, it is not the only factor; equally critical is properly planning for the sale. Presale planning may positively affect the ultimate multiple a seller receives, the after-tax proceeds realized, and how effectively the owner's financial goals are achieved. Wealth planning professionals have a wide range of strategies and tools to employ when an owner is selling an asset, especially when the asset is a business enterprise. Yet, these tactics are complex and involve personal financial and tax analyses and cannot be implemented overnight. Adequate due diligence with the appropriate experienced advisor can be pivotal to selecting the strategy right for you and your situation.

A question we regularly hear from business owners is, "How soon should I start preparing for the sale of my company?" While the answer is straightforward, it does surprise many. Generally, it takes 6 to 12 months to run the sales process from start to deal closing. This is often preceded by three to six months of preparation to ascertain and implement needed changes to the business to help enhance attractiveness and readiness of the business for the sale process. In some cases, these preparations can take much longer, such as when financial reporting needs to be improved. Thus, a minimum of 9 to 18 months from the time the process is started until the business is sold is common.

Of course, this "go to market" timeline should be preceded with advanced wealth, personal cash flow, and tax planning. Many owners skip over this critical phase as the allure of a liquidity event can be so enticing and create the false sensation that there will be plenty of proceeds to mitigate unnecessary tax leakage. Yet, without proper advanced planning, owners may not enter a transaction with the right ownership structure or seek the appropriate transaction structure, compromising the net proceeds they receive and miss the opportunity to help ensure their family's financial security. We advise owners to begin presale planning as soon as an owner has decided a sale is the most likely ownership transition path, regardless of how imminent or far in the future it may be.

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[5] *Pitchbook 1Q 2018, MA Report, pitchbook.com; MA Report, May 2018, GF Data Resources LLC, gfdata.com*

Summary

If you are a business owner considering selling in the next five years, now is the time to meet with your team of advisors and have the sell-versus-keep conversation. Evaluating your options can help you decide whether to begin the sale process now or postpone transition, riding the wave of the next economic cycle. Regardless of which you choose, ask your advisor what presale planning strategies you may employ to help enhance the financial, personal, and business outcomes you desire. Developing a strategy now to be implemented when the time is right for you helps ensure a higher probability of achieving your goals and ultimately realizing transition success.