January 2017

TRANSACTION ADVISORY NEWS

Why Are So Many Businesses Selling?

The following insights are provided through the experience of Wade Kozich, Director of Transaction Advisory Services at GBQ Partners LLC. GBQ's Transaction Advisory Services group is involved with approximately 100 transactions annually.

When I first sit down with an owner who has expressed an interest in pursuing an ownership transition plan, my first question is always "Why?" I have a strong belief that owning and operating a successful, closely-held business is truly a joy and a blessing, especially if the owner is still vibrant. So why are so many middle market businesses being sold these days? From my experience there are four common reasons owners are electing to transition now:

1. The Aging Baby Boomer Demographic

Often, the owner is an aging Baby Boomer nearing retirement with no capable family member or heir to take over running the business. In some instances, it is an owner who is burned out and ready to move on to something else in his/her life. A common belief amongst these owners is that it is going to be harder for them to compete in the future due to tougher regulations, increasing technology demands and/or increasing competition.

2. High Valuations

The owner believes he or she can get a high price for the business based on buzz about valuations, calls or letters from interested parties, friends who have gone through transactions and other media about liquidity in the market chasing deals. In addition, many of these owners believe their business is operating close to its peak, or that it has evolved as much as it can under current ownership.

3. Fear of the Next Recession

Most owners who experienced the trauma of the recession and have some interest in selling do not want to wait until the next recession hits. While most of the economic news seems positive these days, business owners remember this was also the case before the "Great Recession" starting in 2008.

Why Are So Many Businesses Selling? (cont.)

4. Owners can "have their cake and eat it too."

While the previous three reasons are easily relatable, this last one may not be so obvious.

On a very regular basis, many companies, even smaller ones with as little as $500,000 of cash flow, are selling a 70-80% interest to investment firms, like Private Equity or family offices. In situations where the company is strong enough, owners may be able to sell a minority interest. What does this accomplish?

Monetizing a large portion of the value of the company while de-risking and diversifying wealth. For many owners, a good portion of their net worth is tied up in their business. While the owner may have all the confidence in the world in his or her business, small, closely-held businesses would generally be considered a risky asset class as compared to a diversified portfolio of stocks and bonds. As one gets older, risk aversion starts to weigh more heavily. The first lesson in investing is to understand diversification, which is not having 90% of your net worth tied up in one closely-held business. Further, a large nest egg to rely on can also give business owners a different outlook on life and on their own businesses. The selling owner no longer bears the financial liability or risk of the business.

Adding talent and support. By picking the right private equity group, the owner adds a level of sophistication of tactical and strategic thinking to the company that may have never been experienced previously. Furthermore, private equity often brings in industry advisors or new additions to the management team that create improvement and fuel growth. Coupled with financial backing, this expertise can accelerate organic growth as well as growth by way of acquisition.

Continuity of the CEO position with a path to exit when appropriate. In most cases the owner retains the President/CEO position. We find that the length of time a CEO stays in that position varies based on that person's individual goals and future plans. A common theme we hear from CEOs after a private equity deal is that they get a "second wind," which can be very invigorating. Even after relinquishing the CEO role, the owner typically has a consulting role and a board seat.

Driving the value of the 20-30% retained interest. The added talent and financial backing consequently increases the chance of obtaining a higher return on their retained 20% or 30% interest. Many private equity firms reference their success in helping the owners create more value in the 20-30% than was generated in the sale of the 70-80%. This is often referred to as the "second bite at the apple."

Why Are So Many Businesses Selling? (cont.)

Private Equity investing has replaced, to a great extent, Initial Public Offerings (IPO) as a Liquidity and Ownership Transition strategy. For the most part, only very large deals can afford to be done through an IPO. Private Equity has created a very efficient marketplace for even smaller businesses to seek liquidity.

This is not to diminish the benefits of selling to a strategic buyer, especially if an owner is ready to sell 100% and walk away from the business. Strategic buyers have the advantage of industry knowledge and may be able to pay more through natural synergies. Fully understanding the difference between selling to a strategic buyer vs. a private equity buyer is very important.

Any time someone is considering transitioning ownership, we recommend learning about all the various options before selecting a path forward. This ensures the option is suitable and properly aligns with the owner's individual and business goals. For example, employee stock ownership plans (ESOPs) can also check some of the "have your cake and eat it too" boxes.

We understand these owners have spent a great deal of their life building their businesses and in turn how important they are to the owners. It is important to remember that 100% of ownership of businesses eventually transfer, but some are done the right way in a manner directed by the owner and others may not be in control or select the best option.

It is really special to be a part of an ownership transition process that is successful in meeting all of the objectives of that selling owner. This begins with a well thought out plan and you can never begin planning too early.

Wade Kozich, CPA, CEPA
Senior Director
wkozich@gbq.com
614.947.5255