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BUILDING VALUE

A Business Valuation Newsletter for Business Owners and the Professionals Who Advise Them

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Long Term Growth: Have the Facts Changed?

Recent political, fiscal and economic events in the United States have changed the fundamental relationship between the federal government and its citizens. Some say the changes, and their economic impact, are permanent - the cost of capital has fundamentally changed. While that claim should be met with skepticism, if true, it has significant impact on the work of anyone who is valuing businesses, intangible assets, damages, or anything else that requires a long term "crystal ball."

The difference between a capitalization rate, used to value a single sum, and a discount rate, used to value varying future benefit streams, is the expected long-term growth rate. While not the result of a scientific sampling, it is my impression that most valuators use historic inflation or historic growth in Gross Domestic Product as the basis for their projection. Many use both as support for their estimate. Short- to mid-term expectations are that both of those measures are going to be very different than we have become accustomed to. The question is how much should you let recent developments impact your long-term growth estimate? And, what do you do when those two indicators go in opposite directions?

Gross Domestic Product (GDP) is a measure of private consumption, government spending, business capital spending, and the nation's net exports. It is widely viewed as a measure of economic well-being and productivity. Historical growth in GDP generally ranged from 4 percent to 6 percent annually. Since 1790 the average growth in GDP has been 3.8 percent per year. However, from 2000 through 2012 the average growth has been only 1.8 percent. Some believe this is indicative of the long-term future. Significant events that cause some economists to question whether this might be the "new normal" are:

- Government spending as a percent of GDP for the last three years has been 24 percent. This is the highest level since World War II.

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Growth in a Vacuum: Maximizing Value in a Depressed Economy

Borrowing from noted "business adviser" Norm "Normie" Peterson, "It's a dog eat dog world out there – and I'm wearing Milk-Bone underwear." Between a shrinking economy, growing competition and disappearing customers, business owners can't seem to catch a break.

And given that owners are seriously considering exit strategies more than ever before, countless opportunities exist for financial professionals to pull their clients out of the financial mire. Regardless of the exit strategy chosen, maximizing the value of the business makes perfect sense.

The *astute* businessman – and his advisors – looks at the lemons and starts building a lemonade stand. By helping clients to understand the various factors that drive a company's value and make a few simple changes, owners can make the most of the current opportunity for growth and squeeze every last dollar of value out of their closely held business.

Of course, any discussion of increasing value has to begin with an understanding of what value *is* – and what it *isn't*. To begin with, let's consider some sobering truths. I regularly ask business owners the following question, "What is your greatest financial asset?" Too often the question is greeted with blank stares.

Unfortunately, many owners may not realize that their small business is the crown jewel of their financial treasure. They may think of it as "just a job." As a result, they run the company without regard to creating value that they can ultimately benefit from when they sell their business.

But, make no mistake, the most important time to plan on getting *out* of a business, is when you're getting *in*. Thinking frequently of how and when to leave a business from the very beginning forces the owner to look more carefully into the future and ultimately guides day-to-day decisions.

Entrepreneurs should consider different exit strategies at the inception of a new business. Remember that the exit from the business is the payoff for the years of financial risk, sleepless nights, family birthdays on the road, and other unpleasantness. Unfortunately, too many business owners put off thinking about exiting their business until they are ready to retire.

Instead, the business owner should begin with the end in mind. The most important thing for an owner to remember is to have a clear vision of their ultimate objectives from the very beginning. But now for the good news if your client isn't one of those rare prophetic owners – it's never too late to make changes.

A successful exit strategy should revolve around three primary objectives: maximizing value, minimizing taxes and optimizing timing.

As we are very aware, value can be described as something intrinsically desirable. Maximizing the value of a business often revolves around positively impacting other people's perceptions of the business, so that they find it intrinsically desirable.

A business owner should know and understand indicators of high value and low value. Of course, indicators of high value include high sustainable cash flow, room for the business to grow, and low failure rates for the industry in which the business operates. Indicators of low value include heavy reliance on the existing owner, few assets, and concentration of the business in only a few customers.

While valuation professionals will be very familiar with how different business characteristics impact the three approaches to value, most business owners won't. It makes sense then for advisors to concentrate on the following key areas of business opportunities.

LEVEL OF SALES AND PROFIT MARGIN

Is it a business with smaller sales volume and a higher margin, or one with higher sales where operations may allow for improvement and/or growth?

FINANCIAL STRENGTH

Does the company have undervalued assets? Are there inventories that can be used as collateral for financing? How much pre-acquisition leverage is acceptable?

GEOGRAPHIC LOCATION

Where is it located? Is it the only acceptable location? Will efficiencies of scale materialize only if the target is within a certain area?

PURCHASE PRICE, FINANCING TERMS

How much is budgeted? What is the seller's financing? Is an

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earn-out provided for? What financing resources are available? How much value is perceived in the eyes of the lender?

MANAGEMENT STRENGTHS AND WEAKNESSES

Will current management stay? Are there specific management strengths not present?

MARKET AND MARKET STRATEGY

Is the buyer hoping to acquire a particular segment of the market by buying the company?

HISTORY AND REPUTATION

Is the company a family business? Will it be difficult to persuade the key employees to remain?

PROPERTY, PLANT AND EQUIPMENT

Are assets at or under capacity? Has the equipment been well maintained? Is it paid for?

LIABILITY ISSUES

Are there identifiable or contingent liabilities? Are there proposed changes in safety or environmental regulations that affect the industry? Will the company have difficulty complying?

INDUSTRY AND TYPE OF COMPANY

What bearing does product selection have on profitability and growth? Is the business cyclical and what is the competition like? Would it be easier for a buyer to purchase or start the business from scratch? Are they buying your job or a business? What have other similar businesses been sold for in the past?

Naturally, one of the most important factors is the ability of the company to continue to grow without the current owner. It must be a well-oiled machine that can operate on its own. It may be difficult for them to hear, but owners should take steps to make themselves as dispensable as possible. Obviously, buyers place a higher value on companies that can run themselves.

By the time the exit strategy is implemented, whatever it is, the business should be as hands-off as possible. This is the perfect proof that top managers and employees can handle running—and continue growing—the business without the owner.

The owner must consider the tax ramifications. The "tax monster" can take a huge bite unless the exit is effectively structured. Minimizing taxes in an exit strategy begins with selecting the best entity structure.

Serious consideration of a business exit should include strategies that are significantly tax favorable. As the name implies, tax-free split ups, tax-free spin offs, and tax-free exchanges all offer tremendous potential tax saving advantages to the business owner.

In addition, selling all or part of the company to an Employee Stock Ownership Plan (ESOP) should be considered as it enables the owner to keep the business in the "company family" while converting ownership to liquid assets.

The final objective of the exit strategy is to optimize timing. The best time for an exit is when the business owner *wants* to – not when they *have* to.

In short, even though the tepid economy of the past several years has placed a significant burden on business owners throughout the country, it has presented valuation professionals with extraordinary opportunities for practice development as they help fifty- and sixty-somethings ride off into the sunset.

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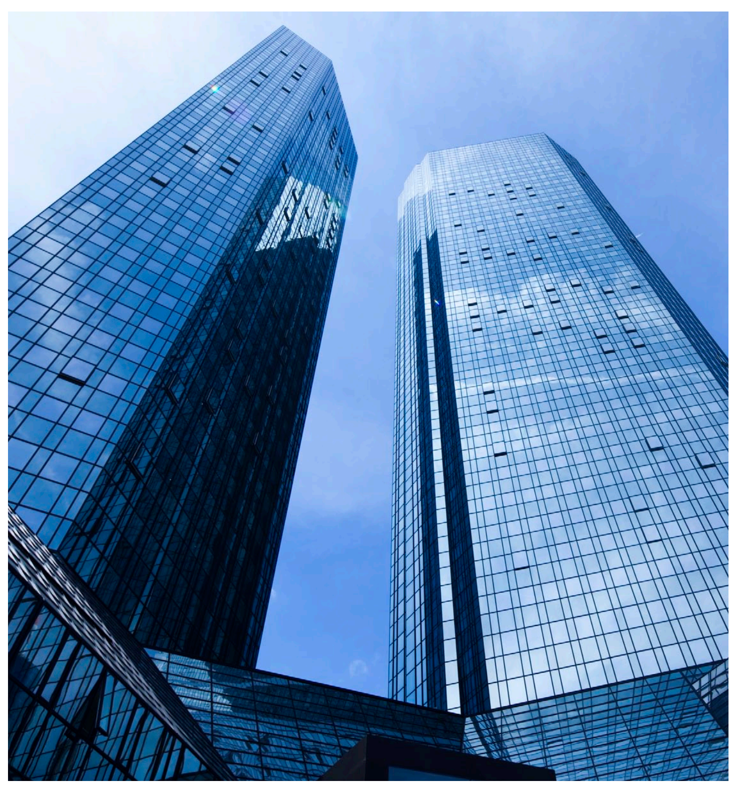

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- Government spending is expected to grow as the demographics of this country age and more citizens are eligible for full Social Security and Medicare.
- Government spending is expected to grow as "Obamacare" is implemented over the next several years.

As government spending makes up a larger percentage of GDP there is, historically, a drag on the growth that can be expected in the private sector. Barry Eichengreen (*Exorbitant Privilege*, Oxford University Press, 2010) estimated that without any changes to Social Security and Medicare, government spending will reach 40 percent of GDP within 25 years. This raises the question of whether the U.S. will be able to borrow the funds needed to finance the spending. At some point the perception of risk will begin to drive interest rates higher.

Whether any, or all, of this means that expected growth in GDP will be less than the historical averages is a decision that each practitioner should evaluate. If you come to the conclusion that 1.8 percent annual growth in GDP is the new normal, than to continue using the historic 3.8 percent will result in high values.

Inflation, on the other hand, is generally defined as the sustained increase in the level of prices for goods and services. It is measured as an annual percentage change. As inflation rises, every dollar buys a smaller percentage of a good or service. This measure is used as a baseline for some practitioners in their estimate of long-term growth because if you do not at least account for inflation you are changing the premise from a going concern to a non-growth company or even one that will not grow enough to survive inflation. The US Inflation Calculator reports inflation from 1913 to 2013 of about 2.3 percent per year (average).[1]

Several factors indicate that the U.S. economy may be entering a period of high inflation and, perhaps, for a sustained period of time:

- The U.S. government has been borrowing in excess of $1 trillion per year for the last four years and that borrowing has been used to finance consumption rather than production.
- To the extent that the holders of U.S. debt lose confidence in the fiscal policies of the country (and hence raises the risk of the debt), interest rates will be driven up.
- The U.S. government has engaged a program of refinancing debt – replacing long-term debt with shorter term instruments. If the market begins to perceive higher risk the impact on the U.S. economy will be fast and severe.
- A general economic recovery is underway and could be expected to evolve into a very robust period of economic growth. This is based on the pent up demand for housing, etc. and the huge volume of cash that has been sidelined in government securities as a safe harbor.
- Federal debt has grown from $5 trillion in 2000 to about $17 trillion in 2012 and there is no projection or expectation that debt will stop growing in the next several years. The most likely way to get out from under that kind of debt load is to pay it back with cheaper dollars – inflation.

Historically, high inflation (in excess of historical averages) is a short-term event. Projections to the contrary are concerning but should be viewed in the context of history. In 1979 reported inflation was 13.3 percent. By 1982 the inflation rate had fallen back down to 3.4 percent.

The purpose of this article is not to make political calculations or commentary. It is designed to cause practitioners to consider how they view long-term growth and to be prepared to explain and defend their estimate. When we enter a period of high inflation there will be pressure to increase long-term growth to those apparent realities. Alternatively, if the GDP growth rate remains below historical rates there will be pressure to lower long-term growth expectations. These opposite pressures will change the current environment where the expert can base long-term growth on both inflation and GDP growth.

One of the roles of a financial expert is to understand the assumptions we are making, balance all the conflicting indications such as long-term growth, and be able to define, explain and defend those assumptions. It may get a lot more interesting and challenging in coming years.

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[1] http://www.usinflationcalculator.com/historical-inflation-rates

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