



Could it be time to “Sell in May and Go Away”?

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The stock market started the New Year with a bang but has recently suffered from tremendous volatility and uncertainty due to geopolitics, the threat of rising interest rates and a potential trade war. With our post-recession recovery now in its ninth year a majority of economic indicators are suggesting we may be toward the end of another economic cycle if history is our guide. Business owners and entrepreneurs also have anxiety over how to build sustainable enterprises while maintaining momentum in a difficult, volatile and uncertain operating environment. As business owners recently filed their tax returns, they were reminded of the favorable impact that a healthy overall economic backdrop can bring but now many likely wonder how long good times can last.

The U.S. economy has clearly regained its growth following the 2008 and 2009 economic downturn albeit at a much lower level – GDP under 3% – well below historical norms following previous recessions. As we head into the 10th year of this recovery, the

historical trend of business cycles repeating themselves is not lost on anyone, and the risk of another recession with the passage of time continues to loom larger and larger. The impact of higher interest rates, a strong dollar, fickle consumer confidence and higher energy prices all factor into future uncertainty and could derail recent favorable results on the eve of one of the most important and unpredictable mid-term election cycles in recent history. Despite all these obstacles and challenges, the overall environment for M&A across most sectors is quite healthy (excluding retail) and poised for continued strong activity coupled together with better business backlogs for 2019. **Now might be a great time to think about pursuing a proactive liquidity event or transition strategy together with the perfect “partner” rather than deferring the decision until later when options might be limited or market conditions aren’t as favorable.**

Why “Now” is time to act:

1.) Deal Markets are Favorable Today.

Valuation levels in both the public and private markets are favorable for sellers or owners looking to raise capital. It is important for business owners to consider the value of achieving full or partial liquidity today via an exit versus trying to hold out for possible future growth and a higher valuation level tomorrow. By waiting to realize a potentially higher value for your business, you are also taking on unnecessary risk to complete the transaction subject to the execution of a game plan or having to overcome unforeseen negative events (death, environmental issue, lose of a key customer, macro events, etc.). Sellers today are typically in the driver’s seat for favorable valuations and deal terms while closing transactions in record time.

2.) Buyers Have Money to Spend.

Large strategic buyers have money to spend and will likely need to grow through acquisition while organic growth prospects remain limited. Management teams are finding it hard to meet Wall Street’s expectations and are constantly looking for ways to show consistent earnings growth. In the absence of viable organic growth opportunities, many companies are now looking to

acquisitions to achieve this growth. The private equity marketplace is also full of new and well-established funds seeking both platforms and add-on acquisitions to create “award-winning” investments. Low interest rates and relatively easy access to credit have also helped to facilitate the recent above average deal volume. Family offices have also emerged as new alternative sources of capital for those seeking a more patient, flexible and longer term oriented partner versus an exit to private equity.

3.) Time May Not Be on Your Side to Wait.

Aging owners are always fearful of the next downturn. This is especially apparent and paramount for those owners running a cyclical business that suffered through the last recession. Many of these owners have found themselves hanging on since 2000 waiting for the optimal time to exit and could miss an ideal window if they do not act soon. It is much easier to tell a story with the wind at your back and realistic growth forecasts during favorable business conditions versus trying to convince investors or buyers of future improvement after or during a negative operating environment. A solid and robust pipeline or backlog with strong macro indicators goes a long way towards generating a higher sale price and creating a competitive auction for “trophy assets”.

4.) Some Businesses are More Prepared and Thus More Valuable than Others.

For example, within the metals sector, downstream / fabricators and niche manufacturers are better positioned to realize optimal proceeds and will garner more interest than a commodity scrap trader. Companies with solid financial and operational profiles, accurate financial reporting, established management teams and attractive long-term prospects are highly desirable to buyers and financial partners.

5.) Banks are De-Risking.

Banks are seeking relief from troubled or over-leveraged credits and are beginning to show a reduced appetite for commodity risk, falling inventory/asset values and anything having exposure to the retail industry (particularly those businesses negatively impacted by Amazon or other technology disruption). Lenders likely will not

be as supportive during the next downturn as they were historically due to the increasingly stringent regulatory environment that they find themselves operating in today. The “extend and pretend” behavior exhibited by banks in the past may not work during the next down cycle. To this point, many manufacturers have already transitioned away from cash flow loans to ABL facilities and now have new lenders with a new set of priorities.

6.) Political and Regulatory Uncertainty.

Following the election of President Trump, political theater has been front and center on a daily basis and filled with many surprises. There is a real threat for continued political uncertainty in Washington, and as we approach mid-term elections later this year. I suspect that new challenges will reemerge regardless of the election outcome. A majority of businesses and their owners have benefited from lower taxes and reduced regulatory burdens despite being exposed to Washington rhetoric, theater and daily Twitter communication. With the economy performing favorably and geopolitical uncertainty on the horizon, business owners should be asking themselves if it might be better to avoid these unknown risks and maximize proceeds sooner rather than later.

7.) More Investment Required.

Often we see owners who lack the confidence or conviction to invest and upgrade their business to truly remain competitive on a global scale. Technology, the Industrial Internet of Things (“IIoT”) in particular, requires significant expenditure and comes with substantial implementation risk. Many middle market organizations lack both the skills and long-term horizon to reap the investment rewards that these initiatives can generate. With this in mind, “Bigger and Better” will likely be the mantra for firms preparing to remain competitive on a global scale today. Private equity is well suited to act as a partner for owners looking to make these types of investments in their business. There is an abundance of dry powder currently available to fund growth investments while also allowing owners to diversify their net worth and de-risk their ownership positions should these investments fail to realize the intended results.

8.) A Good Offense is a Great Defense.

Opportunistic versus strategic and truly game changing deals will always capture the headlines, but sellers need to prepare for an exit well before they begin a formal transaction process. There are numerous steps owners can and should take to get their house in order to maximize value before having any formal or informal interaction with a buyer. “How will prospective buyers view my business, and what changes can be made to increase their desire toward a strategic combination?” is a question anyone considering exploring the sale of their business should be asking themselves.

Plan B

For owners who decide against the “sell now” scenario, they would be advised to consider alternative strategies to enhance long term value or enable future liquidity. While there may not be a compelling reason or driver for seeking liquidity today, there are always initiatives available to maximize the value for a thriving and well-positioned company.

1.) Hire Professional Management and Upgrade Talent.

Is your current management team effective and ready to go the distance? Often owners overstate their capabilities or compensate for deficiencies through their own actions and duties. Consider how the business would function if you were to disappear for a month or longer? It is just as important for owners to understand their limitations and strive to replace or upgrade mediocre or under performers – even if that means firing themselves or a family member in the process. Numerous businesses form a board of outside directors to hold the management team accountable and act as a sounding board for new ideas. If you do not have a written and formal succession plan in place for your business, it is imperative to create one!

2.) Optimize the Capital Structure Through a Debt Recapitalization.

Even if your business does not need more capital, it might be advantageous for owners to take some money “off the table” to

diversify their wealth through a modest debt financing before rates rise. This not only provides immediate liquidity but has the added benefit of a tax shield and can act as a driving force to ensure the continued performance of the business in order to pay down debt and increase equity value. Most debt facilities also come with a fixed maturity date which can serve as a natural target date to facilitate exit planning or pay employee bonus compensation. It should be noted that before undertaking a recapitalization, determining the optimal amount of leverage to add to the balance sheet is critical to ensure the enterprise is not overly leveraged or unable to survive an economic downturn.

3.) Pursue M&A.

Companies pursue M&A for a variety of reasons, but most often they relate to a) building scale to improve market position and/or b) responding to pressure from industry consolidation to keep up with competitors. M&A is an excellent tool for companies to enhance and expand their product offering and ultimately create better value for their customers. Acquisitions can also help to diversify risk by expanding a company's geographic footprint, growing their customer base, and broadening existing sales channels.

4.) Get Your House in Order.

Most private companies can benefit from upgrading their internal financial reporting package and budgeting process. These upgrades will generally include IT systems and the implementation of company-wide employee and labor tracking metrics. Improving your financial reporting can also assist a management team in identifying possible revenue and cost synergy opportunities. Detailed and thorough internal due diligence can help owners identify risk factors before a potential buyer does – it is crucial for a business to discover and mitigate these risks before a buyer points them out to management for the first time during due diligence. If you currently only have your financial statements “reviewed” annually, making the shift to annual “audited” statements is likely worth the added cost and time as this will add legitimacy to your internal reporting and help to get buyers/lenders/partners more comfortable with the numbers you are presenting. It is also a great time to discuss tax planning strategies

with your accountant and identify possible ways to reduce the tax burden placed on running a profitable and thriving business in today's economy.

5.) Get Lean!

Just as larger and sedentary adults gain weight and need to exercise, certain businesses can always improve their performance and develop disciplined business habits and techniques to streamline manufacturing processes, improve sales, source products and find new customers and markets. Smaller, private companies generally do not have internal lean resources within their business and should evaluate hiring experts to facilitate “lean journeys” and “kaizen” events throughout the company. Once installed and engrained into the daily work flow of business, a successful lean initiative becomes part of the company culture and standard day-to-day employee behavior for years to come. Owners will reap efficiency benefits from investments in lean processes and future buyers will also favorably factor these profitability improvements into their valuation when the business is sold. Business owners should also evaluate the need and opportunity to strengthen and build technology tools into their business through initiatives such as enhancing their web presence or adopting internet of things devices and implementing them in their day-to-day operations. Boosting “goodwill” value with brands and other intangibles such patents and intellectual property is also a sound and worthy investment. When properly implemented, these initiatives can help drive real value when it comes time to exit the business.

In Conclusion

While the historical insatiable deal appetite displayed by financial and strategic buyers will likely slow, there is still time to jump into the fray and benefit from favorable valuations and market conditions. Historically, the middle market, defined as transactions less than \$1 billion, has been somewhat more resilient due to typically lower leverage and relatively reasonable valuation multiples. Business owners that wait will run the risk of trying to convince buyers to pay more in a difficult macro environment defined by higher interest rates, tougher financing conditions and

finicky capital markets coupled with inferior business prospects for the target company due to competitive factors or underinvestment of capital.

Hope is never a successful strategy for managing a business!



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