

▼ **OPINION**

A stronger M&A outlook for privately held firms

The pace of business transitions among privately held companies in the Puget Sound region has been slow for the past two or three years. In fact, 2002 was the slowest year I had witnessed in more than a decade, and so hopes were on the optimistic side when 2003 rolled around. Yet as the year progressed, it became obvious that the business fundamentals were not supporting such optimism.

On the other hand, the fundamentals do support optimism for 2004. Both the quantity and the quality of the transactions that are being worked are much improved from 2003. The heart of the matter is that the profits and revenues of the companies in the transactions are greatly superior to what my firm and I encountered in 2003.

So my firm believes that we will experience an upturn in business transitions in 2004 among privately held companies in the Puget Sound region — perhaps a significant increase. Some of the reasons are related to the business cycle, some are demographic and some are tied to changes in the tax code.

- The building economic recovery will in and of itself stimulate business transitions. Sellers will believe that conditions will support their asking price, and buyers will believe that an expanding economy will enable them to gain value quickly from the new company.

The efforts by companies during the recession to make their operations leaner and more efficient will boost the overall profitability of enhanced revenue streams from an expanding economy. That will benefit buyer and seller.

Surveys conducted by our firm indicate that business owners expect their profits and revenues will increase in first quarter 2004 (owners accurately predicted in the previous quarterly survey that they would increase in fourth quarter 2003). Correspondingly, their confidence in the future is also improving — but slowly. Higher confidence is a critical factor in the decision to sell or buy a business as well as to make capital outlays, hire new employees and so forth.

- The recession of the past few years has

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created pent-up demand for business transitions. Depressed revenues and profits led many potential sellers to hold on until they could gain a better price to finance retirement (the primary reason for business transitions among privately held companies). On the other side of the transaction, the fact that we are in the early stages of the recovery will encourage purchasers to act soon so they can take advantage of the

mature stages of the recovery.

- The demographics of owners of private businesses tell us that we are about to see a massive changeover in ownership as the current generation retires and transitions the enterprise within the family, to an internal management group or to an outside purchaser. More than a third of the CEOs/owners of privately held businesses in the nation will change in the next five years and about two-thirds in the next 10 years. Momentum will start to build in 2004.

- The picture for financing business transitions has also brightened. Lower interest rates and less restrictive underwriting standards at financial institutions provide strong incentives for purchasers to consummate their transactions sooner rather than later. Financiers are no longer so concerned about seeing a year or two of solid earnings after a recession; underwriting standards now factor in the pattern of the business cycle and its consequences for the income statement.

- The tax structure offers additional incentives to complete business transitions in 2004. The lower capital gains tax — a 25 percent reduction — reduces the burden and make a transition more attractive. Moreover, sections of the 2003 tax cuts provide incentives to accelerate certain capital outlays because the tax breaks on these capital outlays sunset on Jan. 1, 2005. If a seller were to take advantage of those incentives, that could make

the company more attractive to a purchaser,

- The rising federal and state budget deficits will also influence the flow of business transitions. The growing deficit means that the estate tax is more likely to remain on the books. In the face of the estate tax liability, some owners may choose to sell the business during their lifetimes as an easier solution than retaining the business for a family member.

The one potential brake on more vigorous M&A activity would be the collapse of the

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economic recovery. But I believe the economy is firmly on the road to recovery. Improved activity among smaller, privately held companies is historically an indicator of general economic growth. We are currently seeing that pattern with increased job creation on the part of privately held companies. That is great news for the Puget Sound region where approximately 50 percent of all jobs in the nonpublic sector are provided by privately held companies.

The Pacific Northwest and Puget Sound region in particular remain target markets for companies not currently located here. The likely increased M&A activity among regional companies would be an additional shot in the arm, boosting the recovery that we are already seeing among privately held companies.

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