Elite
Mergers & Acquisitions

M&A Advisor

FOR EXECUTIVES SEEKING TO BUY, SELL, OR RECAPITALIZE BUSINESSES

# 2014: Growth Ahead

### But Watch Out For Those Interest Rates & Leases

The year 2013 was the third consecutive year of growth since the last recession. After several years of anemic or negative growth, businesses are seeing strong growth trends as we exit 2013. Going into 2014, the overall economy including the real estate segment is showing signs of accelerated growth.

All of this is good news for M&A. Businesses are valued based on the potential future cash flows. Acquirers use past earning trends as one of the key measures of how a business is likely to perform in the future. Over the last several years, lacking positive trends, some business owners who were planning on exiting held back - unwilling to face a reduced valuation and hoping things would be a bit better in the not so distant future. That time has finally come. Deal flow in 2013, depending on the source, was roughly 30-40% higher than in 2012. We expect the upward trend to continue in 2014.

Here are some key factors business owners need to take into account while planning exit/recapitalization strategies this year:

- **Economy**: Equity in real estate is an engine that drives the credit markets and the economy. In 2013, credit eased substantially and real estate values have rebounded strongly off the recession lows. Current forecasts calls for a continued upward trend in the real estate market in 2014. Expect a year of widespread growth with construction and real estate related businesses driving a virtuous growth cycle. This positive trend will be beneficial to entire economy.

- **Interest Rates and Liquidity**: Record low interest rates that we have witnessed in the last several years may be coming to an end. Economists are forecasting a 100 to 200 basis point rise in interest rates across the board. Higher interest rates increase financing costs and tend to drive valuations lower. Acquirers may demand lowering of transaction price or sweetening of the deal terms to finance the deal and still meet the cash flow metrics needed. The biggest valuation impact will be on static or low growth companies. Compression in valuation of higher growth companies will not be as significant.

- **Leases:** As economy improves, lease rates are starting to increase, especially in markets where there is not a significant over capacity. For business owners for whom leases are a significant item in P&L, this may be a good time to lock up on long term leases if they have not already done so. Increasing lease rates can quickly reduce profitability of a business. Below market long term leases can add substantial value to a business.

- **Deal Making Opportunities**: Deal making opportunities are likely to be abundant in a growing economy. Acquirers are a lot more likely to buy a business in an upwards trending market than in a downward trending market. Many banks and financing sources consider three years of stable or upwards trending profitability as a minimum requirement for financing a deal. Fortunately, since the end of the recession, many business owners have seen three years of neutral or positive trends and are well positioned to meet this financing threshold.

- **Taxes**: Selling a business with a gain means that a business owner has to pay capital gains tax or ordinary income tax on the gain. Even with recent upwards revisions in capital gains tax rates, business owners continue to be beneficiaries of a historically low levels of Federal Capital Gains Tax Rates. Since capital gains are taxed at a lower rate than ordinary income, a competent business M&A specialist attempts to structure much of the gains from the sale of the business as capital gains.

When evaluating the consequences of environmental trends on the business sale and M&A process, it is useful to keep in mind that the M&A process for a midmarket business can take about 12 to 18 months. Most acquirers/investors look carefully at business performance as they navigate through the deal process and positive trends along the way can be helpful in closing a deal and in getting the terms sought by the shareholders.

All things considered, 2014 would be an excellent time for business owners to review their M&A strategies and determine how to approach the business sale or acquisition process for optimum financial return. Rising tide lifts all boats and a growing economy provides a favorable tailwind to both buyers and sellers.

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