Opportunities Amid Uncertainty

2010 May Be the Time to Act on Important Strategic Business Decisions

The 2010 year is a unique time to accomplish important business objectives, be they operating, financial or ownership related. Business owners must carefully consider the current uncertainties in order to position their companies (and themselves) optimally for the future. In this article, we focus on the current economic, transaction, and tax environments that business owners should factor in their decision-making.

The Economic Environment

The operating environment across many industries continues to be challenging. The overall economy contracted around 2.5% during 2009 as measured by the change in GDP. While the economy appears to have avoided catastrophe (at least to date), and GDP actually increased during the third and fourth quarters of 2009 (5.7% in the fourth based on the most recent data), we continue to see high levels of uncertainty regarding any recovery.

In discussions with business owners and executives across diverse industries, we continue to hear the same two questions:

1. Exactly how long will the economy take to normalize?

2. What is the “new normal” that we are normalizing to?

For many industries, pre-2009 performance levels will not likely be regained in the short-term. Those management teams that appreciate the threats and opportunities of the current economic environment stand the best chance to position their companies for both short-term and long-term success.
The Transaction Environment

Consistent with general economic and financing trends, merger and acquisition (“M&A”) activity during 2009 decreased substantially compared to the last several years. Based on broad market data published by MergerStat, total M&A transactions for 2009 measured 6,751, compared to totals of 10,559 and 8,048 for 2007 and 2008, respectively.

From an anecdotal perspective, our experience at Mercer Capital during 2009 suggests that the middle and lower ends of the M&A market were similarly diminished in 2009. Some deals did get done, but the overall quality of the companies being transacted was generally lower. As with general economic activity, transaction activity did appear to show some signs of life, however modest, during the last quarter of 2009.

The reason for the reduced transaction activity is obvious. With the weak economic conditions (and general lack of capital availability), valuations declined relative to what might have been a reasonable valuation expectation just a few years ago. At these lower valuations, there are fewer sellers, especially sellers of quality companies.

As ownership groups make decisions regarding business transactions (either the sale of their business or the possible acquisition of other businesses), they must understand the market from just a few years ago is no longer directly relevant. Investment decisions (either buy or sell) must be weighed based on a consideration of current market conditions and expectations for future performance and conditions.

In other words, the price that could have been attained three years ago is not the appropriate benchmark from which to make investment decisions. A backward view of the market could result in a business owner missing a viable opportunity for liquidity; an opportunity that may be very attractive relative to what could be available in the future.

The Tax Environment

Usually, the one part of the financial environment that is certain is taxes. While there undoubtedly will continue to be a tax burden, the level and form of taxes is currently in flux. Consider the following:

» As of January 1, 2010, there is no estate tax. The 2001 tax bill which set a schedule to phase-out the estate tax has reached its final year. Expectations for some resolution on the estate...
tax issue before year-end 2009 did not come to pass. Currently, at least three scenarios seem possible:

1. An estate tax bill is passed during 2010, likely with compromises on the level of exemptions and rate, and made retroactive to January 1, 2010. There has been much discussion regarding the constitutionality of such a retroactive feature, so any bill with this feature would likely end up being debated in the court system for several years.

2. An estate tax bill is passed during 2010, again with compromises on the level of exemptions and rate, and is not made retroactive to the beginning of the year. This would create an almost arbitrary mid-year date upon which the tax will be changed.

3. No “new” estate tax bill is passed during 2010, meaning that the 2001 bill phases out and we return to the pre-2001 terms of the estate tax. This would result in much lower exemptions and a higher actual tax rate.

» In 2011, dividends, which are currently taxed at a federal rate of 15%, will revert to being taxed as ordinary income at an individual’s highest marginal tax rate. At the same time, the tax rate applicable to capital gains will increase from 15% to 20%.

» Government expenditures currently far exceed government revenues and this is likely to continue well into the future. Political discourse on spending and tax policy aside, anticipating the future tax environment is critical in assessing strategic business and ownership alternatives.

What will happen regarding the specific tax issues outlined above (not to mention the broader question of regular income tax rates) is unclear. There is likely to be an estate tax by 2011 (at the latest) and the rate on dividend and capital gains is likely to increase in the future.

Business owners must have flexibility in their ownership and liquidity plans to deal with the different possibilities. For example, with a likely increase in the dividend tax rate upcoming, any business organized as a C corporation should closely scrutinize their level of cash and should consider paying out any “excess” amounts in the form of dividends. The cost of future dividends will be higher due to the higher tax rate, so getting that cash out of the business now should maximize the benefits delivered to shareholders.

Mercer Capital will be attending the following conferences

» The NCEO Annual Conference » April 20-22 in Minneapolis, MN

» The ESOP Assn. Annual Conference » May 12 & 13 in Washington, DC
Conclusion

We face several uncertainties in 2010. However, as the legendary coach John Wooden once said, “Do not let what you cannot do interfere with what you can do.” We cannot predict the future, but we can look for opportunities amid the uncertainties in the current economic, transaction, and tax environments. If Mercer Capital can assist you, please contact us at Mercer Capital at 901.685.2120.

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NEW PUBLICATION

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PRIVATE EQUITY SURVEY RESULTS

2009 Private Equity Valuation Survey

In November 2009, Mercer Capital invited over 400 PE shops to participate in the 2009 Mercer Capital Private Equity Valuation Survey. The primary intent of the survey was to evaluate current portfolio company valuation practices at PE shops across the country and around the world. We received responses from a diverse group of private equity funds, primarily based in the United States. By and large, our respondents were middle-market funds that have between $100 million and $500 million in assets under management, each with investments in 10 or more portfolio companies. To view the survey results, click here.

SELECTED LIST OF RECENT & UPCOMING SPEAKING ENGAGEMENTS

January 7, 2010
“Subsequent Events”
Florida Institute of CPAs
P. Lauderdale, FL
Z. Christopher Mercer, ASA, CFA, ABAR

February 1, 2010
“Important Valuation Issues for Banks in 2010”
Acquire or Be Acquired Conference
sponsored by Bank Director Magazine
Phoenix, AZ
Andrew K. Gibbs, CFA, CPA/ABV

March 17, 2010
“Stock-Based Compensation”
VACO CPE Event
Memphis, TN
Travis W. Harms, CFA, CPA/ABV &
Matthew R. Crow, CFA, ASA

April 15, 2010
“Rebuilding the Economic Value of Your Business”
Family Business Magazine
Celebration, FL
Z. Christopher Mercer, ASA, CFA, ABAR

April 17, 2010
“Buy-Sell Agreements”
ACTEC Southeast Regional Conference
Knoxville, TN
Z. Christopher Mercer, ASA, CFA, ABAR

May 7, 2010
“Attorney Tricks & Witness Traps”
American Academy of Matrimonial Lawyers/AICPA Conference
Las Vegas, NV
Z. Christopher Mercer, ASA, CFA, ABAR with
Jeffrey W. Brend, JD, CPA/ABV, ASA, CFA, AAML

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$19.95 via e-mail

The Bank Director’s Valuation Handbook

Sale Price: $45 (plus s/h)

Business Valuation, An Integrated Theory

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The National Economic Review

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2 yr subscription: $399
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