

# Q3 Analysis: Good News, Bad News

## *Mergers & Acquisitions in 2008*

For the past several quarters we have commented on the health of the Merger & Acquisition (M&A) market, and the market for privately held companies in particular. The themes have been consistent: M&A activity this year has been slower than last year, particularly when it comes to the mega-transactions that set records in 2007. However, the market for privately held companies has remained strong, fueled by strategic acquirers who are using cash reserves to grow and by private equity firms with a desire to put their capital to work.

As has been the case for the last several quarters, our conclusions for Q3 are a mix of good news and bad news. For the first 9 months of 2008, global M&A totaled \$2.5 trillion, which represents a 25% decline relative to the first 9 months of 2007. However, 2007 was a record year characterized by a frenzied pace of M&A activity, and even with reduced activity this year, 2008 is still likely to be the second or third largest year of M&A activity in history.

For 3Q2008, global M&A volume totaled \$907 billion and US M&A volume totaled \$403 billion. Those levels of activity are very comparable to the third quarter of last year and show a marked increase over the second quarter of this year. However, 3Q2008 statistics include more than \$100 billion (worldwide) related to bank buyouts. Unfortunately, these banks were generally forced to sell because of liquidity issues that can be traced back to bad investments in mortgage-backed securities.

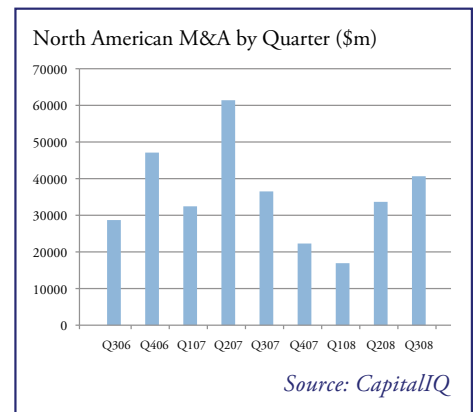
In the first three quarters of 2008, Private Equity fundraising, which acts as an indicator of future M&A volume, totaled \$223 billion – an 11% increase on the comparable period last year. This positive news is tempered by the fact that third quarter fundraising alone was

the slowest since the first quarter of 2005. Even so, buyout-focused private equity firms were already sitting on war chests of capital, and they have almost doubled those cash reserves this year. Additionally, lending-focused Private Equity groups have raised \$36 billion this year, compared with just \$3 billion last year. It would appear that lending-focused firms are preparing to play a larger role in financing acquisitions now that credit has tightened up among some traditional lenders.

As Q3 drew to a close, the economy was showing signs of continued weakness, the credit markets were tightening and the stock market was entering one of its most volatile periods in history. As a result, some companies are now having difficulty obtaining credit for growth while other companies are seeing softness in revenues and/or increases in operating expenses. The income statements for these companies are not going to look as attractive as they may have for the last several years.

Given all the factors described above, business owners whose retirement strategies include selling their company are left asking: is this a good time or a bad time to sell. To help decide, look to your company's operating metrics (rather than the market conditions). If your business is being challenged by the current economic conditions, this may not be the ideal time to sell. Instead, we recommend using the next few years to strengthen the company. After all, the value of a company can be substantially improved with a few years of advance planning.

However, there is always demand for strong companies—particularly those that show stability or even growth while the rest of the economy slows. In fact, companies that demonstrate strength under these conditions



are particularly attractive, in part because their resilience is apparent and in part because the demand for acquisition targets is now focused on a smaller supply of companies that appear attractive.

Now more than ever, acquirers are attracted to profitable companies with strong gross margins, loyal customers, tenured employees/management and attractive growth potential. Acquisition financing is more difficult to obtain than it was a year ago, but transactions are still getting done as lenders seek to finance deals that make sense.

In the end, you can't time the M&A market. The ideal time to sell is when the business is steady or growing, the employee base and/or management team is stable and – perhaps most importantly – when you are ready based on your personal and financial objectives. If you would like to discuss the timing of your sale or if you are interested in planning advice, we invite you to call us for a confidential conversation at 425-450-4800.

## Guest Expert: Wealth Management

*ASG Partners' interview with David Drews, CPA, CFA, Client Manager and Managing Director at Cornerstone Advisors*



*David Drews, CPA, CFA, is a Client Manager and Managing Director at Cornerstone Advisors. He has nearly 20 years experience in the areas of finance, accounting, and wealth management. He specializes in working with entrepreneurs and executives.*

*Cornerstone Advisors, founded in 1984, provides portfolio design, construction & management services, family office services and financial counsel to wealthy individuals, families and organizations. The privately held firm is headquartered in Bellevue, Washington and has 45 employees. For more information about Cornerstone Advisors, visit Cornerstone's web site at [buildbeyond.com](http://buildbeyond.com).*

### **How can owners of privately held companies determine “how much is enough” for retirement to enable them to properly time their sale?**

To find out how much is enough, you can determine what the “cash windfall” from your sale should be by asking yourself these three questions:

1. How much money do I need to support my family in retirement?

This answer depends on your monthly expenses, retirement objectives, and how many years you expect to be retired. In general, we have found that our clients' expenses continue to stay the same, if not increase slightly in retirement. Sure, you may decide to pay off your mortgage, but you will also have more free time on your hands to travel, buy that boat or vacation home you've been dreaming of, or spend more time with family or on the golf course.

**As a good ballpark estimate, we recommend that our clients think about replacing 80% of their current salary with income that they could derive from an investment portfolio.**

More if you expect to pay for your own health insurance in retirement or you don't have any other savings, and less if your income previously was far in excess of your needs.

While forecasting the number of years you'll be retired is less precise, you should assume that you'll live until you are 90 years old...though with advances in medicine, it's possible that you could live longer! For instance, if your current annual salary is \$200,000, and you are 50 years old, you will need at a minimum an investment lump sum portfolio of \$5,000,000 invested at 4% net annualized real return to replace your current salary for each of the next 40 years. You also need to account for inflation and taxes, so in this example, your after-tax portfolio target return would need to be 8–9%.

2. What amount of risk am I willing to take with my cash windfall?

The answer to this question will determine how much of your portfolio should be invested in (higher risk) growth-oriented investments vs. (lower risk) income-generating investments. Our clients' portfolios are built based on their need for current income and their ability to withstand volatility of principal.

**Given the certainty of future inflation, we recommend that our retired clients have at least some allocation to growth-oriented investments in their portfolio so that their income continues to grow in retirement to keep pace with future price increases over their long investment time horizon.**

3. If my cash windfall is capable of generating enough income for my annual expenses, how much more do I need to support my estate planning gifts to family and charity?

This answer depends in part on the size of your cash windfall from the sale of your business. If your ultimate selling price yields an amount far in excess of the windfall amount needed to gen-

erate sufficient sustainable income to cover your annual expenses, you are in an enviable position to begin considering accelerating gifting to family or charity, increasing your annual spending or even modifying your portfolio to increase or decrease the variability of its return.

### **What are the most important factors to consider when making decisions about how to invest the proceeds of a business sale?**

1. Select a good, reliable, well-seasoned wealth management team long before you have your liquidity event.

Most families have similar goals for their financial capital—that is, the preservation and growth of these assets. Look for a firm that has similar values to your own, and one that educates and addresses the broader issues associated with substantial wealth. Just as you once organized your business with purpose and sustainability, a wealth manager should organize and manage your family's assets with purpose and sustainability.

2. Take time to plan how to reinvest your cash.

**As an entrepreneur, you had an extremely concentrated position in one company and one industry. You took an enormous risk, and it worked out well.**

Now that you have sold or are about to sell your business, you are in a position to grow your wealth by taking on less risk. Risk is the most fundamental factor in investing, as there is no return without risk. Different people have different appetites and levels of tolerance for risk. Your reinvestment decision should take time, as



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## Guest Expert: Wealth Management *(continued from page 2)*

you begin to understand your own tolerance for risk and return, your income requirements from your portfolio, and the different risk and return characteristics of a portfolio of various asset classes vs. the risk and return characteristics of owning your own (single-stock) business.

3. Understand the principles of asset allocation.

**Your decision to invest in a specific asset class will make more of a difference in your risk and return experience than precisely which individual securities you buy.**

Investment research demonstrates that the choices made by investors at the asset class level are responsible for the lion's share of the

risks and returns on any investment. Engage a wealth management firm with a solid level of expertise at modeling risk and making asset allocation decisions.

By owning a broadly diversified portfolio of stocks, bonds, real estate and other asset classes, you will not earn windfall returns when any particular asset class does well, but you will earn respectable returns with less risk than you had in your (single-stock) business.

*Cornerstone Advisors' typical business client has a minimum of \$3 million in investable assets and requires sophisticated tax and estate planning. The company's client management team is highly skilled in pre-sale strategy planning and can assist business owners and their families in preparing for a future sale. To learn more, visit [www.buildbeyond.com](http://www.buildbeyond.com) or call (425) 646-7600.*



## Annual Conference: Planning the Successful Sale of a Privately Held Business

Each year ASG Partners presents a highly informative full-day seminar for owners of privately held companies. This intensive one-day educational event covers issues related to the selling process, such as maintaining confidentiality during a sale, finding buyers, maximizing price, minimizing taxes, and protecting yourself from litigation. We also address advance planning topics including valuation, retirement planning, management succession, and how to maximize the value of a future transaction.

The conference will be held on November 11 in Seattle, November 13 in Spokane, and November 18 in Portland. For more information and online registration, please visit [www.asgpartners.com/events.html](http://www.asgpartners.com/events.html).

## ASG Partners in the Media

Principals from ASG Partners contributed two articles to the regional business press in Q3:

**“Determining an accurate market value for your business”**

Spokane Journal of Business, July 24, 2008

Ed Kirk's contribution to the Spokane Journal of Business helped owners answer that perennial question: “What is my company worth?” Ed outlined a framework that would help any business owner determine a valuation range for his or her company, and explained why an accurate understanding of market value is crucial to retirement planning.

**“Get a second opinion on company's price”**

Puget Sound Business Journal, October 2, 2008

Mike Grubb's column in the Puget Sound Business Journal laid out some guidelines for business owners considering having their companies appraised. It explained the different types of valuation and helped owners understand what type of valuation they may need, whether they should pay for it, and what experience and qualifications their appraisers should have.

Find links to both of these articles in the News & Articles section of the ASG Partners web site at [www.asgpartners.com](http://www.asgpartners.com).

# Developing a Management Succession Plan

*Taking inventory of management team's roles is the first step*

If you are considering selling your company, securing a management team that will keep things running smoothly after you leave is one of the most important things you can do. Because potential buyers will want your company's success to continue even after you are gone, the day you start to consider a future sale is the day you should begin formulating a succession plan.

The first step is to thoroughly assess exactly what you do at your company every day. Owners who manage their own businesses do not always realize how involved they are in day-to-day operations, managing relationships with important customers and suppliers, and other crucial tasks. Many say that their day-to-day involvement is minimal, only to reveal after further prodding that they spend ten hours a day at the office and have a hand in everything from customer service to packaging products for shipping on busy days. Some owners do so much that it ultimately takes two or more employees to fill their shoes when they eventually retire.

To assess the depth of your involvement in your company's operations, begin by taking inventory of your own activities. You can do this in whatever format you feel comfortable with – a categorized spreadsheet, word processing document or a notebook. The point is not to record your specific actions in detail, but to get an overarching picture of what types of responsibilities you have, and how much time is dedicated to each category.

Note how you spend your time. For example, at lunch you may record that you have spent two hours speaking with customers and two

hours planning a new direct mail marketing program. Add time spent negotiating with suppliers, overseeing staff in a particular department, or paying bills. Do not attempt to alter your managerial role as you undertake this task; the objective is simply to assess your responsibilities realistically so you can formulate an effective plan to delegate them to others.

Once the initial assessment is complete, look back and see how the hours break down. You may enjoy adding up the hours, creating pie charts and doing some analysis on how your time is distributed, but even a simple pen-and-paper journal will prove enlightening. With your task list in front of you in black and white, you can draw conclusions about the rough percentages of the time you spend on each job area. Many owners who undertake this exercise are surprised to discover where their time actually goes.

Once you have a clear picture of your responsibilities, evaluate who else in the organization is capable of taking them on. Make a list of the top tasks you perform. Next to each one, write the name of the person in your company who would step up to manage the task if you were unable to come to work for a month. Then rate your confidence in that person's knowledge and ability on a scale of one to five, with one representing certain failure and five indicating confidence that they could successfully take responsibility for the work today.

If you see a lot of fives on your list, you are well positioned to begin delegating responsibilities to your staff. Threes and fours demonstrate potential to train the staff members in question to take on more responsibilities, and ones and

twos represent areas in which your company may struggle when you leave. These will need to be addressed either by training current staff or bringing in additional managers.

Next, make a list of the skills and responsibilities of each manager who reports to you. Who would take on their duties if those people were to leave? Are the most important managers in your company satisfied with their work and salaries? Do they have non-compete agreements?

Consider what you may need to do to secure your management team. They have helped build your company's value, and potential acquirers will want them to continue doing so. Conversely, if you have middle managers who are underperforming or failing to add value to the company, now is the time to consider replacing them.

Companies with strong management teams attract a lot more potential buyers than those that require experienced owner/operators to step in and take the reins. Crafting a capable team will not only increase the value of a future sale – it will also bring the benefits of increased stability and profitability in the years leading up to a sale.

*If you are considering selling your business in the future and would like to learn more about planning for a future sale, we invite you to get in touch with us for a confidential, no-obligation discussion. Email [info@asgpartners.com](mailto:info@asgpartners.com) or call us at 425-450-4800.*



ASG Partners is a locally-owned merger & acquisition firm that specializes in the sale of manufacturing, distribution and service companies. ASG focuses on representing owners/sellers of companies with annual revenues of \$3-100 million.

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