CAN A COMPANY BE SOLD IN A DOWNTURN?

By ACHIM NEUMANN | Special for Lehigh Valley Business

After many years of excellent growth in an economy supported by a favorable business tax environment, low-interest financing for investor acquisitions and substantial equity funding available, many business owners approaching retirement age are asking themselves what is the best time to sell a business. This question becomes even more important as most economic indicators continue to predict growth, albeit at a lower rate, with seemingly little support for an imminent recession.

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Regardless of the economic cycle, however, a key metric in any company sale is a proper initial valuation – as we also hear so often on TV's "Shark Tank." Such a valuation, conducted by an accredited valuation firm, typically takes a seven-year financial period into account to establish an accurate value. The past three years based on tax returns or financial statements, the current year-to-date with comparison to the previous year and three years of projections provide a comprehensive period review as also typically demanded by investors. Such a financial review is usually supported by an in-depth review of a company's operation and market position.

Challenges arise when there are 'blemishes' in this seven-year review period, as investors prefer to see consistency – either as a consistent growth pattern or even just as a stable flat top/bottom line. More importantly, are these 'inconsistencies' in the past, historic performance, or are they within the projections – which can be viewed differently by seller and buyer?

For example, let's assume a company has been performing nicely in the last five years in a growing economy, with a consistent growth on both the top and bottom lines. Furthermore, let's assume in 2019 we have a downturn, and the company's sales drop by 10 percent to 20 percent with the bottom line declining by 35 percent.

Clearly, such an event would land within in the seven-year review period if a valuation were to be done in the fall of 2019. The financials would show continued growth from 2016 to 2018, a decline in 2019, and reduced forecasts for 2020 to 2022. Thus, the immediate impact due to the discontinued growth is that investors would attempt to seek a deal structure with any future risk – accounting for any potential further declines – to be transferred to a seller, for example, in the form of a large earn-out for future performance.

In light of such a decline in 2019, some business owners might then argue to just wait a year or two hoping that the business will rebound – an approach we saw quite often in the 2008 recession.

However, let's remember our seven-year valuation review period: a performance decline in 2019 will still come into play even for a valuation performed in early 2021 – based on the historic financial review period of 2018 to 2020. In other words, even if a business would only show a 'dip' in 2019 and would show continued growth thereafter – setting aside for a minute a potential multi-year recession – the business would not really be ready to be valued before 2022 (based on 2019 to 2021 period financials by eliminating the trend line from 2018).

Thus, purely from a business valuation point of view, the "waiting for just another year" realistically translates into waiting at least until 2022 – three years later. Furthermore, we need to add the additional time period of one year to actually sell a business, and all of a sudden, the business owner's retirement plans were delayed by four years to a transaction beginning in 2023. All of this further assumes that there were no further challenges along the way between 2019 to 2023. Many assumptions, indeed.

On a side note, interestingly, this time period is not inconsistent with modern investment portfolio theory, under which most financial advisers suggests to have sufficient cash available in a retirement scenario to bridge a downturn in the equity markets.

Naturally, the view here taken is purely from a financial valuation approach. Many other aspects have considerable impact on the sale of a business, such as the health of the owner, the owner's motivation to continue for another five years, family preferences to possibly relocate, and so forth.

Another issue to be considered is the consistent change in demographics: with baby boomers retiring at record numbers, the demand for midsized businesses will decline, in addition to the fact that we have seen many such businesses severely struggling to obtain qualified employees. Both trends will have a negative valuation impact, as well as impacting the current business owner in managing the business.

In sum, if a business sale is contemplated as part of the retirement planning at any time within the next three years, it might be preferable not to wait that long and to start sooner. Underestimating the impact of a potential decline in the economy, can easily lead to a five-year delay to obtain maximum value for a business.

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