

# HEADWINDS

## WHITE PAPER



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# Introduction

*It doesn't matter how well you start if you fail to finish.* –Billy Sunday (1862–1935)

Bicycle riders appreciate the importance of avoiding headwinds on a long ride, especially as they approach the end. A headwind causes a rider to either expend more effort or take more time to arrive at a destination. When a rider is already tired, neither option is appealing.

A bike race and owning a business are remarkably similar when it comes to headwinds. As we anticipate the end of our business ownership journeys, the headwinds we face today require us to devote more effort or time to exit our businesses in style.

All owners typically face three significant headwinds that increase the difficulty of a successful business exit. One is the economy, the stagnation of which can throw even the best Exit Plans off course. The second is the substantially higher tax bill that's due upon the sale of a business. The third is the long-term mediocre investment climate that depresses the amount of income owners can expect from their sale proceeds and other investments. Combined, these three headwinds wreak havoc on an owner's ability to cross the finish line at all, let alone as he or she originally planned.

Compared to the pre-Great Recession period (1975–2007), these headwinds can double (if not triple) the time and effort that business owners need to create and preserve financial security when they exit their businesses.

Let's look at how each of these headwinds affects your efforts to leave your business in style and which actions you can take today to minimize their effects.

## Headwind 1: The Economy Just Isn't What It Used to Be

Some may object to describing the state of the U.S. economy as “stagnant,” but compared to pre-Great Recession growth rates, it is anything but robust.

A growing economy, like the one we enjoyed from 1975 until 2000, undoubtedly helped your company grow. Like other businesses, yours likely rose with the rising tide of economic growth. Conversely, the economic doldrums that the United States has endured in recent years exposes weaknesses in our companies and allows only best-in-class companies to prosper. Thus, the majority of businesses have retrenched; companies have not regained their former growth rates, especially since 2007.

Let's assume that most businesses grow at a rate similar to that of the national economy, as measured by gross domestic product (GDP). From 1975 to 2000, GDP grew an average of 6.35% per annum (Williamson 2017). Consequently, most businesses doubled their revenue about every 10 years.

Contrast that with the period from 2000 through 2016, in which GDP growth averaged less than 3% per annum (Williamson 2017). Applying the “Rule of 72” (Wikipedia contributors 2017) to that growth rate, businesses will double in revenue/profitability/

value roughly every 25 years or so. When the economy and your customers' revenues are growing at 3% or less per year, it's difficult to grow your business by the annual amount necessary to experience significant increases in value.

Business Enterprise Institute (BEI) recently conducted a survey of business owners in which it asked owners to name what prevented them from moving forward with Exit Planning. One of the most common answers was that their businesses lacked sufficient value to enable them to attain financial security. In short, most owners need to grow value. Larry Summers, former U.S. Secretary of the Treasury, noted in 2013 that the economy might be stuck in *secular stagnation*, "a slump that is not a product of the business cycle but a more-or-less permanent condition" (Coy and Philips 2013, par. 1), which means that growing value requires increasing revenue much faster, and more sustainably, than general economic conditions foster (Allen and Zook 2012).

What is a sustainable rate of growth? According to Allen and Zook (2012) of Bain & Company, "As a benchmark, consider an annual growth rate in revenue and earnings of 5.5%. Most companies expect to attain that level or better—at least that's what their strategic plans call for. But a Bain & Company study of more than 2,000 companies indicates that only about one in 10 actually achieves that relatively modest goal over a 10-year period while earning its cost of capital. In other words, nearly 90% of companies fail to achieve that modest growth objective" (par. 1).

In this economy, growing a business to the point where its value is sufficient to provide you financial security when you sell it is an uphill

ride into a strong headwind, and it's likely to stay that way for the foreseeable future. As the Bain study documented, substantial revenue and earnings growth at the level most owners will need to exit in style is only enjoyed by about 10% of middle-market companies. Will you be part of that 10%? If you need to significantly grow the value of your business to attain financial security upon its sale, doing business as usual won't cut it.

## Mitigating Headwind 1

For most of us, building value in the face of this headwind is not a one- or two-year project. We need more time to get where we are going, typically, 5–10 years more. Building value also requires thoughtful, targeted actions that directly impact cash flow. This economy challenges us to make our efforts more directed and focused. Creating a customized value-building strategy for your company focuses your efforts and can shorten the time it takes to reach your value goals. It's time to get started.

## Headwind 2: The Tax Bite Just Got Bigger

We turn now to tax rates and how the U.S. government's increasing appetite for more revenue affects our ability to grow and reap business value. We'll leave shouting matches about the need to increase taxes on "the wealthy" to others while we examine how increased federal taxes (a) hinder owners' ability to grow their companies and (b) reduce net sales proceeds when owners exit.

## Capital Gains Tax

On January 1, 2013, the federal capital-gains tax rate increased from 15% to 20% on income in excess of \$450,000 for joint filers. This is imposed on the sale of stock of either a C or an S corporation.

## Investment Income Tax

Also effective January 1, 2013, the Affordable Care Act (Obamacare) imposed a 3.8% tax on investment income (including capital gains on the sale of C corporation stock, but not [yet at least] on the sale of S corporation stock) for taxpayers earning above \$250,000 per year. Had you sold your business during 2012, the government would have taken 15% of the gain. Today, it can collect 20–23.8% (if you sell C-corporation stock). That is an increase of 33–59%.

## Creep in Marginal Income-Tax Brackets

Yet another January 1, 2013, implementation was the increase in marginal income-tax brackets for individuals. The new top tax bracket for joint taxpayers earning over \$450,000 is 39.6%. Taxpayers in this bracket potentially face a combined 43.4% (39.6% + 3.8% [ACA]) marginal tax rate on their income.

Because owners of S corporations, sole proprietorships, LLCs, and partnerships are taxed on business income directly, this additional tax affects not only their personal income but also the amount of after-tax income available to their businesses for research, innovation, expansion, and acquisition of other companies. The point the government seems to have missed is that much of the business

owner's taxable income must be kept at the company level if the business is to expand. The money retained in S corporations is taxed, in effect, at the owner's highest marginal tax rate. Raising income tax rates reduces the amount of capital available to fuel growth.

It is difficult to quantify how much this increased tax burden inhibits growth, but it surely is not an insignificant drag, perhaps 5–8%.

## Taxes for Business Owners

Higher taxes affect you as an owner in three ways.

First, if you had sold your business before 2013 and, after taxes, had exactly enough cash to achieve financial security, you'd have to sell that same business for at least 5% more today to cover the higher capital gains taxes and end up with the same amount of cash in your pocket. If your business' cash flow is projected to grow at 5–6% a year, tack on another year or so of growth to the end of your journey.

Second, the increased tax bite will likely reduce the amount of capital available to the business, slowing the rate of cash flow growth.

Third, increased income taxes reduce the amount of money available to you to invest in assets outside the business.

Taxation has always been a headwind in the face of business growth, but the federal government has increased its strength.

## Mitigating Headwind 2

As owners, we are not helpless. In fact, there are several tax strategies and concepts we can use to sidestep higher taxes—but most must

be implemented long before an ownership transfer occurs to be fully effective (at least five years).

In fact, it is most effective to implement tax strategies before your value-building activities take full effect. We encourage you to use the services of an experienced business tax advisor who is familiar with Exit Planning concepts.

## **Headwind 3: Dwindling Returns on Investment**

Many owners who have been in business for decades consider 6–10% to be a conservative return on the investment of our sale proceeds, because that's what we enjoyed during the years we started and grew our businesses. Those days and returns are gone.

There has been minimal growth in the stock market since 2000, and bond rates have plummeted to less than half of what they were just a few years ago.

### **The Statistics**

From 1975 to 2000, the S&P 500 had an average return (dividends included) of 15.825% per year. Contrast that with this century: From 2000 through 2016, the average annual S&P 500 return (including dividends) was 4.683% (PK and Daniels 2017). From 1975 to 2000, the average yield on 10-year U.S. Treasury bonds was 8.37%. From 2000–2017, the average yield was 3.43% (Multpl.com 2017).

“The yield on the benchmark 10-year Treasury note is just under 2.2 percent, compared with more than 6.5 percent, on average, since 1962, according to quarterly

Bloomberg data. And bond investing is likely to remain challenging for years to come. Investors may face a double-whammy — low yields now and the prospect of significant losses as yields rise” (Sommer 2013, pars. 19–20).

Of course, we can hope that the stock market and investment returns will grow significantly in the future. However, we could experience another Great Recession,

during which we'll watch stock prices fall 30 or 40% and deflation emerge, thus lowering the already-low bond rates to something uncomfortably close to zero. It's impossible to predict.

We do know that former owners returned to work when their investment portfolios did not perform as anticipated. Those in their 40s or 50s could restart their business lives, but most of today's boomer owners are older than 55, and returning to work for 5–10 years is not only unappealing but also likely undoable. Few owners want to return to work because they've exhausted their savings after their exits.

To prevent this unpleasant scenario, many financial advisors consider a 3–4% return on liquid funds to be a safe and reasonable return estimate for their clients (Zimmerman 2013).

If you take this conservative approach based on this century's investment experience, it's likely that your investment return will be 50% or so of what you would have expected during the 1980s and 90s. That means your nest egg needs to be twice the size to produce the same income as in past decades.

## Little Time Means Little Room for Risk

When we are young and our income is the result of our business efforts, we invest in the stock market. Because we have time and the expectation of continued business income, we assume the greater risk of the stock market in hopes of greater returns. After we exit and rely solely on investment income, we invest in presumably lower-risk bonds and settle for less income.

## Mitigating Headwind 3

The best defense against diminished market returns is to acknowledge this reality and rely on a skilled financial advisor to inject that reality into your Exit Plan.

Decreased return expectations may prompt you to work in your business longer or invest, rather than spend, excess distributions.

The strategies you choose to adjust to new market realities are part of the Exit Plan you and your advisors create.

## The Headwind Trifecta

We haven't talked about the effects that rising health care costs, increased life expectancies, globalization, and Internet competition have had on (a) a company's ability to grow and (b) funding a retirement. If we consider just the three aforementioned headwinds alone—a stagnant economy, increased taxes on business income and sale proceeds, and a lackluster investment environment—the implications are clear:

1. It will take significantly more time to grow business value unless it is growing far faster than the GDP. Only 10% of middle-market companies grow faster than 5.5% plus the cost of capital per year.
2. Increased taxes serve to reduce the amount of capital both owners and their businesses can accumulate.
3. Compared to pre-recession levels, investment income has been halved.
4. Waiting for headwinds to calm is not an option.

The good news is that a successful exit and financially secure future are still possible. Like the headwinds the bicyclist faces, these headwinds either lengthen the time it will take you to reach your finish line or require more efficient effort on your part.

Unlike the biker who can wait another day to let the headwinds subside, boomers contemplating their exits don't have that luxury. Owners must act to overpower them.

## Conclusion

At a minimum, you need to do three things:

1. Develop a realistic plan to grow transferable value using the tools and techniques used by the top 10% of companies identified in the Allen and Zook study.
2. Engage in tax-minimization strategies while there is time to implement these strategies before your exit begins.
3. Create a strategy to increase the amount of investment capital available to you when you exit.

All of these actions are part of Exit Planning, a unique process that encompasses business growth, value preservation through tax planning, and ownership transition planning for you and your business.

*If you would like more information about how we can help you to create a plan to exit your business that considers the issues involved in this white paper, please give us a call. Our practice is experienced in overcoming these headwinds and would love to help you cut through them on your path to a successful exit.*

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