Ballard Spahr LLP

The Numbers Don’t Lie

Why you should care about Baby Boomer demographics when thinking about a successful exit from your business

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Although this article is applicable to a broader population, it is written with a special eye toward Baby Boomer owners of lower middle-market businesses.[1] Why? First, because it's the Baby Boomer business owners who will be most affected by the demographics of which they are a part. Second, because the resulting market changes create unique challenges to companies in the lower middle-market segment. Demographic trends will have similar effects on businesses in the micro segment (with annual sales of less than $5 million), especially those at the upper end of that category. However, these forces are less likely to affect owners of smaller "lifestyle" businesses that don't count on liquidating their companies to achieve their personal and financial retirement goals.

THOSE WILD AND CRAZY BABY BOOMERS

By definition, a Baby Boomer is someone born between 1946 and 1964. That's over 75 million people in the United States—more than 26 percent of the total population. Baby Boomers became better educated than any prior generation of Americans. The stereotypical Baby Boomer has an optimistic, competitive, "can-do" personality. Due largely to those characteristics, Baby Boomers own a significant percentage of privately held U.S. privately held businesses—likely more than half of companies with more than a handful of employees.

It is estimated that as many as 12 million businesses in this country are owned and operated by Baby Boomers. Many of those businesses, though, are essentially sole proprietorships in which the owner is the business and vice versa. Culling those 'micro' businesses from the total results in there likely being around four million middle-market businesses in the United States still owned by Baby Boomers. Most of those businesses fall into the lower middle-market segment. Experience demonstrates that the Baby Boomer owners tend to remain actively involved in operating their businesses. It's in their DNA.

Given the advancing age of the U.S. population, one would think we'd be smack in the middle of an active period of sales of Baby Boomer businesses as part of the "silver tsunami" that has been predicted for several years. However, the full effect of rising age demographics has not yet been felt. That may be in part because the Great Recession forced many Baby Boomers to delay their transition plans. The strong economy in recent years likely contributed, as well, by enabling owners to realize better returns from operating the businesses than by selling it and investing the proceeds. Furthermore, there is an understandable emotional reluctance on the

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1 *"Lower middle-market businesses" are commonly defined as companies with annual revenue between $5 million and $100 million.*

part of many Baby Boomer business owners to part with their "babies" unless and until faced with compelling reasons to have to.

Despite these factors, the silver tsunami will occur. It is indisputably a key external variable, which lower middle-market business owners must address to plan a successful transition to the next stage of their lives.

THE EFFECT OF BABY BOOMER DEMOGRAPHICS ON THE ECONOMY

The logic underlying proactive planning to address the effects of Baby Boomer demographics on your business flows from two related sources. The first is its likely effect on the economy. The second is its predictable effect on the market for M&A transactions.

Beginning in 2011, about 10,000 U.S. Baby Boomers have turned 65 every day. Those kinds of numbers will continue until the very end of the 2020s. In the recently completed decade (2010 to 2020), nearly as many people turned 65 as in the prior four decades combined. At the same time, the percentage of employees who are at least 55 years of age has risen to about 25 percent.

Baby Boomer demographics are having game-changing impacts on our national and state workforces. The ratio of workers to retirees in Minnesota, for instance, is dropping from 5:1 in 2010 to 4:1 in 2020 to 3:1 in 2030. Since 2016, the number of job vacancies in the State of Minnesota has been higher than the number of people actively seeking employment. More people are leaving the workforce than are entering it. That same phenomenon has existed on a national level since January 2018.

Maintaining vibrant state and national economies depends on employers' ability to increase per-worker productivity or to source labor in other ways. Low workforce growth is a key supply constraint on overall economic growth***. Thus, the strategic planning being conducted by executives of lower middle-market companies tends to include anticipated effects of changes in the state and national economies on what it will take to enable their businesses to continue to enjoy their recent levels of financial success.***

THE TSUNAMI OF BABY BOOMER BUSINESS SALES

Within that potentially challenging economic climate, what do Baby Boomer demographic trends likely mean for sales of lower middle-market businesses?

Some analysts estimate that 65 percent to 75 percent of all small businesses in the United States, very much including lower middle-market companies, will put themselves up for sale during the next 10 years. That type of activity is simply unprecedented. It's driven by the predominance of Baby Boomer ownership. The desire to do something else—or other considerations such as health—will cause the vast majority of Baby Boomer businesses owners to pull the trigger in short order. In fact, the pace of transitions may accelerate if the flood of businesses available for purchase makes it challenging for sellers to command the type of enterprise value that has been available in the current market.

Estimates of the number of businesses coming onto the market supports predictions that the next 15 years will entail the largest intergenerational transfer of private businesses in history. Researchers have projected that more than $10 trillion in business assets may be transferred by the end of this decade.

For these and other reasons, the overwhelming consensus of those who have examined the issue is that we are at the front end of a tsunami-level increase in the number of businesses available for purchase.

POTENTIAL EFFECT ON NET WORTHS OF BABY BOOMER BUSINESS OWNERS

The supply and demand effect of the wave of businesses coming onto the market is obvious. Less obvious is how dramatic the impact will be on business values, especially of well-managed companies. An abundance of capital remains available to invest in good businesses. Nevertheless, it seems improbable that anyone with a profitable business will be able to insist on the types of earnings before interest, taxes, depreciation, and amortization (EBITDA) multiples currently being paid. The availability of more choices will cause buyer "good business" standards to be tightened.

One known factor is that a decrease in valuation of a business owned by a Baby Boomer is likely to have a dramatic effect on that Baby Boomer's overall net worth. A study by researchers Moskowitz and Vissing-Jørgensen of owners of private businesses in the U.S. revealed that "about 75 percent of all private equity in this country is owned by households for whom it constitutes at least half of their total net worth. Furthermore, households with entrepreneurial equity invest on average more than 70 percent of their private holdings in a single private company."

In short, an unprecedented number of privately held businesses representing the lion's share of the owner's net worth will be coming onto the market during a confined period of time—and in a setting where overall economic growth and confidence in the economy may be challenged. That will cause buyers to become more acutely aware of differences among the choices available. Those sellers who cannot demonstrate that their companies are distinctive and have easily transferrable value will become quickly marginalized.

RESPONDING TO INFORMATION ABOUT LANDSCAPE CHANGE

A potential response to statistical-based conclusions is to label them "bad science" and to simply embrace denial. Things have always worked out. Why shouldn't they again? If you fall into this category, read no more. There's nothing that's coming that will be of interest to you.

For those who recognize the inevitability of a landscape change, the challenge is to put that knowledge to productive use.

One alternative, of course, is to give in to sheer panic. Rush out to sell or liquidate your business before it's too late, regardless of whether it's your best move! A panic reaction, though, is probably an indicator that your business is not as ready for sale as it needs to be to meet your "after business" needs.

That said, accelerating the timing of sale of their companies may be prudent for some Baby Boomer owners. The values of their businesses may be at a high point and the cost associated with waiting to sell may outweigh the personal reasons for not otherwise wanting to pull the trigger now***. However, the timing decision should be based on a reliable understanding of (a) what an owner requires in net proceeds of sale of his/her business in order to meet defined expectations for the remainder of the owner's life, (b) what the business is worth right now, and (c) what, if anything, can be done to maintain or enhance that value if either this is not otherwise the right personal time to sell or if current value doesn't meet retirement needs.***

Another alternative, after undertaking the type of audit described above, is to invest prudently in ensuring that your business will be viewed by future buyers as distinctive and valuable even if there are a lot more contestants in the beauty contest.

As a legal services provider, Ballard Spahr has been actively involved in awareness-raising efforts, including educational seminars and workshops, to help lower middle-market companies, a key component of the firm's client base, anticipate and address a changing market when making transition decisions. In addition, the firm has developed service offerings specifically designed to meet this emerging need. We often work collaboratively with financial advisers, accountants, business consultants, investment bankers, fractional CFOs, and other service providers to successfully achieve client transition objectives.

TAKEAWAYS

Two "take-aways" are offered to anyone who will likely be selling or otherwise transferring his or her business in the next 10 years:

1. **Recognize the Trends** – and factor them into your planning. You evaluate external industry and economic factors when developing strategies for your business operations. It's only logical to do the same when positioning for what will undoubtedly be the most important transaction of your life.

2. **Invest in Transition Planning.** Most of you are entering unchartered waters. You're experienced in running your company but not in selling or otherwise transferring it to others. Furthermore, the M&A landscape will be more dynamic and challenging than has recently been the case. Investments today that help you maintain or build enterprise value in your business by the time of transfer deliver a strong ROI. Securing even an extra half point in the EBITDA multiple being used to value your business will no doubt make a tangible difference to your net worth.

TRANSITION PLANNING

Although transition planning a separate subject that deserves more comprehensive treatment, the following are steps that can be taken as part of the owner and business transition planning process:

1. **Carefully Think Through Both Personal and Business Goals.** "Where you want to be" includes clear identification of your post-transition financial needs but isn't limited to that. Your personal and legacy goals may be key drivers of how you want to structure the way in which you deliver to others the business you have nurtured over the years. Almost invariably, though, step one in the process will be understanding what level of monthly income is required in order to accomplish what you have identified as important for the next act of your life story.

2. **Audit Where You Are Now.** "Where you are now" includes obtaining a well-founded sense of how your business would likely be valued if it were to be sold right now. It also includes evaluation of the other components of your net worth and determination of what level of income will be necessary to keep you content after you have been weaned from your business. Finally, your "now" audit includes assessment of where you and your family are in preparing for the "personal" (sometimes psychological) side of life after business.

3. **Give Yourself Time to Succeed.** It's not too early and you don't want it to be too late. Develop a path that gets you from point A, where you are right now, to point B, where you are positioned to exit your business in a manner that meets your transition needs. That path-charting will likely concentrate primarily on business transition planning, very much including the development of transferable value (repeatable performance even in your absence). Deepening your company's level of transferable value is important whether your ultimate plan is to sell to a third party, to transfer ownership within the family, or to sell to management or to an ESOP. When putting your plan together, consider getting input from others who are experienced in identifying factors that influence buyer perception of value. It's worth the time and money. Also, explore how to measure your progress toward meeting plan goals. Finally, be ready for contingencies. The one thing you know for sure is that whatever plan you develop will need changes along the way.

4. **Invest Wisely**. More often than not, your plan will include development of intangible assets (processes, information, people, financial reporting) to protect and enhance the value of your company. It may also have risk management features. Investment of time, focus, and money in those more ethereal endeavors tends to get deferred as you deal with the press of day-to-day matters. Again, the goal is to make your company fully transferable and otherwise attractive to prospective buyers. Make intangible asset investment decisions in the same way you would decide on capital expenditures or other tangible asset investments. Prioritize the items that lie closest to the core of what makes your company successful. Ultimately, the difference in exit value should be a multiple of what you spend to enhance your business's transferable value. Especially with an increasingly dynamic M&A market, it's critical that you create and start implanting a plan early enough to enable your investments to bear fruit.

Baby Boomers have had a very successful run. The results of demographic trends can only affect the degree, not the existence, of Baby Boomer success. It behooves all of us, service providers included, to work in concert to take the steps needed during the next decade to secure sale prices for middle-market businesses that empower their owners to meet post-business life expectations.

To explore whether Ballard can help you meet business transition planning, estate planning, or tax planning objectives, please contact:

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