HOLLENCREST
CAPITAL MANAGEMENT

HEADWINDS
WHITE PAPER

Presented By: Hollencrest Capital Management

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 near the finish. 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 very 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 more time to exit our businesses in style.

Today, all owners face three significant headwinds that increase the difficulty of a successful business exit. One is our flat economy—today and for the foreseeable future. The second is the substantially higher tax bill that's due upon the sale of a business. And last, but not least, 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 they originally planned.

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

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

HEADWIND ONE: THE ECONOMY JUST AIN'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.

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"Larry Summers, the man who was almost chairman of the Federal Reserve, is awfully gloomy about U.S. growth prospects. In a Nov. 8 speech [2013] at the International Monetary Fund, he suggested the U.S. might be stuck in 'secular stagnation'—a slump that is not a product of the business cycle but a more-or-less permanent condition."[1]

A growing economy, like the one we enjoyed from 1975 until 2000, undoubtedly helped your company grow—it, like other businesses, rose with the rising tide of economic growth. Conversely the economic doldrums that the U.S. has endured for the last 15 years exposes weaknesses in our companies and allow only the "best of class" to prosper. As a result, the great 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 the Gross Domestic Product (GDP). From 1975 to 2000 GDP grew an average of 6.35 percent, per annum. Consequently, most businesses doubled their revenue about every ten years.[2]

Contrast that with the period from 2000 through today with GDP growth averaging less than three percent per annum.

Applying the "Rule of 72" to that growth rate, businesses will double in revenue/profitability/value roughly every 25 years or so.[3] When the economy and your customers' revenues are growing at three percent or less per year, it's very difficult to grow your business by an annual amount necessary to experience significant increases in value.

Business Enterprise Institute, Inc. recently conducted a survey of business owners in which it asked owners to name what prevented them from moving forward with exit planning. The most common answer was that their businesses lacked sufficient value to enable them to attain financial security. In short, most owners need to grow value. When 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," growing value requires increasing revenue much faster, and more sustainably, than general economic conditions foster.[4]

"What is a sustainable rate of growth? As a benchmark, consider an annual growth rate in revenue and earnings of 5.5 percent. Most companies expect to attain that level or better— at least that's what's called for in their strategic plans. 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

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cost of capital. In other words, nearly 90% of companies fail to achieve that modest growth objective." (Bain, Ibid.)

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

...substantial revenue and earnings growth at the level most owners need in order to exit in style is only enjoyed by about 10 percent of middle-market companies. Will you be part of that 10 percent?

Mitigating Headwind 1. For most of us, building necessary 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: think five to 10 years more time.

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 TWO: 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.

Let's leave shouting matches about the need to or folly of increasing taxes on "the wealthy" to others while we examine how increased federal taxes: 1) hinder owners' ability to grow their companies and 2) reduce net sales proceeds when owners exit.

Capital Gains Tax. On New Year's Day, 2013 the federal capital gains tax rate increased from 15 percent to 20 percent 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 Health Care Act (Obamacare) imposes a 3.8 percent tax on investment income (including capital gains on the sale of C corporation stock, but

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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 percent of the gain. Today it can collect 20 to 23.8 percent (if you sell the stock of a C corporation). That is an increase of 33 percent to 59 percent.

Creep in Marginal Income Tax Brackets.

Also on New Year's Day of 2013 the marginal income tax brackets for individuals increased. The new top tax bracket for joint taxpayers earning over $450,000 is 39.6 percent. Taxpayers in this bracket potentially face a combined 43.4% (39.6% + 3.8% (AHCA)) 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, acquisition of other companies, etc.

The point the government seems to have missed is that much of the income taxable to the business owner 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 highest marginal tax rate of the owner. Raising income tax rates reduces the amount of capital available to fuel growth.

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It is difficult to quantify how much this increased tax burden inhibits growth, but it surely is not an insignificant drag, perhaps five to eight percent.

Taxes For Business Owners. Higher taxes affect you as an owner in a number of 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 today by five-plus percent more to cover the higher capital gains taxes to end up with the same amount of cash in your pocket.

If the cash flow of your business is projected to grow at five or six percent 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

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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 Feds have increased its velocity.

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

In fact, it is most effective to implement tax strategies before your value-building activities take full effect. We encourage you to seek out an experienced business tax advisor who is familiar with exit planning concepts.

HEADWIND THREE: DWINDLING RETURNS ON INVESTMENT

Many of us of a certain age consider six to ten percent 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 those 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 (dividend included) of 16.88 percent per year. Contrast that with this century: From 2000 through 2013, the average annual S&P 500 return (including dividends) was 2.324 percent.

From 1975 to 2000, the yield on 10-year U.S. Treasury bonds was approximately eight percent (8.37%). During the past six to eight years: approximately three percent (3.78%).

"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."[5]

Of course, we can hope that the stock market and investment returns will grow significantly in the future. Or we could experience another "Great Recession" during which we'll watch stock prices fall 30 or 40 percent and deflation emerge thus lowering the already-low bond rates to something uncomfortably close to zero. Who knows?

We do know former owners who returned to work when their investment portfolios did not perform as anticipated. Those in their 40s or 50s were capable of

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restarting their business lives, but most of today's Boomer owners are older than 55 and returning to work in five or ten years for five or ten years is not only unappealing, but likely undoable. Few owners want to return to work after their exits because they've exhausted their savings.

To prevent this unpleasant scenario many financial advisors consider a three to four percent return on liquid funds to be a safe and reasonable return estimate for their clients.[6]

If you take this conservative approach based on the investment experience of this century, it's likely that your investment return will be 50 percent 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.

After we exit and rely solely on investment income, we invest in presumably lower risk bonds and settle for less income.

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. We have time and the expectation of continued business income so we assume the greater risk of the stock market in hope 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 to 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 on a company's ability to grow and on funding a retirement. If we consider just these three 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 ten percent of middle-market

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companies grow faster than 5.5 percent 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 lengthen the time it will take 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 have to act to overpower them.

ACT NOW

At a minimum:

1. Develop a realistic plan to grow transferable value using the tools and techniques used by the top 10 percent companies identified in the Bain & Company 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, that unique process which 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.

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[1] http://www.businessweek.com/articles/2013-11-18/larry-summers-has-a-wintry-outlook-on-the-economy

[2] http://www.measuringworth.com/growth/growth_resultf.php?begin%5B%5D=2000&end%5B%5D=2013&bginP%5B%5D=&endP%5B%5D=&US%5B55D=NOMGDPCP

[3] http://en.wikipedia.org/wiki/Rule_of_72

[4] http://www.bain.com/publications/articles/the-strategic-principles-of-repeatability.aspx"

[5] http://www.nytimes.com/2013/06/09/your-money/why-many-retirees-could-outlive-a-1-million-nest-egg.html?hp&_r=0

[6] See: http://www.nytimes.com/2013/05/15/business/retirementspecial/the-4-rule-for- retirement-withdrawals-may-be-outdated.html?src=rechp

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