You Should Consider a Liquidity Event Now

Business owners and investors should carefully consider a meaningful "liquidity event" in 2012. A confluence of factors has created an advantageous time to pursue a sale of all or a portion of company stock or assets, or, for certain owners, a dividend re-cap. These factors include a high likelihood of rising capital gains and dividend tax rates, a much improved company sale valuation environment and the prospects for future economic and market challenges. Together, they have combined to form a compelling argument for business owners to actively evaluate transaction alternatives in the immediate term.

Rising Capital Gains and Dividend Tax Rates

Unless Washington extends the current rate, the federal tax on capital gains will increase from 15% to 20% on January 1, 2013. In addition, as part of the Obama healthcare legislation, 3.8% will be added to capital gains, so that for most sale transactions in 2013, the new rate will be 23.8%.

For many long-time business owners, a sale of stock or assets will trigger a substantial taxable gain since their cost basis is so low. Paying a 15% tax this year versus 23.8% in the future will result in significantly higher net proceeds and long-term wealth. Due to the greater starting principal and the impact of compounding investment returns, Bernstein Global Wealth Management has estimated that a seller at a 15% tax rate will have nearly 43% greater wealth in 30 years than a seller at 23.8%, all else equal.

Certain owners have told us they are better off waiting on a sale because their higher forecasted earnings in future years will result in an increased valuation that will offset any capital gains tax rate increase. Assuming constant valuation multiples and market conditions and an owner who has a very low cost basis (the purchase price is practically all taxable gain), EBITDA would need to increase by over 11% to achieve the same net proceeds. Considering the time value of money, EBITDA may need to increase by 15% or more. For some businesses, this may be an appropriate trade off if there is a high probability of substantially greater future earnings. However, there is significant inherent risk in this strategy that negative changes will occur in the transaction environment, with interest rates and/or regarding economic conditions - see below.

Similarly, the federal tax rate on dividends is set to rise from 15% to the marginal ordinary income rate of as much as 43.4% (including the 3.8% Obama healthcare increase on higher income earners). For certain companies such as C-corporations, a dividend recapitalization, wherein new debt proceeds are distributed to shareholders, makes much more sense to pursue in 2012 before the tax rates rise.

Improved Company Sale Environment

Market conditions for company sales have improved substantially in 2012 for several reasons. Firstly, there is an unprecedented amount of acquisition equity capital on the sidelines available for deals. It is estimated that private equity funds have over $500 billion and corporations over $2 trillion in liquidity. With relatively few quality companies "on the market", these large war chests are bidding up valuations.

Secondly, interest rates are extremely low and acquisition debt capital has become more readily available through the high yield markets and commercial banks. As lenders are providing greater amounts of low cost leverage through higher multiples of cash flow and/or advance rates on collateral, buyers are able to pay higher prices.

Thirdly, the economy has demonstrated some strengthening with improved metrics in many areas including unemployment, manufacturing and, even, housing. This has a positive effect on both consumer and business confidence, encouraging buyers to "pull the trigger" on acquisitions.

Overall, these and other factors have led to an uptick in valuation multiples being paid in M&A

transactions. For healthy companies in particular, some market participants are observing that the bidding wars for such businesses today are reminiscent of the 2005-2007 time period.

Potential Challenges Ahead

While the economy and capital markets are demonstrating strong trends for sellers, much risk of a stumble or shock to the system exists. Certainly, any major European debt or structural meltdown could set back the stock markets as well as investor and lender confidence. Oil prices have been rising, and $5.00 a gallon gas would paralyze the consumer who represents two-thirds of the U.S. economy. Also, the U.S. economy remains fragile, in that most of the corporate profit gains have come from pushing the labor cost line down to the lowest percentage of sales in recent memory. This brings into question whether corporations have any more ammunition for profit improvement, especially when the top line sales are held down by, not coincidentally, the low wage environment. All of these topics are front and center in the 2012 Presidential election, which itself inject tremendous uncertainty into the future direction of taxes, the economy and the capital markets. Lastly, with federal, state and local deficits running wild, government spending and employment will continue to drop, reducing economic demand for goods and services. In sum, there are real economic and political risks that could readily dampen the M&A market for sellers in 2013.

Urgency Required

We recommend to business owners considering a sale transaction that they formulate an accelerated plan in order to "get in front" of the busy anticipated M&A calendar later this year. We expect many owners to pursue liquidity events for tax purposes by December 31st. Also, many private equity firms are looking to sell portfolio companies this year before carried interest (their promoted share of profits) is converted from capital gains treatment to ordinary income. As a result of the heavy forward calendar, the fourth quarters is likely to be "clogged up," and the availability of financing sources, legal professionals and other sale transaction resources will be very limited. Also, we believe buyers will have substantial negotiating leverage in the fourth quarter as they will know the economic benefit to sellers of closing in 2012.

Conclusion

Whether you are a business owner, investor or stockholder, if you are contemplating a meaningful sale or cash distribution during the next several years, we believe you should consider acting with urgency. There are numerous alternatives available from a 100% divestiture to a majority control sale to a minority equity sale to a dividend re-cap. Whatever makes sense for you, it is prudent to orchestrate a liquidity event in order to diversify your wealth in what is likely to be the lowest tax rate environment of our lifetime and in a very favorable deal market. We encourage you to act promptly. Trinity Capital has substantial experience in all types of sale and dividend transactions and would be pleased to share our perspectives on your situation.

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