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J.P. MORGAN
ADVICE LAB

in your interest

A WINDOW OF OPPORTUNITY FOR BUSINESS OWNERS

Factors are aligning to create a potentially favorable market for those interested in exploring a sale. But it's important to prepare now, as conditions may not last.

Many private business owners would like greater liquidity for their retirement or so they can pursue other endeavors. Unfortunately, their options have been constrained during the past three years, as the worldwide financial crisis froze credit and withered mergers and acquisitions (M&A) activity.

The second half of 2011 looks like it may offer a better market for the sale of both private and public businesses. Favorable drivers of M&A activity are in place, including high levels of corporate cash; large amounts of uncommitted capital at private equity firms; easier access to credit; and an improving economic outlook. These factors suggest a window of opportunity is opening. However, because dealmakers know from experience that such windows can close quickly, it is important that business owners prepare now.

We recommend that owners plan well in advance of a potential transaction so they can better meet a range of goals—from optimizing income and maximizing tax efficiency to transferring wealth to families and/or charities.

MOTIVATING BUYERS

An improving economy is expected to unleash pent-up demand and capital to put more buyers in the market, boding well for owners who want to consider liquidity options such as a sale, a partial sale or recapitalization of their businesses.

Entering 2008, global merger volume was barreling ahead, riding high on five consecutive years of growth.¹ This momentum came to an abrupt halt at the end of the year due to the stresses of the global financial crisis.

After a period of market contraction through 2008 and 2009, the U.S. economy grew at a healthy rate of 2.9% in 2010.² Transaction levels began to pick up, although much of this activity involved the sale of distressed companies and value deals.

Continued improvement of economic conditions and accompanying consumer confidence may bolster M&A activity through the second half of 2011.³ Strategic buyers are eager to enter the markets after months of sitting on the sidelines. Non-financial companies are flush with cash, with liquid assets representing approximately 15% of their combined tangible assets as of the first quarter of 2011.⁴ With mounting pressure to grow organically, corporations are expected to seek strategic acquisitions to drive returns.

In addition, private equity (PE) firms have been building significant liquidity to fund acquisitions. At the beginning of 2011, an estimated \$434 billion in capital was available for buyouts alone.⁵ With investment periods for many private equity funds reaching their expiration, fund managers are pressured to put that committed capital to work.

¹ Jessica Hall. "Global M&A falls in 2008." *Reuters*, December 22, 2008.

² Bureau of Economic Analysis, U.S. Department of Commerce, March 25, 2011, release.

³ The Consumer Confidence Index stood at 63.4 for March 2011. While consumer confidence dropped 8.6 points from February 2011, it was the fourth consecutive month the Index had a reading above 60. The Conference Board, *Consumer Confidence Survey*, March 29, 2011.

⁴ Federal Reserve, Flow of Funds data as of the fourth quarter of 2010.

⁵ Bain & Company, *Global Private Equity Report 2011*.

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Furthermore, banks have begun to ease their lending standards,⁶ causing leverage levels to trend upward and providing access to capital for owner recapitalizations as well as leveraged buyout deals.

ATTRACTING SELLERS

Sellers and buyers have reason to consider a transaction.

Prices for businesses have been on the rise. Global M&A market volume is still far from its peak in 2007, although market fundamentals already have provided a boost. Global M&A volume increased 28% from the first quarter of 2010 to the first quarter of 2011.⁷ That increase in volume was accompanied by general improvements in transaction multiples. Multiples are now significantly above their 2009 lows for deals both above and below the \$500 million mark. They too are still below their 2007 peaks.⁸

A potentially time-limited tax opportunity also suggests that U.S.-based sellers should act now.

Recent legislation extending the Bush-era tax cuts to 2013 provides short-term clarity regarding owners' potential transfer, income and capital gains taxes.⁹ However, with financial pressures mounting on the federal government, it is unclear whether Congress will extend the current low tax rates for high-income earners beyond January 1, 2013.

REDUCING TAXES

Private business owners who had the foresight to implement wealth transfer strategies during the market lull are poised to take advantage of this window of opportunity.

For example, if they gifted shares of a business with depressed values to a trust for the benefit of their heirs, any sale premium could be realized off their own balance sheets, thus saving gift and estate taxes on gains transferred to heirs. The value of gifts and their associated tax burden may be further reduced by potential discounts for lack of marketability and lack of control.

Gifting strategies still may benefit business owners who have yet to focus on estate planning but do want to take advantage of favorable conditions. They should not delay discussing with their legal and tax advisors the full array of planning techniques that might be put in place both before and after a transaction.

As just one example of a potential post-transaction technique, consider the GRAT (grantor retained annuity trust).

Even though credit markets are improving, many deals are likely to be partially or wholly financed with the acquirer's stock. Soon after the transaction, sellers may want to use their cash proceeds from the sale to adjust their overall investment portfolios to account for this single-stock concentration. In addition, if sellers expect the stock to appreciate before they can diversify out of the position, they might be well served to utilize a GRAT so that gains might be transferred tax-free to their heirs.

This goal is accomplished by having the seller transfer the stock received in the transaction to the GRAT while retaining an annuity from this trust. The annuity is calculated using an interest rate, the 7520 rate, which is determined by the Internal Revenue Service. Generally, if the return outperforms the hurdle rate over the term of the trust, the excess value passes to heirs free of gift and estate taxes. Today's low 7520 rate¹⁰ makes this strategy particularly compelling.

A GRAT is only one of many wealth-transfer planning strategies available to sellers. Business owners should work with their legal and tax advisors to choose an approach that works best for their particular situations.

INCREASING NET PROCEEDS

Preparation for a potential transaction may increase not only the value of the transaction, but also the likelihood the sale will be completed.

For example, one owner initially worried that the net proceeds from a proposed sale of his business would be insufficient to meet his lifestyle needs and legacy goals. Careful pre-transaction tax planning enabled him to project an additional \$4 million in value from tax savings, which made him comfortable proceeding with the sale.

⁶ *Loan Officer Opinion Survey on Bank Lending Practices*, Federal Reserve, May 2, 2011.

⁷ Dealogic, *Global M&A Review*, First Quarter 2011.

⁸ Dealogic data, as of the first quarter of 2011.

⁹ The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 was signed into law by President Obama on December 17, 2010.

¹⁰ The Annual Mid-Term Applicable Federal Rate as mandated by Internal Revenue Code Section 7520 was 3.0% in May 2011.

The pre-transaction planning was relatively straightforward: Well in advance of the sale, the business owner funded—with discounted, pre-transaction stock representing a minority interest in his company—various trusts in Delaware, including a generation-skipping transfer trust for the benefit of his children and grandchildren.

The owner then worked to make his business more marketable by shoring up its balance sheet: eliminating unnecessary debt and expenses; and identifying addbacks to the balance sheet. When the company's shares later sold at a premium, the trust's location in Delaware allowed for state income tax savings, as the trusts were not considered residents of the owner's home state for tax purposes.

The owner was able to meet his income target and his legacy goals for his children and grandchildren.

THE TIME TO ACT IS NOW

While the M&A market may be primed to provide favorable, near-term exit opportunities for business owners, this window may not stay open for very long. In the United States, there are worries that higher commodity prices could trigger inflation and that depressed home prices, a reduction in government spending, a weakening dollar and unemployment could stunt growth.

Business owners who envision selling all or part of their business should plan now to maximize the marketability of their business and to assess their longer-term personal financial goals for themselves and their families.

Planning now can increase the likelihood of a successful deal for the owner and his or her heirs.

**THIS PAPER IS WRITTEN BY
THE ADVICE LAB
AT J.P. MORGAN PRIVATE BANK**

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