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2022 outlook for business owners

ADVICE AND PLANNING UPDATE

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Key takeaways:

- The beginning of a new year is a great time to review and reflect on your goals for the business and your personal plans, and to be intentional about the path forward.
- Market and economic indicators continue to be strong despite inflationary fears, but there are also risks to consider.
- The current merger and acquisition (M&A) climate is seller-friendly across virtually every industry sector and size of business. If you are considering a sale, now may be an opportune time.
- Aligning your business plan with your personal goals can reveal gifting and wealth transfer strategies you may not have considered.

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When is the last time you asked yourself, “What do I want from my business?” As we turn the page to 2022, after two years of dramatic change in the economy, the markets, and personal lives, many business owners are reflecting on and reevaluating their intentions like never before.

No matter how your business fared through the pandemic, protecting and capitalizing on the value of your business is a top priority. This outlook is intended to help you assess several factors that can have significant impacts to business owners and suggest key actions to consider as you plan for the upcoming year:

- What are your goals and intentions for the business?
- How might the economy impact your success?
- Could the outlook for M&A demand alter your plan?
- How coordinated are your personal and business plans?

What are your goals and intentions — have they changed?

Business success often relies on finding the optimal balance between opportunity and risk. The pandemic changed everything, creating dramatic shifts in business fundamentals and revealing some of the risks associated with ownership that are always present but maybe not so visible. This caused many owners we advise to question their level of commitment to the business or to rethink the timing of a transition.

For those who wish to keep their enterprise, the outlook for 2022 may provide a good opportunity to build value and create wealth. For those who decide to transition the responsibilities of ownership, market and valuation trends appear favorable. For either option, inflation will be a factor.

Standing at this crossroads – should I stay or should I sell? – is, for many owners, the most challenging point in their ownership journey

How do you evaluate the pros and cons? Assess the many “what if” scenarios? Often, a guiding question can help you choose the right path: *What do I want my business to do for me and those I care about most?*

Make a list of top priorities — for example:

- Generate income to support my lifestyle and fund retirement
- Provide financial security for my family
- Reward loyal employees
- Benefit my community

Then, create timelines and activity plans for achieving those goals. If you find it difficult to build enthusiasm for your plan, it may be time to reassess your goals.

How might the economy impact your success?

As we look to 2022, it appears that the country is ready to forge ahead despite the persistence of COVID-19. Jobs are plentiful, corporate profits have been strong, many businesses have reopened, new business start-ups have hit record levels, and consumers are financially healthy, as savings and incomes have expanded considerably.

However, Wells Fargo Investment Institute (WFII) expects this hot economic growth to cool this year as the booming expansion of the past 18 months transitions to a slower, but more sustainable, trajectory in 2022.

Inflation should slowly ease as supply shortages normalize but will still be higher than the low levels we have experienced over the past decade. As these early-cycle dynamics evolve into mid-cycle drivers, history has taught us to expect lower market volatility, rising consumer confidence, tightening monetary and fiscal policy, and money flowing into riskier assets.

In the 2022 investment outlook titled “[Which Way to the Recovery?](#),” WFI addresses the impact of inflation, how the Federal Reserve is addressing it, and the future impact of COVID-19 on both the markets and the economy.

Could the outlook for M&A demand alter your plans?

2021 was the biggest year on record for M&A volume, with annual growth of 82% in the U.S. and 64% globally. All major regions around the world and all industry sectors experienced significant growth.

That unprecedented volume translated into aggressive buyer behavior and the rising impact of private equity. In the U.S., average valuations rose about 10% among companies with enterprise value less than \$1 billion. This valuation growth partially reflected a rebound from the lull in M&A activity during the first half of 2020 and partly reflected a general increase in valuation levels that we’ve not seen since 2015. Private equity buyers, who have an unspent war chest of approximately \$571 billion in North America, represent about 26% of total M&A volume — an all-time high.¹ One upshot of this appetite is the growing incidence of private equity suitors outbidding their corporate counterparts. This is especially noteworthy to business owners because many corporate buyers bring incremental acquisition firepower; they often add to the expected financial benefits of an acquisition through *combination synergies* — for example, economies of scale, new markets, etc. — that stand-alone private equity bidders are unlikely to realize.

We expect M&A momentum to continue into 2022, with volumes and valuations remaining within historical highs. Why? CEO confidence remains robust, U.S. and international economies are strong, there is ample liquidity in the financial markets, and equity markets continue to be strong. In fact, the correlation between the equity markets and M&A activity has been quite consistent over the years.

However, we also see the potential for considerable downside risk in 2022. Key factors that could materially impact the current M&A momentum include:

- A repeat of pandemic-related shutdowns. That said, one mitigant is that COVID-19 forever changed market participants’ willingness to execute deals in a virtual manner.
- A flat to down equity market well into the 2nd quarter of 2022. The correlation between the equity markets and the M&A markets has been quite consistent over time.
- Margin contraction and/or business disruption related to sustained supply chain issues, labor turnover, and/or the inflated cost of goods outpacing the ability to raise prices.
- Changes in the tax code. This looks less likely given the current climate on Capitol Hill, but any material changes to capital gains taxes could restrict the number of deals closing.
- Regulatory authorities are striking an increasingly cautious tone, viewing more sectors and deals under an anti-trust microscope.

¹ Preqin, December 31, 2021

How coordinated are your personal and business plans?

Whether you plan to pass the business on to your children or just want them to benefit from your hard work and good fortune when you sell, coordinating your plans in advance allows you to transfer value to the next generation in a tax-efficient manner.

Here's a perennial challenge faced by business owners: "How much should I gift now?" At the moment, gift and estate tax rules remain unchanged; the individual exemption is \$12.06 million for 2022. However, it is scheduled to revert to \$5 million (adjusted for inflation) by the end of 2025. It may be time to consider taking advantage of the large exemption and wealth transfer techniques while they are still available. Transfer assets that you believe have the potential to grow substantially in value, and consider transferring early. The faster and longer the assets grow outside of your taxable estate, the more value ends up in the hands of your beneficiaries. That said, it's important to also understand what you can afford to gift. Work with your advisor to capture your current and projected financial picture, understand your options, and make an informed gifting decision based on your situation.

Many business owners worry about losing control of, and access to, assets or cash flow, but there are ways to address those concerns.

It is also essential to understand your wealth transfer planning options. For example:

- A spousal lifetime access trust (SLAT) shelters assets while potentially allowing the donor to indirectly benefit from a gift to a spouse.
- Creating voting and nonvoting shares or interests in the business allows value to be transferred without giving up control, or voting rights, in the business.

These strategies, among other options, may allow you to leverage the higher exemption during a limited wealth transfer window.

What does this all mean for business owners interested in selling?

- With ample liquidity in the market and broad buyer appetite, sellers can be selective about their partner of choice and have a voice in setting key terms and driving valuation. The menu of private equity partner options is more diverse than ever, ranging from traditional buyout shops, to family-owned players with longer investment horizons, to sovereign wealth funds that often have lower return hurdles and longer investment cycles.
- Buyers are taking a constructive approach to pandemic-related earnings adjustments, so it is important to present a normalized business case that eliminates temporary swings (positive and negative) due to the pandemic in order to maintain credibility with sophisticated bidders.
- For businesses with outsized vulnerability to global supply chains or low-technology manual labor, be wary of launching a sale process with exposure to predictable business disruption. The single greatest value destroyer in a sale process is losing momentum in the back end through underperformance or other material surprises to otherwise motivated buyers.
- Get ready early. The bulge in M&A deal flow that hit in mid-2021 opened the eyes of sellers to the importance of the quality of earnings and having legal, M&A, tax, and other key partners lined up early. At

points in 2021, M&A processes were delayed or challenged by the unprecedented bandwidth constraints of the third-party service providers who are critical to execute a deal.

The current M&A climate is seller-friendly across every industry sector and size of business. However, almost every successful sale process comes back to setting clear objectives up front, preparing early, and customizing a game plan accordingly.

Focus on incremental progress to avoid feeling overwhelmed

The market outlook, opportunities, and risks can make decisions about your business feel complex and overwhelming, but they don't need to be made all at once. Take time in the new year to review, reflect, and reset your intentions for the business and to make important connections between your business and personal goals. For advice on your personal situation, please contact your advisor. Your advisor has access to a team of business owner advisory specialists who can help outline your options, model "what if" scenarios, and manage through complex transition processes.

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