We're in a Recession. What Does That Mean for Business Owners?

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It's here, folks. Despite what collective mental gymnastics the federal economic bureaus are practicing, the recent announcement marked two consecutive quarters of gross domestic product contraction. Midterm elections notwithstanding, that measurement connotes a recession.

We can't say it comes as a surprise. We're fresh out of crystal balls here at Zachary Scott's World Headquarters, but based on the anecdotes that business owners and capital sources have shared with us since the beginning of 2022, we've held the sense that this was an inevitable next step to the monetary policy choices and macroeconomic disruptions of the last two years.

So what happens now? While nobody can definitively say what the next 12-18 months will bring to our markets and businesses, we can safely say that the current climate is one of uncertainty. The last two years have been—please forgive the overused term—*unprecedented times* for private markets and particularly private capital's ravenous appetite for private businesses. As the market turns, many business owners are contemplating if they can still realize value from their businesses like some of their peers have in the recent past. What recapitalization options exist for a business owner today? Are there still attractive options? Did owners miss their window for achieving peak value?

There is no one single answer, but there are a few underlying drivers that can help someone determine where they stand.

Private Capital is on the Hunt

That's the thing about captive pools of capital: they have a ticking clock and they need to be spent. And that pool didn't get smaller over the course of the pandemic—it got much, much larger. Private equity as an asset class is not shrinking, and despite the volume of transactions completed over the last two years, neither is the dry powder overhang.

Even though private equity dollars are bursting at the seams and searching for private companies, it would not be out of character for there to be a shift in the types of businesses or business attributes that see the most demand. Investors can have short memories and we should see an uptick in the private equity screens that list "pandemic resistance," among other risk areas, as a key due diligence item. Investors are typically extra-sensitive to current or recent issues in their portfolios, and act accordingly when looking at new investments.

It will be worthwhile to keep an eye on lending. Buyers, particularly financial investors, rely on cheap credit to fund acquisition purchase prices, and the credit markets have been ready, willing, and able to support aggressive purchase prices.

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When credit markets tighten, it affects prices of businesses [Credit Availability Affects Business Valuation, Insight, Winter 2008] Cracks in loan portfolios aren't being observed yet. Although we have heard from different lenders that they are expanding their credit spreads (meaning that they want to be paid more for the risk), there does not appear to be any quenching of thirst for more assets. For the moment, aggressive financing awaits buyers' calls.

We can see an interesting scenario brewing for cyclical businesses. We've written before about what happens to investments in cyclical businesses over time and through changes in the economic climate [Value Expectations in Cyclical Industries, Insight, Winter 2015]. Suffice to say, it's a rollercoaster, as owners of a cyclical business very rarely get full value for the earning power of their business—regardless of the position in a cycle.

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However, it's been thirteen years since the last real recession, and in the interim, a new class of patient private investment capital with very long-term horizons (call it the "permanent equity" class of family offices and other endowment-like capital pools) has grown significantly. Based on our own conversations and observations, we think that group of investors, because of its investment horizon and target industries, is geared toward the very types of cyclical investments that historically have seen demand drop during uncertain times. We haven't yet seen this capital class in action during a downturn, but it would not surprise us if owners of cyclical businesses have a much larger pool of interested options for recapitalization over the next few years than previously expected.

What About my Multiple?

Almost every business owner wants to know how multiples are trending. Candidly, we dispute the premise of the question because it treats a derivative metric as a predictor. EBITDA multiples are a function of a single business's expected future free cash flows (as realized by a buyer, so that's inclusive of cost-cutting or other synergies), and the perceived risk inherent in those cash flows [What's in a Multiple? Insight, Summer 2014]. Aggregated transaction multiples lose the specificity to be useful as predictive metrics in any unique situation, outside of a loose sanity check.

When transaction multiples trend upwards over an industry, or over a whole economy, it reflects a decline in perceived risk, an increase in perceived growth opportunity, or both—in the eye of the most aggressive buyer, that is, the price that is required to win (said differently, the actual price paid is never a reflection of the aggregate market sentiment, because the median bid never wins in an auction).

If competition for all assets declines, the ones that see a decline in price are the businesses on the margins – the ones with "hair" on them that are on the edge of transacting or not. Quality assets with defensible growth forecasts that perform well in recessionary environments often see their values increase in times of uncertainty, as those businesses are scarce and demand for them increases when the next available option looks comparatively less attractive.

So, in conclusion: in periods of uncertainty, some businesses will find their multiples declining, and others will find them increasing, even in the same industry or same subsector. *The spread widens*.

Now What?

Now is the time to take a critical look inward at a business. An experienced transaction advisor can help owners take an unbiased look at what a potential buyer will find valuable and where their concerns will be. That can help determine in what light a buyer might look at a business, and what recapitalization options are actually going to be on the table. Some owners expecting the same demand for their business as existed a year ago are going to find themselves disappointed, and some owners already buckling down for another "preserve and reload" phase have more options than they realize. As always, consult with a professional and know the options.

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