

THE BUSINESS-OWNER LIQUIDITY BOOM

» A generation that launched businesses in droves is set to exit them the same way.



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by **Brian Keane**

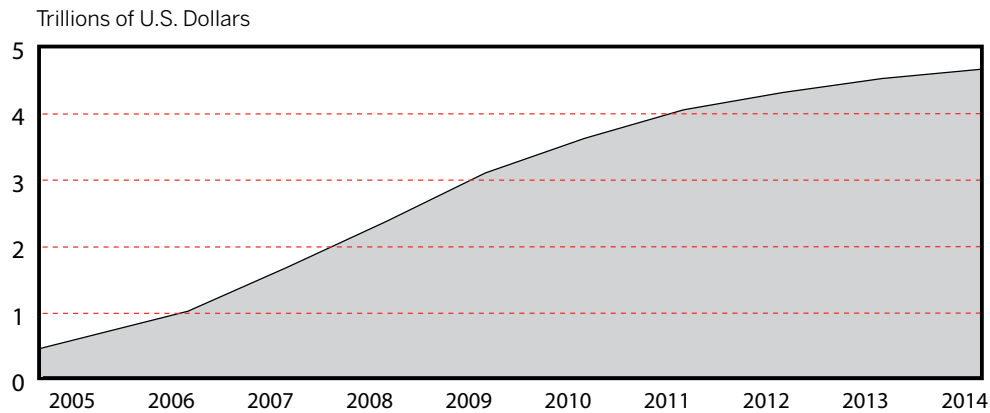
Managing Director and Head of Investment Banking
Citi Capital Strategies

» In the early 1980s, Bob Anderson took the most audacious step of his life. He walked away from his job and risked everything on one heretical idea—a notion that he could turn a \$5,000 home-equity loan into a building products company that would ride what he foresaw as a coming building boom in the southeast.

Twenty-five years later, that audacious step became a victory lap, when Bob turned over the keys to his business to a new owner – in exchange for a \$32 million check that will change his family's life.¹

¹Note: This case study is for illustrative purposes only and may not be typical.

» THE LIQUIDITY BOOM



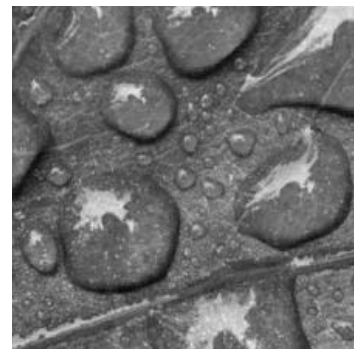
Source: Data from VIP Forum, 2004; Chart by Citi Capital Strategies.

THE MOST IMPORTANT ECONOMIC STORY OF OUR TIME

To read the newspapers, you'd think that these are the days of the mega-deals. Flush with cash, public companies are devouring each other. Recent examples include CVS Corp.'s merger with Caremark for about \$25 billion, Coca Cola's purchase of Energy Brands for \$4.1 billion and Motorola's acquisition of Symbol Technologies for nearly \$3.9 billion.² And then there's private equity funds putting their record capital to work, like KKR's \$7.4 billion acquisition of retailer Dollar General, or Clayton, Dubilier & Rice's purchase of The Servicemaster Co. for \$5.3 billion.³ —Everywhere you look, bigger is eating big.

While those ten-plus-figure transactions are impressive, they're actually not the real story of the coming decade. Instead, that accolade goes to the little guys. Guys like Bob and their middle-market building supply companies, software development firms and manufacturing firms. As Baby Boomers age, we will see an unprecedented amount of wealth trade hands as retiring entrepreneurs cash out of their businesses. Indeed, the impact of these

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² FactSet Mergerstat LLC database, Aug. 1, 2007 (transactions closed in 2007).

³ FactSet Mergerstat LLC database, Aug. 1, 2007 (transactions closed in 2007).

transactions—on the markets, on companies, on families, on workers—is the most important economic story of our time.

Before you dismiss this as hyperbole, consider the numbers. According to Dun & Bradstreet, there are 135,000 mid-size, privately held businesses in the US.⁴ So what are they worth? The VIP Forum, a Washington, D.C.-based research firm, analyzed the US Federal Reserve's 2004 *Survey of Consumer Finances*, and came to a startling conclusion: Private business owners will realize a collective windfall of \$4.6 trillion by the year 2014 through the sale of their businesses.⁵ And that's the mid-range forecast; a more aggressive estimate puts the total at \$8 trillion.

To put the amount of money at stake in perspective, \$4.6 trillion is equivalent to the projected tax receipts of the US Treasury Department—for 2007 and 2008, added together.⁶ The higher number of \$8 trillion is roughly equal to the US national debt.⁷

SETTING UP SHOP

The owners of these businesses look a lot like Bob: born after World War II; raised by modest, hard-working middle-class parents; and products of public schools.

After launching careers in fields as varied as the American work force, this generation of soon-to-be entrepreneurs began leaving their jobs in large numbers to start companies.

By the late 1970s, the media was beginning to take note. In cities across the country, publishers catering to business owners rapidly expanded. *Entrepreneur Magazine* was born, and a few years later, *Inc. Magazine*, a publication expressly directed at young, private companies, featured then-mid-size companies like Microsoft, Domino's Pizza and Timberland on its annual lists of the 500 fastest-growing private companies in America.

What these lists didn't show were the tens of thousands of other private companies across the country that remained—firmly, profitably—in the middle-market category, amassing tens of millions of dollars in value while their owners took modest paychecks.

Jim Taylor, vice chairman of Waterbury, Conn.-based research firm The Harrison Group, and former chief executive officer of Yankelovich Group, has conducted extensive research on this generation of entrepreneurs. He sees

⁴ Dun & Bradstreet database as of Oct. 13, 2006, combined with data from the 1992 US Economic Census from the US Census Bureau. A "Mid-size" firm has annual revenue between \$10 million and \$250 million.

⁵ The VIP Forum analysis of the US Federal Reserve's *Survey of Consumer Finances*, 2004.

⁶ US Treasury Department and Office of Management and Budget, 2007 Budget of the US Government.

⁷ US Treasury Department, Schedules of Federal Debt, April 30, 2007.

their economic impact as historic. He says that American wealth since the 17th century came in three waves: landowners, factory owners (the Industrial Revolution) and shareholders (corporate and professional wealth).

Wealth today, he says, has changed. "It's the wealth of people who built their own companies. It's earned in this lifetime, overwhelmingly, by people who walked away from other careers and took a chance." Taylor says that we are living in the "Age of the Entrepreneur," and he believes that the impact of this on society is as great as the impact of the prior wealth-building eras.

WELCOME TO GENERATION L

It appears that the Age of the Entrepreneur is an economic reality, with its first generation beginning to reach maturity. As these business owners approach retirement, the question is this: How many of these owners will exit their businesses?

The answer is, of course, all of them. Eventually.

But just how will they do it, and when? According to the 2007 Laird Norton Tyee Family Business Survey, with nearly 60% of majority shareholders in family businesses age 55 or older, and 30% age 65 or older, succession issues are "imminent."⁸ As these busi-

ness owners sell and retire, this sea change will create a significant population of Baby Boomers who will realize substantial wealth in the next few years, with more to follow. We call them "Generation L," the Liquid Generation, and the wealth that is generated by these sales will have profound effects for more than just the current generation.

THE TERM "FAMILY BUSINESS" IS A MISNOMER

For Generation L, what was once thought of as "the family business" has become something else entirely. Of the business owners now thinking about retirement, only one-fifth expect to transfer the business to a family member, according to PricewaterhouseCoopers.⁹ The reasons are as complex as the businesses.

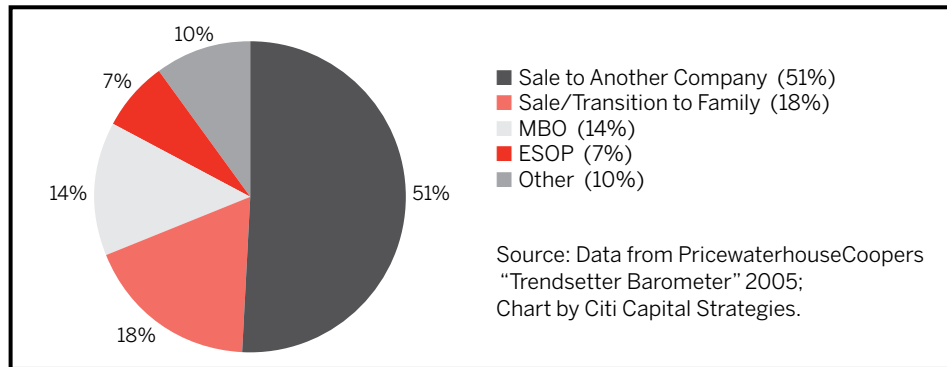
In many cases, like Bob's, the company was never really a family business to begin with. Such businesses were often started by partners with economic ties, but the business was not tied to any of the partners' family members. Children were raised and, in this age of opportunity, chose other fields, and had little or no involvement in the business.

In other cases, the business owners had a management team and developed a plan for who would eventually take over the company—well before the kids

⁸ Laird Norton Tyee Family Business Survey, *Family to Family*, 2007.

⁹ PricewaterhouseCoopers, *Trendsetter Barometer* 2005.

» BUSINESS TRANSITION PLANS



grew up. Sometimes, acquisitions introduced the company to new managers, creating unclear career paths for the owners' children.

With the evolution of family businesses, it is not surprising that most business owners are seeking exit alternatives other than a sale or transition to next-generation family members. According to PricewaterhouseCoopers' 2005 *Trendsetter Barometer*, a full 72% expect to sell their companies to another company, to the company's management team, or create a partial sale to employees through an employee stock-ownership plan (ESOP).

TODAY'S ENVIRONMENT FOR SELLING A BUSINESS

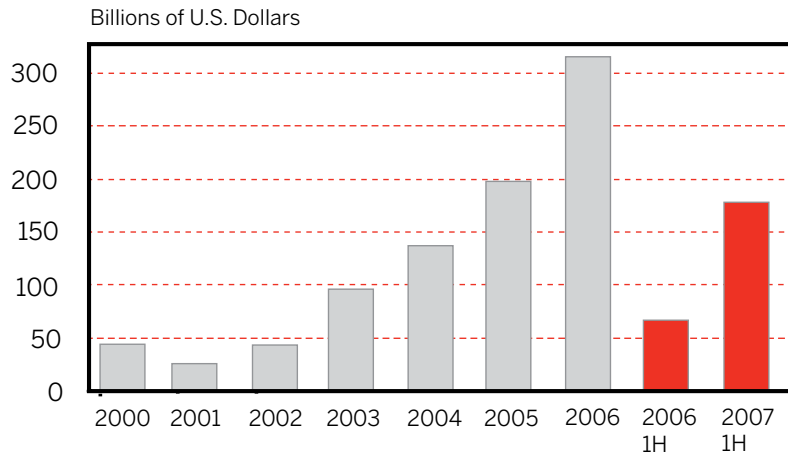
As it turns out, Bob Anderson's liquidity event coincided with a strong economy and a robust mergers-and-acquisitions market. Both corporate buyers and private equity groups were interested in his company, and there were even

a few foreign corporations involved in the negotiations. Such competition among buyers helped to drive up the value of his firm. While Bob's business associates urged him to sell at the very peak of the market, Bob knew that moment was impossible to predict. He recognized that he could only control whether he sold in a "good" or a "bad" market; if he tried to time the peak he was afraid he might miss the opportunity altogether.

As Baby-Boomer business owners reach retirement age, they are greeted by one of the strongest markets for business sales in history. Contributing to the activity are a healthy economy and relatively low interest rates.

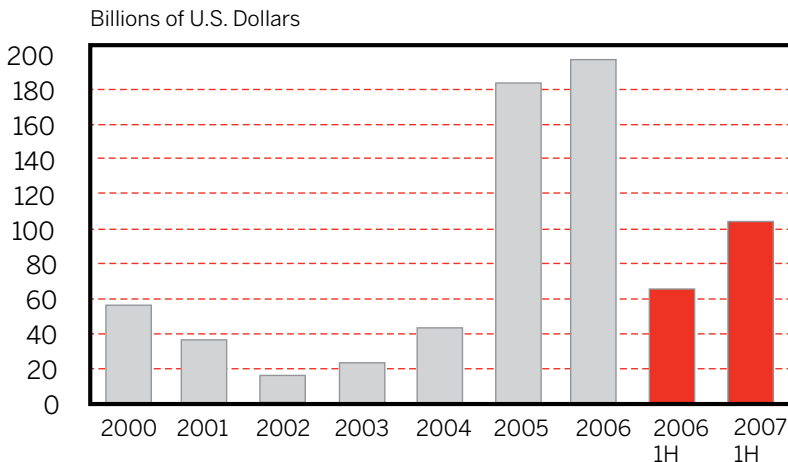
Competition among buyers is stiff, with corporate buyers and private equity groups active in today's market. Corporate buyers are generally supported by healthy balance sheets and driven by the need to supplement organic

» PEGS INVESTING RECORD AMOUNTS



Source: Data from Buyouts 1/9/2006, 1/8/2007, 6/25/2007; Chart by Citi Capital Strategies.

» PEG FUNDRAISING HITS NEW HIGHS



Source: Data from Buyouts 1/9/2006, 1/8/2007, 6/25/2007; Chart by Citi Capital Strategies.

growth. After several years of cutting costs, corporations are once again in an expansion mode and actively looking for acquisitions. International buyers are also active, motivated by the devaluation of the US dollar and by the growth of the US economy.

But private equity groups, or PEGs, are the real drivers of today's

mergers & acquisitions market.

PEGs set another investment record in 2006, reporting transactions worth \$315 billion.¹⁰ For the second straight year, PEGs set a fundraising record as well, tallying \$198 billion in funds raised.¹¹ Flush with cash, PEGs are searching for solid companies to buy in whole or in part.

¹⁰Buyouts, January 8, 2007

¹¹Buyouts, January 8, 2007

THE RISK OF A GLUT?

As with any major economic event, it's natural to wonder how it will end. While there is clearly a cyclical element to business sales, there's a significant overall change occurring as well. The US has never had the sheer quantity of business sales that the marketplace is going to have to digest. While valuations remain strong today, the question that everybody's asking is: Will we reach a tipping point where there's a glut that drives down the values that sellers will be able to command for their companies?

The statistics back up the concerns. In 2005, 350,000 business owners were estimated to have retired, according to The VIP Forum. In 2009, that figure is expected to more than double to 750,000.¹²

But will the simple law of supply and demand dictate the valuations these owners will be able to command for their companies? We believe that it's a bit more complicated than supply and demand dynamics. A glut of businesses for sale will have some effect, but values should continue to be driven mainly by fundamentals: the financial health of each business, the health of the economy in general and the strategic needs driving the behavior of the acquirers.

We also think that fewer transactions will involve outright sales, in which ownership completely changes hands. Instead, our clients are increasingly interested in leveraged recapitalizations and ESOPs. Leveraged recapitalizations are a partial acquisition of an owner's shares by a private equity firm, using debt to finance a portion of the purchase price. ESOPs are similar, but the buyer is an employee stock-ownership plan. Both options allow business owners to take some cash out of the company but to remain involved in running the business.

THE MOST IMPORTANT STATISTIC

The statistics are compelling. But the only statistic that matters to Bob Anderson is the number on the wire transfer to his bank. Bob occasionally allows himself to think for a few moments about how fortunate he has been—but only occasionally. The business offered an interesting career, but there was no shortage of sacrifice and risk along the way. Virtually all of his net worth was concentrated in the value of his business. Fortunately, the worst risks never transpired. And Bob graduated from being a proud member of the Baby Boom to an even prouder member of Generation L.

¹²The VIP Forum analysis of the US Federal Reserve's *Survey of Consumer Finances*, 2004.

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