WHITEPAPER

The Business Cycle: Staying Ahead of the Curve Leads to Entrepreneurial Success

The business cycle, a sequence of phases of economic expansion and contraction, is extremely important for business owners to factor in when planning and executing strategic business moves.

Business owners who have yet to experience first-hand the ups and downs of an economic expansion and contraction may be in for a harsh awakening. It is highly plausible that the successes of some businesses are tied to the growth and expansion of the overall economy that began in March of 2009. These businesses hitched the growth ride up alongside every other business in the expanding economy. Although it is undoubtedly probable these business owners are savvy, it's important they aren't fooled into believing that their success is entirely self-made.

Part 1:
What is the business cycle?

The business cycle describes the rise and fall in the production output of goods and services in an economy. Business cycles are generally measured using rise and fall in real – inflation-adjusted – gross domestic product (GDP), which includes output from the household, the nonprofit sector and the government sector, as well as business output.[1]

The figure below illustrates the main key elements of the business cycle. The four stages of the business cycle include: 1) Expansion, 2) Peak, 3) Contraction and 4) Trough.

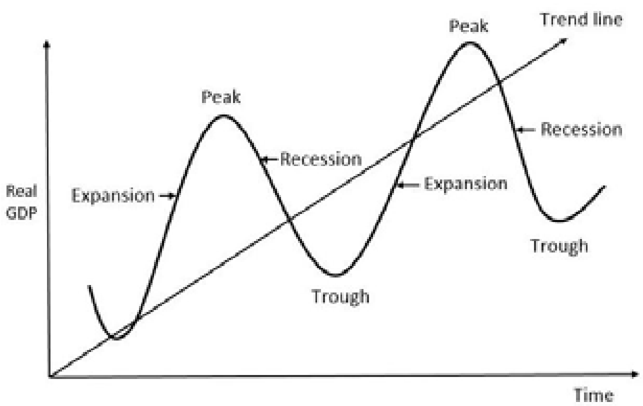

Figure: The Business Cycle

Expansion
The expansion phase of the business cycle, also known as an economic recovery, is the period when business activity flourishes and GDP grows or expands until it reaches a peak.

The GDP growth rate during a prototypical expansion period ranges from 2 - 3 percent. Currently, the US GDP growth rate is 2.9%.[2] The robust labor market and 17-year record low unemployment rate can be attributed to this economy's expansion.

Interestingly, in an expansion period, small to mid-sized businesses with strong leadership and management are inclined to thrive because they are more agile than their much larger rivals. Furthermore, this agility affords these small to mid-sized businesses the power to better take advantage of the market's opportunities.

Peak
A market peak is the highest point between the end of an economic expansion and the start of a contraction in a business cycle.[3] A peak is the result of maturing positive growth in GDP and the labor market, which induces inflation where the broad level of prices for goods and services goes up. Oftentimes when the economy and the markets overheat alongside rising inflation, the Federal Reserve steps in by raising interest rates to decelerate investments and consumer spending.

A market peak is the best time to sell an asset (e.g. housing, stocks, bonds, businesses, etc.) because valuations reach higher levels, but timing the market is nearly impossible.

Contraction
The contraction phase, also known as an economic recession, of the business cycle generally occurs as a result of rising interest rates when economic growth slows but is not necessarily negative. In this phase, the unemployment rate increases, and the trading of publicly listed securities enters into a bear market. In terms of privately-held assets, this is a less than ideal time to sell as valuations will fall to lower levels.

Trough
The trough period is the bottoming out of an economic recession or contraction. During the trough period, the GDP rate and employment rate reach their lowest levels in the business cycle.

For M&A buyers, troughs and maturing contraction periods are ideal for buying businesses because assets are cheaper. In the first few months following a trough, the business cycle will refresh and enter into an expansion phase followed by a peak where the buyer's return on investment(s) may be realized. As they say on the Street, "buy low and sell high."

In a trough or contraction, larger corporations and institutionally-backed companies tend to fare better because they have the size and the capital to withstand economic headwinds. These larger companies can also pick up or acquire struggling competitors at more favorable prices resulting in market share gains.

Part 2:

Where are we in the cycle?

Discerning the business cycle and its phases in real-time is like looking at a painting up close – it is difficult to see the details of the art in its entirety. Just like stepping back to see the complete work of art, one must step back and look at the market historically to distinguish the business cycle and its fluctuations.

Although it's nearly impossible to time the market, we can discuss what we do know: current trends and their historical parallels.

We are currently in the 2nd longest bull market in the history of the capital markets. As of May 10th, this current bull market is 110 months old. The longest bull market was the dot com bubble which lasted 115 months and ran from 1991 to 2001. By historical measures, today's bull market has exceeded expectations and its end wrongly predicted numerous times by financial analyst these last few months. That said, what goes up will eventually go down and the relevant indicators are certainly pointing in that direction.

The GDP growth rate for a prototypical market peak is above 3 percent. According to the Federal Reserve Bank of Atlanta, Center for Quantitative Economic Research, the latest forecast (as of May 3, 2018) for current GDP growth is 4.0%.[4] Additionally, the current unemployment rate is at a 17-year low registering at an astonishing 3.9%, its lowest level since 2000.[5] Moreover, according to Mark Zandi, chief economist at Moody's Analytics, wage growth is approaching 3% and accelerating.[6]

As discussed, during a market peak, inflation transpires when certain levels of GDP and employment growth rates, including wage growth, occurs. The Federal Reserve targets an inflation rate of 2% which is the benchmark it uses to determine when to implement monetary policy, like raising the discount and funds rates.[7] The current US inflation rate is at 2.2%, a 0.2% higher than the Federal Reserve's target, and economists believe there will be an additional two to three rate hikes this year.[8]

Figure: U.S. Inflation Rate
Source: U.S. Bureau of Labor Statistics

As mentioned previously, the Fed raises interest rates to restrain inflation and decelerate an overheated economy by inducing a market correction or contraction. Although interest rates are on the rise, the Index of Consumer Sentiment, a reputable measure of consumer confidence, shows a current index approaching 100, a figure that is at a 10-year high, and only second to the record high in March of 2000 right at the peak of the dot-com bubble.[9]

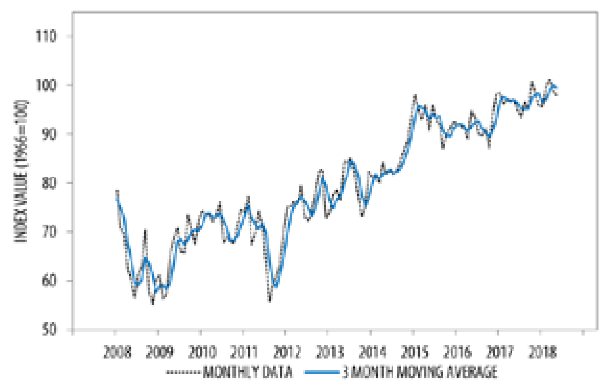

Figure: The Index of Consumer Sentiment
Source: University of Michigan, Surveys of Consumers

Major US stock market indices like the Dow Jones Industrial Average (DJIA) and the Standard & Poor's 500 Index (S&P 500) have historically been leading indicators about the economy. One reason is that conscientious investors comb through economic data for signs about future stock market performance and react accordingly.

2017 was an extraordinary year for the stock market. In 2017 alone, the DJIA grew by 25%, and in January of 2018, the DJIA broke a record 26,000 points. Then February came along, and the stock market saw roller coaster swings of of gains and losses, precipitating an increase in the market volatility index (VIX index) that's currently on an upward trend.

So, based on what we know, where are we in the business cycle?

Based on our analysis of current trends along with comparisons to historical data, we are forecasting that the business cycle has reached its peak. However, this peak to a certain extent will remain somewhat sustained before a downward trend or correction. We believe this sustained bull market is partly due to economic stimuli like the tax cuts and jobs act. The figure below shows a representation of where we believe the business cycle stands currently and over the next 12 – 18 months.

With regards to mergers and acquisitions in the middle market, even if the economy were to experience a downward trend in the business cycle, sellers of privately-held businesses will benefit from sustained economic tailwinds like excess investible capital and positive M&A sentiment stemming from M&A ROI successes over recent years. We believe that valuations for businesses will not remain at today's record high levels, but we do believe they will sustain secondary highs. However, during this period of change, M&A buyers and investors will become much more selective in their investment targets.

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Figure: Allegiance Capital Analysis
Note: *Figure is a representation; Figure not drawn to scale*

Part 3:

Financial and strategic partnerships: De-risking your largest asset

Why do the largest hedge funds and financial institutions like private equity (PE) do so well? The answer is they understand market dynamics, like the business cycle, and they use this knowledge to their advantage.

Accordingly, business owners need to also spend time understanding the fluctuations of an economy over time and how it impacts their business. Operating a business during a prolonged economic expansion is much different than operating a business during an economic recession.

The economic expansion of 2001 – 2007 which lead up to the Great Recession was quite robust, especially for businesses and corporations. Unfortunately, small businesses that had no choice but to weather the economy's contraction with limited access to capital were hit hard. In the immediate aftermath of the recession, the doors closed on roughly 223,000 small businesses (businesses under 100 employees).[10]

So, how do financial professionals protect their investments in any market? They de-risk and hedge their investments. In a seller's market (like the current bull market), these professionals "take chips off the table" by cashing in their earnings, and re-investing in safer, diversified assets.

For a business owner whose principal net worth is tied up in their business, selling all or part of his or her company enables the owner to take some chips off the table while the company is still performing well. This provides the business owner with two distinct benefits. It ensures the owner's personal financial future through investments in safer assets, and it taps into any future success as the company grows. Moreover, financial acquirers, like private equity, make strong strategic business partners. Private equity investors are very familiar with the business cycle and have the ability to withstand economic turmoil. For example, after the global financial crisis, PE assets under management (the portfolio companies managed by a PE firm) were barely affected, only disturbing 6% of all PE assets.[11]

In addition, these investors have the aptitude to either take advantage of or stay ahead of market and technological risks. Subsequently, private equity-backed middle-market companies have historically outperformed the S&P 500 by as much as 400 – 600 basis points.[12]

Given our forecast on the business cycle landscape, achieving and maximizing monetary and operational success requires strategic execution ahead of the curve, which includes market contractions, industry cyclicality, technological threats, and more. For business owners considering de-risking their largest asset, which is typically a business, it is critical for these business owners to begin the conversation with a reputable investment bank like Allegiance Capital. As M&A transactions can take anywhere from 6 to 18 months to complete, waiting too long may result in missing favorable market conditions. If a business owner is on the fence about "taking chips off of the table", he or she may want to reconsider as it could be another 7-10 years before the markets are in his or her favor again.

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Having closed over 200 transactions, Allegiance is where deals get done.

20+
Professionals
Allegiance Capital is one of the largest boutique investment banks.

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Aggregate Value
Our bankers have collectively closed over $20Bn in transactional value.

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