Elizabeth Mower:

Hello, this is Elizabeth Mower, president of BEI.

John Brown:

And I'm John Brown, the founder.

Elizabeth Mower:

Each episode we take you into the world of exit planning, sharing the stories, struggles, and opportunities of business owners and their advisors. We'll get into this episode's conversation right after this.

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John Brown:

Welcome to this edition of Why We Plan. I'm your host, John Brown, the founder of BEI. Today I am happy to tell everybody that I'm with Thomas Stewart, who's the executive director of the National center for the Middle Market. Which is a nonprofit organization that I personally have been following online for years.

John Brown:

It's wonderful to have Tom talking to us about the results of a survey the center conducted late last March on what I call Tom, the owner sentiment surrounding the COVID crisis. You will find a link to this survey in the show notes. So Tom with that, tell us a little bit more about yourself, the center and especially about the survey.

Thomas Stewart:

John, first of all, thank you. I'm delighted to be here and delighted to have a chance to work with you guys at BEI and to learn why we plan. The National Center for the Middle Market is a research group that's part of the Ohio State University. We're part of the business school at Ohio State. And we were founded 11 years ago to try to understand mid sized companies and the issues and challenges that face mid sized companies.

Thomas Stewart:

Every quarter we take a poll of a thousand of them. It's a pulse check, it's a how's business pulse check and we ask about performance and growth and employment and challenges, so on and so forth. We would normally have gone into the field in March with that survey and we thought, "No, no. We're going to go in and do a special look exactly at what the impact of the COVID pandemic is."

Thomas Stewart:

We went and we got 260 responses. And what's cool about it is we were able to go back to the same companies we pulled in December. We have people talking to us about the world they saw at the end of 2019 and the world they're seeing now between March 23rd and March 25th, which is when this poll was in the field.

John Brown:

Interesting. A couple of things. One, you define middle market as companies with revenue of 10 million to a billion dollars, I believe. I'm guessing most of those businesses fall far closer to the 10 to $50 million mark than the upper ranges. Or is that not it?

Thomas Stewart:

Yeah, it's a pyramid. Narrow at the top and above $1 billion, it gets narrower still. Overall that group is about 200,000 companies. And I forgot the exact number, but I think only the top 15% are above $100 million dollars and the rest are below that.

John Brown:

Okay. All right.

Thomas Stewart:

And within that group you get almost all of them are private, 85 or 90% are private. And a lot of family businesses, almost a third are family businesses. A bunch of private equity investment.

John Brown:

Well let's assume similar to the demographic graphics, our members and exit planners in general tend to represent. So tell us, what does the survey say?

Thomas Stewart:

The first thing it says is, "Boom. Wow." The vast majority of middle market companies looking at the end of March were saying that their business was being negatively affected. 25% said that they thought the impact of COVID-19 would be catastrophic on their business, which is a pretty big number however they want to define catastrophic.

Thomas Stewart:

86% said that there was going to be a negative impact on business operations, 84% said a negative impact on projected revenue. About 80%, four out of five saying a negative impact on payroll or employment, cash. Basically all of these things, four out of five companies said there was going to be a significant negative impact on those things. They weren't able to quantify how much, they just said they knew they were going to hit it, but at this point they're still in the stage of, "We see the damage, but we just don't know how big the damage is going to be."

Thomas Stewart:

Half of these companies said that the ongoing uncertainty was the most difficult aspect of the current environment. So they know they're taking it, they know they're getting hit, but if you asked them how much? By what percentage? They would be very hard pressed to say because the damage is still being done.

John Brown:

That is fascinating. That is fascinating. Did you have anything that indicated what the future holds for their companies and for the economy in general?

Thomas Stewart:

You have quite a number of things. First of all, we keep track of something that we call a short term index, which is a ratio of positive to negative sentiment about three things. My own sales, what I think my own sales are going to be like in the next three months. What I think demand is going to be like in the next three months and what do I think the business climate is going to be like in the next three months.

Thomas Stewart:

The optimistic news in this, if you can say it, is that people feel much less good about their own sales than they do about demand or the business climate. They think our sales are going to go way down, but the business climate, they still think it's less good, but it's not going down as much.

Thomas Stewart:

It's as if they're feeling like we're falling but we're not free falling. There's underlying demand and that when we can get back to business, there will be demand to satisfy and when we can get back to business, it's not as if the whole business climate has gone to hell. It's still going to be there to support it. Right now, great uncertainty, a lot of damage. But in an environment where they think that as things come back, there will be some underlying support in the form of demand and a fundamentally decent business climate.

John Brown:

If you can think back to the great recession, you probably had similar surveys in general. Can I assume then that the sentiment of the businesses then was much less optimistic about the future of the economy?

Thomas Stewart:

The nice thing is my complete ignorance to that because we didn't exist. Then we came in just as we were coming out of the great recession. So the next Center for the Middle Market comes out of that. But there's two interesting differences here. The great recession was an infarction in the financial system. The banks were closing down.

Thomas Stewart:

It was that's where the damage started. And the rest of the body, the rest of the business was okay. The problem was its financial heart wasn't beating and if it didn't get beating, there'd be organ failure. Here, the banks, the financial system itself seems to be okay. Everybody's dealing with a lot of demands and a lot of confusion right now, but it's not as if the banks are failing.

Thomas Stewart:

What's happening is that demand is going away, business is going away, we're shut down. There's a very different feeling. I think there's a different sense on the part of real businesses as opposed to non-financial businesses about what's going on. I like the way Paul Krugman says that we put ourselves into a medically induced coma, but the financial system touch wood seems to be fundamentally sound.

John Brown:

I think this is something business advisors to clients will find valuable. That it's terrible news but it's not long-term in nature hopefully. At least that's what most owners are thinking.

Thomas Stewart:

Yeah. Of course, it depends on when we come out of or are brought out of this coma, but 80% of the people we talked to said that they thought that they could be up and running within six months. And 40%, 39% said they thought they could be up and running within a month. They're feeling resilience, but of course the longer this goes on, we'll see how that number holds up. But I'm curious to know what advisors are saying and what you're seeing that people want from their advisors under these circumstances.

John Brown:

We actually are going to have a webinar with our members in a couple of weeks and I'll have a lot more information on that then. But in general, I think advisors are probably doing far better in general than their clients. They're in a service business and again-

Thomas Stewart:

One is they can get paid, right?

John Brown:

Yeah. But they're plenty busy right now. But I think they're searching for, I'm going to talk about this right now. How can I help my clients? What can I do to help them? And I think there's really maybe three action steps that advisors can take. And if owners are listening in on this as I'm sure many are, they can take note of this as well.

John Brown:

First of all is discuss this survey with your clients. Unlike the great recession, it's not the end of the world is in sight doom and gloom that owners have. Back in 2008 and 2009 and 2010, it was really the depths of almost a depression. We just didn't know how we were going to get out of this. Now we think it's relatively short term in nature.

John Brown:

I'm not nearly as optimistic as owners are, but as we know, owners are entrepreneurs, so they're by nature optimistic and let's just hope they're right. But one thing is, talk about this with your clients. It'll give them a sense that one, I'm not alone in this world. There are lots of other businesses and business owners having these thoughts, but we don't think it's long-term. That's one thing.

John Brown:

The next thing I would look at is to ask your clients what they think about the recovery and what steps they think they needed to take directly within their businesses. Because I'm sure all the businesses you surveyed, especially these larger middle market businesses, they're moving head with a plan of action right now to address all of the issues that are confronting them.

John Brown:

Smaller business owners, maybe not so much, they don't have the resources or the experience to do that. So advisors are going to need to step in and give them some suggestions. That's what I want to end up with, is some suggestions, recommendations, ideas, advisors can give to their business owner clients. And there's three or four I think that are really important. And these are aspects of the exit planning process that our members bring in general to their business owner clients who are wanting to leave their business between next Friday and 10 or 15 years.

John Brown:

What characteristics do they need to have, to have a business that's transferable, that's strong, vibrant, durable? The first thing is, and we always emphasize this, is the strength of the management team and the key employees. Without that, the business really isn't even transferable. I think as advisors we need to caution our owners against taking dramatic steps, laying off their management team or reducing their compensation below what's possible because eventually as recovery begins, we're going to need that management team to drive the business forward.

John Brown:

One idea we have, and we do this a lot in exit planning, is if we do need, because cash flow is really severely curtailed in some businesses. We may need to reduce compensation temporarily for not just the management but certainly for the owners. But consider designing an incentive and retention plan for that management team along with this temporary reduction.

John Brown:

And what we do in exit planning often is we're trying to motivate and incent the management team to grow value or cash flow more quickly than has been historically to allow the owner to close any financial gap so that they can exit. While here, we're trying to do the same thing.

Thomas Stewart:

John, one of the things that we learned at the National Center for the Middle Market in our research is looking at talent planning, dovetails exactly with what you are saying. These people know really well who their key players are. If you ask them, "Do you know my key players?" Yeah, they all raise their hands. And they also know that these key players are key players. They can't lose them.

Thomas Stewart:

But you know what they're lousy at? Succession planning. And if you put that in an exit planning or a transition thing, the stakes on that are squared. Not only do I have to know who are the people I want to make sure stay with the business through the transition and beyond it, I've got to have a plan with them to make sure that they do stay there because the very fact that their key people makes them important to keep, but also makes it easier for them to leave.

John Brown:

Yeah.

Thomas Stewart:

That's really critical. There's one other thing I was thinking about is I'm thinking that ... You hit something that I've been thinking, which is right now for some companies we're talking first date. Cash, operations, just first date on the business. But for most companies we hope they're past the stage of first aid and what are you going to do in the next three months to six months to keep the business going, find the right vision for the business, maybe do some right sizing.

Thomas Stewart:

But also what are the projects you want to undertake now to keep the business strong or to even strengthen the business so that when we can come back, you're a little bit leaner, a little bit smarter, you've captured the knowledge, stuff like that?

John Brown:

Yep. That's exactly what we do in non-crisis situations. It's even more important here. And just a couple of other things along that path, the biggest risk for business owners right now in the midst of this downturn in their revenue and disappearance of their profits is if they don't keep those key employees, what happens?

John Brown:

Those key employees for the most part can leave, they can go to a stronger competitor and they can take customers, they can take employees, they can take vendor relationships. If we haven't done the planning necessary to match the incentive plan with some type of a restriction such as a non-solicitation agreement, which very few smaller businesses have. We are at great risk here.

John Brown:

Not only can our management team lead, but they can take the profitable business with them in a lot of situations. We really need to as advisors, to talk to our clients about that risk. That's something that they should suggest. And talking about business continuity planning, succession planning usually is as the ownership transfers from one person to another. Third party sales and talking to our investment bankers who are BEI members unless a deal is close to completion, they're going away. Or they are stalling.

John Brown:

No one's doing new deals at all from what I can tell. I'm sure there's some going on, but it's very limited. If cash flow isn't with companies, if that's been decreasing, it's hard to sell the insiders.

Thomas Stewart:

How would you do valuation right now? The value of that business on January 1st and the value of that business on April 1st. How could any sensible person actually ascribe a value to a business right now? [crosstalk 00:17:50] to show that. The deals are being tabled, acquisitions are being tabled, sales are being tabled. What's not being tabled is let's go in and fix the business, do some restructuring.

Thomas Stewart:

Maybe that's the agenda right now. Get the business safe and then figure out what you can do to make it strong, which will make you deal ready when we come out of this, but also make you business ready when you come out of this. And that's the main thing,

John Brown:

Yeah, that's the essence of exit planning in our world. The last thing I'd suggest is for owners to pay attention to what happens in the event, the unforeseen event that they now become disabled or they die or their key employee or employees. And often smaller businesses may only have one or two key people. What happens if they die?

John Brown:

That would just be a double whammy for a lot of businesses. It would be the end of a lot of businesses without some planning. And again, we have a lot of tools and exit planning stay bonuses and continuity plans and all kinds of tools that need to be put in place now so that events like this occur, that business doesn't fall flat on its face. And that can happen. As we leave, I know you have some final thoughts on business ownership and what business owners are thinking and doing. If you would share those Tom.

Thomas Stewart:

Yeah, John. And the thing is wonderful is they dovetail very much with yours. One of the things that we learned is that these companies are hit, they feel strong and resilient, the things they're having the hardest time managing are not the things within their four walls, but the things outside their four walls, the things over which they have the least influence. Deals are going away, but almost half, 44% said that they were more likely to restructure. That they were going to try to use this time to make the business stronger.

Thomas Stewart:

Now they may have to also be lopping off a weak part of the business that the restruction can be painful. But I think that the smartest ones seem to be thinking, "This is really difficult. I don't know where I am, but I've got a good team. I got to get my good team and my good customers around me." And then think about what I want my business to look like coming out of it.

Thomas Stewart:

Am I going to just recover? Am I going to recover with restructuring? Do I want to recapitalize, do something fundamentally different? But I think the smartest ones are thinking, "We've got to think about what's that? What does that future look like a year from now? And what do we do now so that we're taking the right steps to get us there?"

John Brown:

Well Tom, as we end every one of these sessions with, "That's why we plan." And you said it better than I could, that's why we need to plan today. Not just for the owner's eventual exit, but to make sure that business maybe needs to reorient itself a bit and become stronger and more durable. Thank you very much. I really appreciate this. This has been wonderful.

Thomas Stewart:

Thank you John.

Elizabeth Mower:

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