

LOOKING AHEAD – 2014
ENERGY, ENERGY, ENERGY
*Strategic Issues in the Apparatus Service
Industry in 2014 and Beyond.*
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ENERGY, ENERGY, ENERGY

Visualize the energy cycle: sourcing (oil and natural gas drilling, wind, solar, or other alternate sources), energy conversion, (hydro generation, steam plants refining), transportation (railroads, pipelines, transmission lines, trucking, oil supertankers) or consumption (manufacturing, water treatment, automotive).

Your company is connected in many ways to this cycle through your customers, the products you sell and the contributions you make to saving energy and energy costs for your customer. Every new electronic device sold worldwide is consuming more energy. The growing demand for energy may even result in some rolling brownouts in this country as early as this summer.

Looking Ahead: Scrutinize every aspect of your business through energy colored glasses. What other opportunities are open to you to capitalize on this very strong growth? The only long term forecast for which I am completely confident is that the demand for more energy will increase over the next decade and you can profit from that.

ANNUAL CLIENT SURVEY

Each year I informally survey different clients throughout the United States. First, I ask how well their business is doing for the current six months compared to the prior year, up, down, or flat. The second question is how they see the next six months. We then discuss areas of growth and areas of concern. The table below summarizes the results.

The May NFIB (National Federation of Independent Business) Small Business Index was 96.6, the highest since September 2007. NFIB reported that energy, health

care, federal economic policy, regulations and red tape are the predominant concerns among small business owners. To avoid repetition in the table below, suffice it to say this informal survey of the apparatus service industry reflected the same concerns.

Location	Jan-Jun 2014	Jul-Dec 2014	Areas of Strength and Comments
Northeast	Flat	Flat	Manufacturing, Electric Utilities, Water Treatment
Mid-Atlantic	Up Slightly	Flat	Increase in Pump Sales and Repair
Mid-Atlantic	Up Strong	Flat	Strong increase in smaller new motor sales
Southeast	Up Slightly	Up	Manufacturing, Automotive
Mid-West	Up Slightly	Up	Manufacturing, Electric Utilities
Northwest	Up Slightly	Flat	Increase in small motor sales, lumber muted by environmentalists.
Southwest	Up Slightly	Up Slightly	Copper strong
California	Up Strong	Up Strong	Wind, Roads, Bridges, Water Treatment
Coal Belts	Flat	Some decline	Exports keeping industry going, new regulations will hurt coal fire plants domestically
Multiple Locations	Up Strong	Up Strong	Strong increase in drives and controls
Oil and Gas Locations	Up Strong	Up Strong	Fracking everywhere, Natural Gas potential but muted by low market prices

FINANCIAL RESULTS

According to the Performance Analysis Report prepared for EASA by the Profit Planning Group, the industry pre-tax profit margins improved slightly in 2013 over 2012. EBITDA, or Earnings Before Interest, Taxes, Depreciation, and Amortization increased by approximately 0.3%. EBITDA is the number to which many buyers apply a multiple to get an Enterprise Value of a business.

ECONOMIC ANALYSIS

GDP

The first quarter Gross Domestic Product (GDP) was approximately a negative 1%. Much of this is attributed to the bad weather throughout the Northeast and Mid-West. Many shops nationwide were slow in January. The overall strength for the first half of the year indicates the second quarter GDP should be over 3% and perhaps as high as 4%. While not a 100% correlation, the electrical aftermarket: service and sales, tracks closely with the GDP statistics.

QE

The reduction of the Quantitative Easing (QE) by the Federal Open Market Committee (FOMC or sometimes, the Fed) has not had as dire an outcome as many pundits predicted a year ago. Interest rates should remain relatively low through the 2016 elections. Credit standards are still tight for small businesses. The accelerated Section 167 depreciation may be renewed again this year to incentivize additional capital expenditures. Letters to each of your congressional representatives requesting renewal of this tax incentive for small business capital investment would be a good move on your part.

Other - Opportunities

The United States is slowly becoming energy independent from the rest of the world. In addition to coal, we may soon become a supplier of other forms of fossil fuel to the world.

Domestic manufacturing is increasing. Automotive, steel and rail transportation equipment are particularly strong.

Housing, commercial and infrastructure construction, while bumpy and geographically diverse, are increasing.

If you believe government statistics, the US employment has recovered all of the jobs lost in the recession.

The China Effect is now; the India Effect is to come. Of the 7 billion people on earth, 1.35 billion or almost 20% are in China with a strong centralized socialistic government, a growing economy and a very like-minded culture. India has 1.24 billion people, 17%, in a less centralized but emerging economy with a more diverse culture and 300 million people without electricity. Contrast that to the 314 million people in the United States, less than 5% of the world population, with very diverse backgrounds and cultures. (2012 statistics)

An increasing part of the US economy is becoming interdependent with China and other emerging markets worldwide. Today the rate of growth in China is clearly influencing the US economy. The stock market moves up or down depending on the reported GDP for China almost as much as it fluctuates from the reported GDP for the US. Forecasting whether this interdependency is a long term opportunity or risk is way beyond my pay grade.

Other - Risks

Judged by actions not political rhetoric, our current federal government is very disparaging toward business. This is emphasized by over-zealous federal regulations particularly in regard to fossil fuel emissions. While alternative energy sources are excellent long term goals, our relatively comfortable lifestyle is, and will be in the foreseeable future, dependent on fossil fuels including natural gas, petroleum, and coal.

This negative attitude coupled with the uncertainty in the outcome of the 2014 and 2016 federal elections are of particular concern to all business owners.

Geopolitical unrest in the Middle East, the Ukraine, and possibly other of the former Soviet republics is a persistent economic risk.

There are those who assert that the economy remains tenuous and that a serious recession is looming. History has shown that the economy and the resulting effects in the stock markets are cyclical. These downside forecasters are correct; there will be a downturn as the cycle continues. The question is simply when?

Looking Ahead: Capital expenditures for increasing capacity and improving efficiency are favorable now. Any long term borrowing should be at fixed rates or convertible to a known fixed rate without balloon payments.

If I were giving odds, I would say there is a 95% probability of continued strength in the apparatus service industry for the rest of 2014, an 85% probability of strength in 2015 – the biggest variable is the results of the this November’s elections, and a 75% probability of a good 2016. Beyond that, it’s a coin toss depending on the results of the 2016 elections and changes in long term interest rates. What we can count on is the continued increasing demand for more energy.

EMPLOYMENT

Good, experienced employees are getting harder and harder to find including shop, sales, and management. This is old news, but still relevant.

The salaries and wages to attract these good employees are increasing over prior years. The eventual medical and financial consequences of Obamacare are still ambiguous, at best.

Small businesses are slowly hiring, but remain very cautious of increasing their total headcount. More productivity with fewer employees is every owner’s objective. The paradox however, is that the aging workforce in this industry is forcing owners to hire and train younger employees as replacements.

We have an unbalanced labor force. Most workplaces, even fast food restaurants, are becoming more technologically advanced. Much of the work force, particularly people over 50 and those who have been out of the workplace for an extended period of time are less proficient using the internet, computerized work stations, tablets, hand held devices, and modern communications.

Regarding our public educational system, based on test scores particularly in math and science, the United States ranked 17th out of the 34 developed nations in the OECD (Organization for Economic Cooperation and Development). With all due respect to the individual teacher giving his or her best to their students, the public education system is sorely lacking in providing students with the skills, attitudes, and work ethics needed to excel in today's workplace, even at the entry level.

Looking Ahead: Industry, including your company, will need to provide training to develop the skilled work force needed now and for the next generation. Since the initial "Looking Ahead" newsletter seven years ago, this is a recurrent theme.

If you are not tied in with your local Veteran's Administration, try it. With the troops returning from Afghanistan over the next year, there will be more Vets looking for employment. While not minimizing the effect of PTSD in any way, most of the returning Vets make excellent employees with a good work ethic and an ability to be trained for shop and management positions. Hire a Vet or two or three!

COMPETITION

Regional and even national competition has increased on larger motors and generators. Geographic loyalty is declining in favor of price, reputation, virtual presence and the capabilities of the repair facilities.

Looking Ahead: The colleague sitting next to you at a seminar or convention, whose company is 1,000 miles away, may become your competitor on the next large bid.

THE NEXT BIG THINGS

Turn on your water tap. Chances are you get clean, drinkable water, at a very low cost. But if you are in central California, you better not be watering your lawn on the wrong day or otherwise wasting this resource. The water police will find and fine you.

After energy, the demand for clean water will also continue to increase with population increases. Millions of gallons of clean drinkable water are wasted daily in

leaks to often hundred year old water mains throughout the United States, while the drought in California is driving up the price of many vegetables and meats.

Pump sales and pump repair are very complementary to this industry's current markets, shop and work force capabilities.

Road and bridge collapses in Connecticut, Minneapolis, Oakland and Los Angeles are just a few more examples of our seriously deteriorating road system. The Interstate system was a masterful idea from the 1950's Eisenhower Administration that has brought great prosperity to the US. But, many of these roads and bridges are already decades older than their planned useful life.

Beginning sometime in 2015, a mile long elevated section of Interstate 20 through downtown Birmingham will be rebuilt. It will take over a year to complete. Large chunks of concrete have already fallen into the parking lots below the roadway hurting some, while unpleasantly surprising car owners finding their cars smashed beyond repair. The project will create chaos in our downtown driving.

What are the condition of the roads and bridges in in your area?

Money for these projects may come from the various levels of government. Increased gas taxes and road usage fees/tolls are beginning to emerge already. Fines for misusing water are already going into the government coffers. And with the improved economy, government deficits are declining and more money is available for repair and upgrades to water systems, roads and bridges.

Unfortunately, these expenses are in the "kick the can" category. It is more likely that any surpluses will be directed to political goals that create votes and campaign contributions rather than to smooth, safe driving conditions or an ample clean water supply for everyone. It will probably take a catastrophic event with a significant loss of life or significant economic loss before any real changes are made beyond absolutely necessary repairs.

Looking Ahead: The demand for concrete, aggregate, steel, pipe and other construction products should increase over the next decade.

Consider adding pump sales and repair services as a way of diversifying your business without significant additional investment. Pumps can be very profitable.

MERGER AND ACQUISITION (M&A) ACTIVITY

M&A activity has increased significantly in 2014 for larger companies as the economy improves and interest remains low. These transactions are led by strategic buyers with lesser activity by the private equity firms. There is a trickle-down effect into this industry. Timken's recent strategic acquisition of Schulz Electric is a confirmation of their commitment to the industry. Other strategic buyers as well as the private equity firms continue to comb through this industry looking for the right companies to acquire.

Strategic buyers and private equity buyers both have a role in the acquisition arena. For owners that want to cash out but remain with their companies for a number of years, private equity may be a good route. Usually private equity firms let the prior owners continue to operate fairly autonomously. The caveat is that the company must perform to the expectations of the new owners or they are quick to make changes. Private equity firms typically have exit plans to divest of their investments in five years, plus or minus. Owners staying with their company with an employment contract or an earn out provision should consider an acceleration clause should their company be re-sold to another buyer within the period of their contract or earn out.

Strategic buyers will typically pay a higher multiple than private equity firms. There are other advantages for a current owner to sell to a strategic buyer in addition to the price for the company. Larger acquirers often allow an earlier exit for owners ready to retire. Additional markets, human relations support, fringe benefits, and better purchasing power often accompany a strategic acquisition. These benefits may provide stability and better job satisfaction for your good employees.

However, these advantages usually come with a cost. If you read announcements about larger company mergers or acquisitions, the articles often mention the cost savings that result from the combination of the two companies. Remember those cost savings are primarily reductions in headcount. Strategic buyers look at ways to integrate marketing, operations, human relations, IT, purchasing, and other areas to reduce costs, i.e. less employees.

Owner-operators of privately held businesses have different financial goals than third-party owners. If you are considering selling your business, history has repeatedly proven that the earlier you begin preparing your business for sale, the higher the price you will achieve. A Business Valuation is one key cornerstone of that preparation.

I had one smart client start five years in advance. We did an initial Business Valuation and updated it annually. Numerous changes were made over the ensuing five years to better position the company for acquisition by a strategic buyer. When the time came to sell, he achieved his financial goals and maximized his price, even in the middle of the last recession.

Looking Ahead (Sales Plug): A good Business Valuation prepared by an industry experienced professional is much more than just a number. The valuation is essentially a "dry run" of how a prospective buyer will evaluate your company. The financial analyses and the issues provide a roadmap to preparing your business for a sale and getting a higher price. A good business valuation will explicitly identify the strengths to build on and the weaknesses to change and improve.

EXIT PLANNING

There are 10,000 Baby Boomers celebrating their 65th birthday each day for the next twenty years. One can argue that Exit Plans are not worth the time and cost. After all, if you are dead or mentally impaired, it is somebody else's problem.

Every business owner should have an Exit Plan that answers the following questions:

- Who will take over my ownership when I exit the business?
- When do I plan to exit the business?
- How much is my business worth – realistically?
- How will my ownership transfer: sale, gifting, other? What are the terms and conditions?
- How can I minimize the taxes on the transfer of the business?
- Until my exit, how will current strategic and operational decisions affect this plan?
- What will I do after I am no longer the owner of the business?
- Do I need Life Insurance to fund estate taxes or buy/sell transactions?

The supporting documents such as Wills, Business Valuation, trust agreements, and leases, should be professionally prepared and communicated to family, partners, and other stakeholders. While not needing to know the details, the employees are reassured knowing that an Exit Plan is in place, especially for older owners.

Inevitably life brings surprises and Exit Plans must change. Existing Exit Plans should be reviewed at least once every five years. I have had clients where the son, daughter, brother, or partners were tragically killed and no plan was in place or the current Exit Plan was immediately obsolete. Today, 50% of all marriages end in divorce.

The time spent and out-of-pocket expenses incurred to prepare a simple Exit Plan are not cheap. However the costs, both monetary and emotional, of an unplanned exit are significantly greater.

You probably know a business owner or family that has experienced the legal costs and heartaches triggered unexpectedly by one of the following events:

- Owner's death,
- Incapacitating health issues,
- Changes in partnership or co-owner relationships,
- Changes in family relationships,
- Divorce.

While none of us want to deal with the inevitable, it borders on negligence not to deal with the Exit Plan questions above. Once a triggering event happens, emotions flare and greed steps in. Without an Exit Plan, these issues will be resolved - with the related conflicts and expensive legal costs - by family, an "ex" or "exes", other co-owners, or worse by a county probate judge if no Will exists. For example in Alabama, depending on the facts and circumstances, if a parent dies without a Will a separate attorney may be appointed by the courts for each child. And, those costs are coming out of the estate. Ouch!

Looking Ahead (Another Sales Plug): As a business owner, if you don't have a Will and a written Exit Plan with a Business Valuation, prepare them now!

MY CONTRIBUTION

Regardless of the size of your company, Business Valuations and Exit Plans play an important role for any business owner considering the sale or succession of his or her company. For over thirty years I have assisted business owners in this industry in selling their businesses, business valuations and exit planning.

I will be attending the EASA Convention in Boston and staying at the Westin Copley Hotel adjacent to the Convention Center. Please call me to arrange a confidential meeting. Of course, if you are not attending the convention, please call me at your convenience. (Cell: 205-837-4845)

Two questionnaires I have prepared for helping to initiate a good discussion may be found at:

- <http://www.emailmeform.com/builder/form/mr5TcsC2RffdG> for valuation,
- <http://www.emailmeform.com/builder/form/Opu487J20rbh6A> for succession planning.

They can be printed out for your private use only, or completed and submitted to me. Submitted information will be kept confidential.

Hopefully you have found the information in this newsletter valuable. I only send one issue of "Looking Ahead" each year. If a major economic or geopolitical event were to occur, I might send an addendum, but never more than two mailings a year. To be added to the mailing list for this free newsletter, please send me an email. If you wish to be removed from this mailing list, please send me a reply email from the email address that received this newsletter. Put the word **REMOVE** in the subject line.

Please send any questions or comments regarding this newsletter to the email address below.



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