Five things business owners should keep in mind ahead of the next recession

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Everywhere you look these days, there is much hand-wringing about the warning signs of a looming recession. We are more than 10 years into a bull market, the longest in history. When – not if – the correction comes, it will have a detrimental impact on people's savings and investment portfolios. And then come the observations and advice as to what people should do with their portfolios.

Let's be clear. We are definitely in the late innings of the current bull market, and people should be adjusting their thinking about investments accordingly. That said, there is one big asset many Canadians usually overlook. There are almost 1.2 million small and medium-sized businesses with less than 500 employees in Canada. These businesses are, in general, their owners' single biggest asset. History shows that when the market turns, the value of these assets will be impacted negatively. And given that these assets are illiquid, this impact on business owners is significant.

For business owners who contemplate a potential exit, and for financial professionals who want to help business owners prepare in the face of a market downturn, there are five important points to keep in mind:

1. IDENTIFY THE NON-FINANCIAL DRIVERS

Business owners have many reasons for doing what they do: build a business for their children, provide for their employees and support their community – among others. All are valid reasons – and none of them are purely financial. Thus, it is important for business owners to understand their non-financial drivers and their relative importance. Doing so will inform if, when and how they approach external lenders, investors or buyers. For example, if a business owner wants to ensure that a future buyer keeps all the staff after the sale, or keep a commitment to the local community, she may find that a buyer is willing to agree to those terms – but at a lower purchase price.

2. DON'T TRY TO CONTROL THE TIMING

When investing in stocks, a key lesson is that you cannot time the market. This is equally true for business owners who may look to exit their businesses. In 2007, many business owners who thought they would work for a couple of more years and then sell their companies found that their plans were thrown out the window. They ended up working a lot longer than they had planned. The lesson for business owners today is that you may not be able to sell at the time you want and at the price you want.

One potential solution is that a business owner may choose to agree to a partial exit now with a mechanism to sell the rest of the company in a few years. Conversely, the business owner could choose a full sale now with a post-sale consulting or employment contract. A variety of options may exist that allow business owners to protect their downside while retaining some upside – a business owner is typically in a better position to negotiate these options before a market downturn.

3. DON'T BE LULLED BY OVERCONFIDENCE

Research shows that 75 per cent of professional fund managers and 90 per cent of car drivers think they are above average. Such overconfidence is mathematically impossible and extremely dangerous. For example, everyone is familiar with Blockbuster Entertainment Inc. and Netflix Inc. Both initially operated in the DVD rental market. When Netflix moved to a new business model – streaming movies – Blockbuster, a much larger and more financially successful company, largely ignored the move as a fad. However, streaming technology displaced DVDs; Netflix thrived and Blockbuster went bankrupt. The lesson for today's business owners is that they should beware the overconfidence trap: past success may not continue in a new market environment.

4. DON'T FALL VICTIM TO THE 'IKEA EFFECT'

We all tend to value our own efforts more than someone else does. Research on two groups of subjects – one who assembled IKEA boxes and a second group that inspected the already assembled boxes – found that the first group would pay significantly more for the boxes than the second group simply because they had spent time and effort assembling the boxes. Business owners often fall prey to the IKEA effect and price themselves out of the market by valuing their sweat and tears at a higher price than justified objectively.

5. TREAT A BUSINESS AS A BUSINESS – NOT A WAY TO FUND A LIFESTYLE

Some business owners like to operate their business as an extension to their lifestyle. Of course, business owners need to compensate themselves appropriately, but the payout needs to be in line with business results, not with lifestyle wants. The inherent risk is that potential lenders or buyers do not see a viable business that exists independent of the owner and, therefore, choose to pass on the opportunity or do so on less favourable terms.