

BANKING & FINANCE

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Why Deal Structure Counts in M&A Transactions

by Curtis Campbell, CPA, MST, Partner, HMWC CPAs & Business Advisors

If you're planning to buy or sell corporate assets or stock in a merger or acquisition, you'll need to negotiate more than just the selling price. How you structure the deal can have a major impact on how much cash and potential liabilities you'll wind up with after the dust settles.

A fundamental choice in a corporate deal is whether its stock or its assets will be sold. In a stock sale, all the outstanding shares of stock transfer to the buyer, and the business can continue to operate uninterrupted. In asset sales, the buyer purchases all (or most) of the corporation's assets and liabilities, renegotiates contracts and applies for new licenses, titles and permits. From a tax and liability perspective, sellers generally prefer a stock sale, while buyers typically prefer an asset sale.

With a stock sale, sellers pay tax on the difference between the selling price and their basis in the stock — and at the more favorable long-term capital gains rate as long as they've held the stock for more than 12 months. But asset sales trigger double taxation for C corporations. The shell corporation — which the seller retains and winds down in an asset sale — pays tax on the gains from selling assets. And the shareholders pay tax on cash distributions.

When buyers purchase stock, assets stay at book value, and existing depreciation schedules apply. Although simpler to execute, stock sales typically result in higher taxable income for the buyer than do asset sales. Asset sales enable the buyer to report assets, such as equipment and furniture, at fair market value. The value allocated to each fixed asset provides a fresh basis for depreciation, thereby lowering taxable income in the future.

S corporations have a third option that may serve as a middle ground between asset and stock sales. By electing IRC Section 338 (h)(10), the parties may be eligible to treat a stock sale like an asset sale for federal tax purposes. Although the election won't save sellers any tax, buyers will reap the tax benefits of an asset sale.



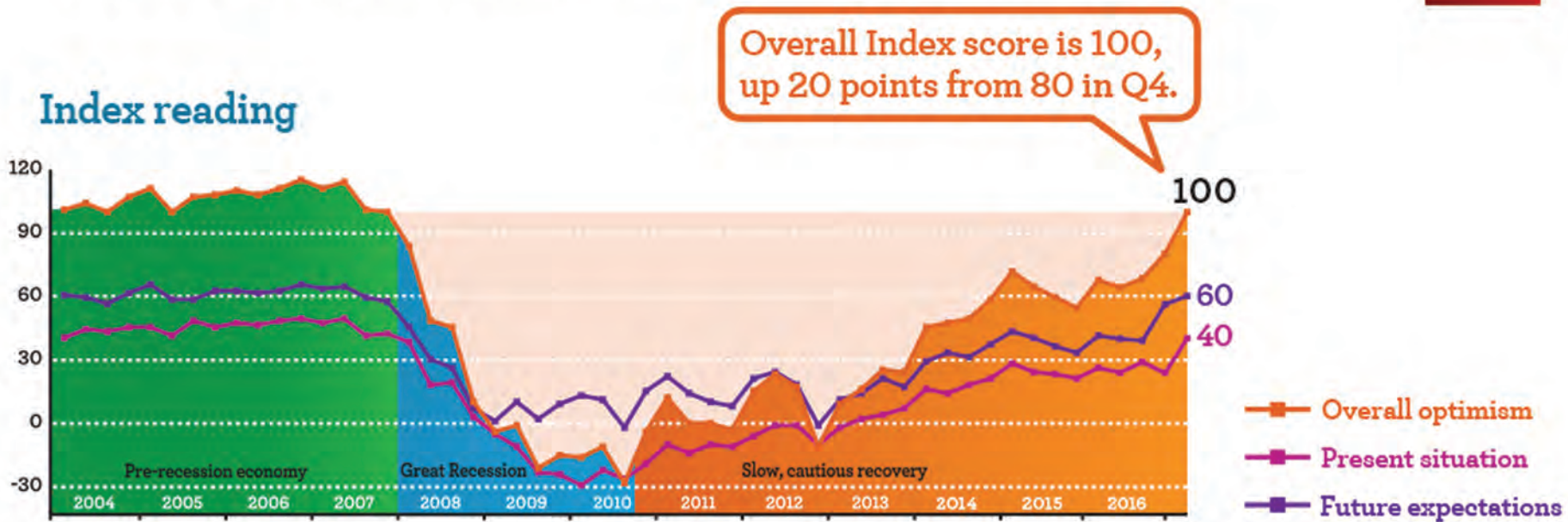
Curtis Campbell

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714.505.9000 to discuss how your company or client could benefit from HMWC's services.

Small Business Owner Optimism Surges in First Quarter.

The Q1 Wells Fargo/Gallup Small Business Index



The Wells Fargo/Gallup Small Business Index is calculated from a quarterly survey of 602 small business owners and measures current and future perceptions of their business financial situation. More information can be found at <https://wellsfargoworks.com/small-business-optimism-surges-to-pre-recession-levels>. © 2017 Wells Fargo Bank, N.A. All rights reserved. Member FDIC. March 13, 2017

Small Business Optimism Surges to Pre-Recession Levels

Small businesses report improved revenues, cash flow and access to credit; business owners are saving for retirement, feel confident about financial matters in retirement

Small business owners are the most optimistic they have been since the start of the Great Recession, according to the latest findings from the Wells Fargo/Gallup Small Business Index.

In the quarterly small business survey, which measures the optimism of small business owners, the overall Index score increased significantly to 100 in February, up from 80 in November and up 33 points from a year ago. This marks the highest optimism reading since July 2007 when it was also 100, and represents a return to pre-recession levels.

Small Business Index Key Drivers

Several factors contributed to the jump in small business optimism this quarter, most notably, how business owners rate their current business conditions. The present situation score – how business owners gauge their perceptions of the past 12 months – shot up 16 points to 40 in February, representing the largest quarter-over-quarter increase in the history of the survey. The future expectations score – how business owners expect their businesses to perform over the next 12 months – climbed four points to 60.

Other key drivers this quarter included:

- ◆ **Better financial situation** – Seven in 10 (71 percent) said their current financial situation is very or somewhat good, up from 66 percent in November
- ◆ **Increasing revenues** – Almost half (45 percent) said their business's revenue increased a little or a lot over the past 12 months, up from 37 percent in November
- ◆ **Stronger cash flow** – Sixty-four percent said that their cash flow was very or somewhat good over the past 12 months, up from 55 percent in November
- ◆ **Access to credit** – Forty percent said that credit was somewhat or easy to obtain over the past 12 months, up from 34 percent in November

Looking Through a Long-Term Lens

Small business owners were asked about their retirement plans in February, and overwhelmingly the survey found that most plan to work for as long as possible with 73 percent expecting to either cut back on work but always maintain some involvement in the business, or never retire until they are unable to work. Another 19 percent expect to sell or transition the business in order to do something else and just six percent said they expect to retire and stop working completely. In fact, more than half of survey respondents said that if money were no object today, they would continue working in their business either full or part-time; 27 percent said they would retire completely and 17 percent said they would start another new business.

The survey also found that most small business owners do not have a clear strategy for business succession, as 70 percent said they do not have a formal, written plan in place to outline what they'll do with their business when they retire or are unable to work. When asked the main reason why they do not have a transition plan for their business, more than half (51 percent) said it is not a priority at this time and 17 percent said they don't know today how they'll transition the business. Twenty-one percent cited some other reason, and seven percent said they do not have time to work on a plan. Of the small business owners who do not currently have a formal, written plan, 59 percent plan to create one before they retire or stop working.

Small Business Owners Are Saving for the Future

Small business owners also said they are actively saving for retirement. In the

February survey, 82 percent of small business owners said they are currently saving or investing money toward their retirement, and 76 percent said they think they'll have enough money to live comfortably in retirement, up 10 percentage points from when this question was last asked in January 2014. Small business owners also reported fewer concerns regarding their financial matters in retirement:

- ◆ Forty-six percent said they are very or moderately worried about being able to pay medical costs of a serious illness or accident in retirement, down from 57 percent in January 2014
- ◆ Less than half (42 percent) are very or moderately worried about being able to build back retirement savings lost during the recent economic downturn, down from 50 percent in January 2014
- ◆ Just 21 percent said they are very or moderately worried about being able to sell their business when they are ready to, down from 33 percent in January 2014

Small Business Challenges

When business owners were asked to identify the most important challenges facing their business today, government regulations rose to the top of the list (14 percent) followed by attracting customers and finding new business (12 percent) and taxes (9 percent). Hiring and retaining quality staff, the economy and financial stability/cash flow were also reported as top concerns (8 percent). These challenges have been consistently reported as the top concerns of small business owners since early 2013, although the order of concerns shifts from quarter to quarter.

Ben Alvarado

Ben Alvarado is executive vice president and president of Wells Fargo's Southern California Community Bank.

He oversees approximately 3,800 financial professionals at 233 branches and manages more than \$37.7 billion in deposits and \$9.5 billion in loans.

Alvarado, a 25-year banking veteran, assumed his current role in December of 2014. Prior to being named president for the Southern California Region, he ran the Orange County-Inland Community Bank. He also has served in various positions at the company, including retail bank district manager for the Pasadena and South Bay markets; commercial loan officer; sales development coach; branch manager; personal banking officer, and bank teller. As one of the top ranking executives in the bank, he also sits on the Management Committee, which provides oversight on operations, practices and to lines of business.

Alvarado earned his bachelor's degree at California State University, Long Beach, and an MBA from Pepperdine University. He is active in the community and serves on the board of directors for Orange County United Way; the advisory board for Miller Children's & Women's Hospital in Long Beach; the board of directors for Bundles of Books in Los Alamitos; Game Changer Charity and is the current president of Wells Fargo's Latin Connection team member networking group.

Alvarado resides in Rossmoor with his wife and two children.



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The Trump Rally

by Carson Lappetito, Chief Operating Officer, Sunwest Bank

The election of President Trump sparked a significant rally in the equity markets catapulting the healthcare, energy, industrials, materials and financial services sectors higher. Among the winners, banks have experienced the greatest increase in value with the industry's primary indices rising between 20-24%. For all those equity investors and particularly bank investors, the question is why and is it justified? There are three main drivers contributing to the Trump rally outlined below; tax reform, economic expansion and deregulation.

Tax Reform

President Trump has committed to reducing the corporate tax rate and simplifying the tax code. In theory, this consists of eliminating many of the pork barrel tax deductions/credits and reducing the overall tax rate from 35% to 15-20%.

A meaningful reform to the US corporate tax code will increase economic activity and corporate profits. This is particularly impactful for small and medium size businesses because their effective tax rates are typically higher than large companies since they receive fewer tax advantages due to their limited lobbying power. For example, the effective tax rate for the S&P 500 is 24% compared to the statutory rate of 35%, which most small/medium size business are taxed at. Tax reform will favor these companies because they are taxed at a higher rate.

The prospect of tax reform has driven publicly-traded equity values higher due to expectations for higher future earnings. Equities are generally valued based on a multiple of earnings or a price-to-earnings (P/E) ratio. Since tax reform will increase corporate earnings, investors are willing to pay a higher price for an increase in future earnings, lifting equity values and P/E ratios. For instance, if we assume a California company's tax rate is 40% and tax rates are reduced by one-third, earnings would increase by approximately 13%. The banking industry has benefited greatly from expectations for tax reform because they have one of the highest effective corporate tax rates because they cannot push their production offshore where most of the loopholes exist. Regional and community banks pay on average 32-35% in federal taxes in addition to state taxes. As a result, banks equities have received a significant lift from expected tax reform.

Economic Expansion

Jobs, Jobs, Jobs! A significant part of the Trump platform is revitalizing America's economy and creating jobs for its citizens through energy production, infrastructure development and incentives to bring jobs back to the US. The resumption of construction of the Dakota XL pipeline will create jobs and lower the cost of energy production in North Dakota. Additionally, drilling activity has rebounded from its low in 2016. President Trump has outlined his top 50 infrastructure priorities, which could create thousands of jobs for on-site workers as well as all the necessary inputs and services to support these projects. Further, President Trump has used his influence to drive businesses to keep jobs in the United States and has been initially successful in persuading corporations to retain American jobs.

These prospective initiatives should drive job creation and economic expansion in the US. Forward indicators such as the NFIB Optimism Index and the Michigan Consumer Confidence Index are at near-term highs in anticipation of broad economic growth. This has helped to fuel equity values of industrial, material, energy and consumer discretionary companies. Bank valuations are also receiving a large benefit from this optimistic economic outlook.

"A bank is a levered play on an economy"
– Eric Hovde, Chairman & CEO of Sunwest Bank

Banks are a levered play on their economy with loans and deposits growing when the economy is performing strongly. Expectations for future growth are high and this has translated into expectations for higher future earnings and bank valuations.

Deregulation

No industry has been impacted more from the ever increasing level of regulation than the financial services industry. Reducing the cost of regulation has been a keystone of President Trump's platform. The President signed an executive order that requires any new regulation to be offset by the elimination of another regulation. His goal is to create a more business-friendly environment in the US to stimulate growth, particularly for small businesses. Regulations for the energy industry are being rolled back and the Administration is focused on relaxing industrial and manufacturing

regulations, labor laws, FDA red-tape as well as the role and scope of the EPA. The President is focused on deregulating the financial services industry including many costly regulations implemented by Dodd Frank that have hampered the industry. Banks have felt immense pressure from the enhanced regulatory scrutiny from the FDIC, OCC, the Federal Reserve and CFPB. This has increased compliance costs, restricted the availability of credit, and reduced shareholder

returns. Expectations for reduced regulation from Dodd Frank and CFPB have caused investors to assume future growth, increased M&A and better operating efficiency across the industry; driving bank equity valuations higher.

Banks and Interest Rates

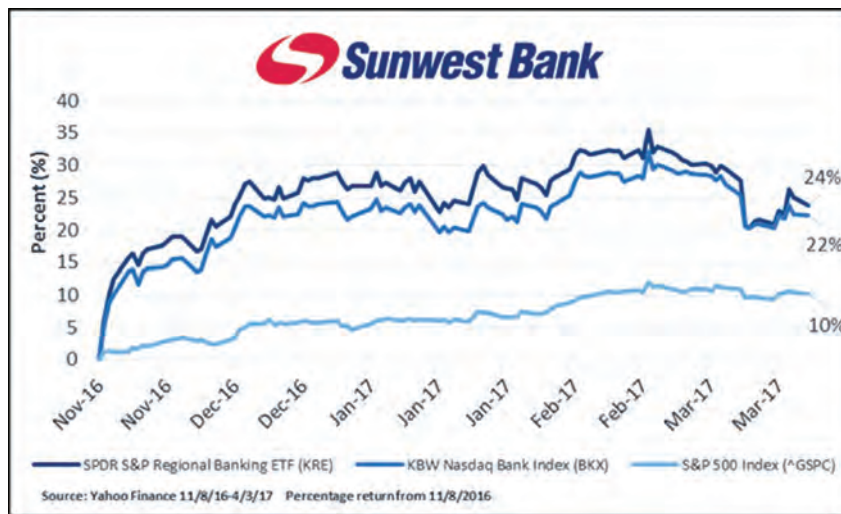
As we outlined above, of all the sectors benefiting from the Trump Rally, banks have increased the most. In addition to the factors outlined above, expectations for rising interest rates have generated significant optimism for the banking industry from expectations of better margins and increased earnings. The exceptionally low rates that the industry has been operating under since 2008 have reduced margins. The shift of interest rates back to a normalized environment will significantly improve profitability. It is important

to remember that rising interest rates are dependent on the state of the economy, business expansion, the labor markets and expectations for inflation.

The broader equity market and particularly bank equities have experienced a significant rally since President Trump's election based on expectations for policy changes that will spur economic growth. Most of these policies will require congressional action to achieve the objectives outlined during his campaign. As we have seen during the President's attempt to pass the most recent healthcare bill, the path to implementing these policy changes can be rocky and equity values tied to the state of these policy changes will likely fluctuate with success and failure in Washington.

To learn more about the economic impact of Trump's policies, please visit SunwestBank.com/insights to download Sunwest's analysis of Trump's First 100 Days and subscribe to our economic updates.

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Carson Lappetito

Mr. Lappetito serves as the COO of Sunwest Bank and its parent company H Bancorp. Prior to the formation of H Bancorp, he served as Vice President of Hovde Private Equity Advisors where he was responsible for analyzing and valuing investment opportunities as well as assisting portfolio companies with M&A, investment management and ALCO. Prior to Hovde, Mr. Lappetito was a senior analyst and product manager at Darling Consulting Group, where he was responsible for advising a wide range of community banks on asset liability management, valuation, risk management and strategic planning. Mr. Lappetito graduated from Bates College with a Bachelor of Arts degree in Economics and Political Science with a minor in Mandarin Chinese.



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Obtaining Bank Financing in Difficult Situations

by Deborah Dickson, CPA, CFF, MAFF, President, Smith Dickson, An Accountancy Corporation

Obtaining or renewing bank lines of credit or loans isn't always a simple process. A business may be declined credit and not have a clear answer as to why it was refused the financing it needed. Banks consider the "Five C's of Credit" (capacity, capital, collateral, conditions and character) in extending financing, which can be difficult to evaluate from a typical commercial applicant's perspective. On top of those criteria, other factors can play a key role when credit is not approved, such as lack of preparation, poor records, and the bank's level of risk aversion for certain types of loans or industries. It is in these more challenging situations that a qualified CPA firm can prove to be particularly helpful.

Expert Assistance

Smith Dickson offers specialized expertise in obtaining bank financing. Our work typically includes: determining financing requirements; preparing financial statements, projections and plans that lenders request; ascertaining banks' requirements; and negotiating loan fees and terms with bank representatives. For companies that have difficulty in obtaining traditional bank financing, we are often able to help turn their situation around. Here a few examples:

◆ **Financial statement issues:** A new client came to us recently with severe issues affecting their ability to obtain outside financing. Their underlying records

were grossly inaccurate. Our accountants came in, cleaned up the records and prepared compiled financial statements. With our guidance and assistance, the company was then able to obtain a large working capital line of credit from a highly reputable bank.

◆ **Financial ratios compliance:** A company may have clean financial statements, but it is not able to meet lenders' financial ratio requirements. Our experts are able to work with the company and provide strategies to make adjustments that will keep the company operating effectively while achieving ratio standards.

◆ **Covenant violations:** If a covenant violation is imminent, we can work with the bank ahead of time to seek a covenant waiver letter. We have been able to negotiate with banks based on criteria besides ratios that help companies to achieve their financing needs.



Deborah Dickson

Seek Guidance

Smith Dickson has decades of experience in helping companies of all sizes with their external financing needs. We have strong relationships with numerous banks and understand their specific lending criteria. If your company is experiencing difficulties with bank financing, contact us.

Deborah Dickson, CPA, CFF, MAFF is president of Smith Dickson, An Accountancy Corporation (www.smithdickson.com). Contact her at 949.553.1020 to learn more about how Smith Dickson can help your company with bank financing.

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