It's the part you *don't* see that sinks the ship

Business Ownership & Building Wealth

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In an earlier article I described the crucial importance for private business owners and their advisors to treat the business as a ***unique class of assets***, with its own properties (risk, return expectations, liquidity issues, etc.). Based on that, a few bold assertions:

Assertion 1: Owning a private business is perhaps the most effective way possible to create significant personal and family wealth. I am not saying that owning this type of asset is for everyone (also true for conventional asset classes like real estate and stocks), and I am not saying it is without risk (again, also true for every other asset class, from cash to stocks and bonds, to real estate, as the 2008-2011 downturn has shown so clearly). As with any class of assets, we decide to own it with the expectation that over time it will be worth more than when we bought it, and that we will be able somehow to "harvest" that extra value for out own purposes.

Assertion 2: As with any asset class, to build value over time the asset must be properly managed by someone who understands its unique properties. Examples: Stock brokers and portfolio managers understand how publicly traded stocks and bonds behave, and real estate professionals have similar expertise in their area, but neither is a good resource for understanding how to build value in a private business.

The problem confronting most business owners and their advisors, especially when the business is still fairly small (below $10 million in revenue), is that they tend to look at business ownership in a flat, linear way. They end up concentrating on just a couple of aspects of business ownership, usually centered around buying or selling it, or perhaps around solving a particular set of operational problems. This leads me to

Assertion 3: To really ***manage*** this asset requires instead that it be understood and managed across its entire life…what I will call the "*Business Ownership Cycle.*" As the name suggests, and as the following diagram illustrates, owning a business is anything but linear.

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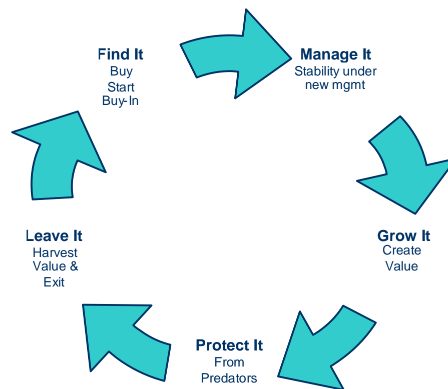

To create true value in the business, as a basis for creating wealth ("wealth" is simply harvested value in an amount large enough to accumulate over time after paying for the expenses of daily life, and large enough to pass along to benefit future generations), the business owner and his/her advisors must learn to recognize the distinct value drivers that exist at each of the five stages in the Business Ownership Cycle, as well as understanding how they interact with one another. Some examples:

Stage 1: Find It. This stage defines how the owner gets into the business in the first place: either through finding one to buy, or starting one from scratch, or buying into a business where he already works or which is already in the family (in the latter case, the "buy in" could involve money, or time served in a junior role; it could be premeditated, or by happenstance). Clearly, this step needs the proper legal structure to it, and the amount of time, money and other resources invested in it need to bear some relationship to the actual, risk-adjusted value of the business opportunity.

Stage 2: Manage It. Once the owner is settled behind the desk, he/she immediately starts making decisions that can have a lasting impact. These are typically operational decisions that cut across all areas from finance to HR, from supply chain to business development. This is the period where the wise business owner gets comfortable running the business, comes to understand its normal rhythms, and develops a leadership style. The emphasis is more on stabilizing the business and moving it forward under new stewardship than it is making dramatic efforts to grow or expand it.

Stage 3: Grow It. In time, the business owner gets a good feel for the strengths and weaknesses of the business, and starts to think of ways to grow it. This process can be organic or can involve acquisitions. It can involve expanding or improving the product or service the business sells, or going after new markets or customers. NOTE: Acquisitions can also be used to remove a competitor: if you can't beat 'em, eat 'em! This is also the time when the wise business owner starts looking at personal as well as business goals (these can focus on money or prestige, family or legacy, among other things) and starts to appreciate how the two sets of goals are related. This is the stage at which the business owner tries to get the business to the point where, to borrow a phrase from Michael Gerber's "E-Myth Revisited" they switch from working ***in*** the business to working ***on*** the business.

Stage 4: Protect It. As with any other asset that starts to become quite valuable, it is important to take steps to protect it. In the simplest of cases this can involve simple

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things like key man insurance policies, being sure there are current buy-sell agreements between partners, there is a succession plan in the case of the death or disability of the owner. At a certain point the business gets large and valuable enough that it makes sense to consider structuring the ownership in a way that discourages predatory lawsuits or judgments that can destroy a good business in the blink of an eye (think of the Chimpanzee owner in Stamford, CT, all of whose assets were frozen by a court for several years (she died before the matter was settled) because an animal she considered a pet attacked and severely injured a friend visiting her house, and the friend sued). At a certain point it also becomes increasingly important to deal proactively with potentially crippling things like inheritance taxes, which have forced many a family to give up control or sell a business outright just to pay taxes for which they had not planned.

Stage 5: Leave It. This stage is inevitable, but it is the one about which most business owners are in ***complete denial*** (according to a recent Price Waterhouse study, 72% of business owners do no exit planning at all!!). It is a biological and a business certainty: 100% of all business owners ***WILL*** leave their businesses, one way or another, voluntarily or not. You can do it on your own terms, or you can wait and be carried out. As I like to tell clients, though, dying at your desk does not constitute an exit strategy, and it often times devastates both the business and the owner's surviving family.

There is one interesting wrinkle that comes up as the "Leave It" stage unfolds. When a business owner exits, assuming the business continues as a going concern after this transition, then a major decision has to be made: should ownership and control of the business stay within the business owner's family, passing to children, or a spouse, or other relatives…or should it pass to someone or some structure outside of the family? Either way, a new Business Ownership Cycle begins, but in the case of keeping the business in the family an entirely new layer of family-related factors start to form which require special attention. For the first generation owner of a private business there are always friction points between the owner's family or personal life and the professional demands of running the business. Once the ownership starts to span multiple generations, however, the occasional friction points start to resemble an earthquake fault line: things can go on for quite a while looking calm and rosy, but when something does happen it can be truly catastrophic for the business and the family.

Once the business owner, his/her advisors, and family members start to look at the business as an asset, they should start to treat it the same as any other component of a business owner's net worth (albeit, the business is usually by far the largest component of that net worth, especially in early generations, and often there are unusually strong emotional ties to the business bearing the family name). As they get older, the owner, other shareholders and family members have to decide whether to keep it in the family and pass it through their estate or by other means to their kids, or whether they sell it and pass what is left of the proceeds into their estate for future generations. We will return to this critical issue in a future article.

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