EVERGREEN™ EXITS
A DIVISION OF EVERGREEN WEALTH SOLUTIONS

THE BUSINESS AS AN INVESTMENT VS. THE PIGGY BANK SYNDROME

FROM THE DESK OF: **EDWARD BARONE**

I. BUSINESS OWNER A.K.A. INVESTOR

The life of a private business owner brings independence and financial freedom. These are well-deserved perks, considering the courage and hard work it takes to build and run a private business. However, it is all too easy to treat the business as a personal "piggy bank". Shareholders aren't making demands. The owner is the one taking all the risk. Why not reap all the rewards?

One must not forget that the business is an investment in the owner's future sale value and ultimate replacement income. Remember the mantra, "Buy low, sell high." It is the key to successful investing. Why wouldn't a business owner approach the ownership and ultimate sale of their privately-held business with the same philosophy?

AN OWNER ESSENTIALLY LIVES OUT OF THE BUSINESS, RUNNING PERSONAL EXPENSES THROUGH THE P&L. HE MAY NOT THINK ABOUT HOW THIS PRACTICE WILL ULTIMATELY -AND NEGATIVELY- AFFECT THE VALUE OF THE BUSINESS, AT LEAST ON PAPER.

It makes intuitive sense for a business owner to treat his business as a publicly traded entity to ensure the highest possible profit. As the sole (or majority) shareholder, he or she stands to gain the most from this approach. However, few private owners run their businesses in this fashion. In many cases, the private business owner draws upon business revenue as personal income. He essentially lives out of the business, running personal expenses through the P&L. He may not think about how this practice will ultimately - and negatively - affect the value of the business, at least on paper.

It’s understandable. To the business owner, this “piggy bank” represents much more than a personal checkbook. It is a lifestyle and a place of sanctity and control over his environment. After all, he went into business for himself, with the intention of doing exactly what he wanted in life. The goal was and still is “time and money freedom”. However, when an owner thinks about exiting the business, he needs to consider whether he views it as an investment or merely as a job. He may need to change perspective about what the business represents. This exercise can be extremely difficult. It helps to boil it down to the following two (2) steps:

1. How will a Buyer perceive these expenses?
2. Which bank account will pay the living expenses after the business exit?

These two steps are a starting point for this discussion. The following sections will explore in further detail this key element to any successful business exit strategy – how to overcome the “piggy bank syndrome” and, as a consequence, to represent the true value of the business to a Buyer and to assess a replacement income for the exiting business owner.

II. STEPPING INTO A BUYER'S SHOES

When beginning to plan a business exit strategy, the business owner must first shed his President and CEO hat. He must become Chairman of the board of directors, putting the interest of the company’s shareholders foremost in his mind. This exercise simulates the separation of ownership and management in the corporation in order to create a new perspective. This is an important and often challenging first step. But it can be eye-opening. The introspective nature of the exercise is often completely new and different for the owner. In all likelihood this is the first time he has considered what he truly wants for himself from the business.

LIKE A SHAREHOLDER OF A PUBLIC COMPANY, HE (THE BUSINESS OWNER) CAN NOW LOOK FOR THE HIGHEST POSSIBLE RETURN ON HIS INVESTMENT.

The exercise also allows the owner to view the business through the eyes of a future buyer or potential investor. He sets aside his emotional and personal ties. He sees his business as a publicly traded company. And like a shareholder of a public company, he can now look for the highest possible return on his investment. He might find that the business is not earning the highest possible return, and as in many cases, has turned into the owner’s personal “piggy bank”.

THE NATURE OF EXPENSES

In order to fully appreciate the "piggy bank syndrome" a business owner must analyze and potentially re-evaluate the nature of "business expenses". All businesses incur necessary, recurring operating expenses - without them the business could not function. The question be- comes, however, what constitutes necessary spending - and how does this affect the "piggy bank".

To be deductible, a business expense must be both ordinary and necessary. An ordinary expense is one that is common and accepted in the industry. A necessary expense is one that is helpful and appropriate for the trade or business. An expense does not have to be indispensable to be considered necessary.

However, it is important to distinguish business expenses from:

- The expenses used to figure cost of goods sold,
- Capital expenses, and
- Personal expenses i

One can immediately see all the "grey areas" created by these very general classifications. Expense deduction is more of an art form than science. Most business owners know that they generally cannot deduct personal, living, or family expenses. ii However, when an expense is used for both business and personal purposes, it falls into one of those undefined "grey areas". Creative accounting sometimes prevails in these (common) situations.

For example, if 70% of an expenditure was spent on the business and 30% went toward a family vacation to Cape Cod, one can deduct 70% of the interest as a business expense. The remaining 30% is clearly personal. Regardless, an owner might deduct more than 70% because he either believes
the expenditure is necessary for business or because he has grown accus- tomed to running certain expenses through the P&L. Furthermore, a business owner will always aim to "lower his take home income" in order to minimize his tax bill. Publicly traded companies take the opposite approach by minimizing expenses and maximizing profits to show the highest possible return to
investors.

The point of this exercise is not to question or deny a successful business owner the luxury of spending his hard earned liquid wealth in the manner in which he sees fit. The point, rather, is two (2) fold:

1. To establish owner empathy with his future buyer or investor in order for a transaction to proceed harmoniously; and
2. To help define the income a business owner will need to fulfill his goals.

If this exercise produces a tremendous amount of discomfort for the business owner, or if he outright refuses to perform the exercise, then the owner is counseled to

realistically consider his preparedness in exiting the business. That owner might consider going back to the basics and engage in a compare and contrast analysis of private and public securities.

PRIVATE VS PUBLIC SECURITIES

An effective exit strategy plan will appreciate and distinguish between privately held businesses and publicly traded entities. For starters, consider the availability of information on public vs. private companies. The public market is symmetrical and transparent whereas the private market is asymmetrical and opaque. For the purpose of this paper, the private business owner must adopt the information standards of a public entity. This is often difficult for the owner, who is not required to report to investors and who, together with his accountant, decides what qualifies as a business expense.

It is, however, a necessary step in the process. The owner will need to "come clean" for the Buyer on what constitutes "additional expenses". Alternatively, the company could present a lower profit margin. In the end, this won't make it any easier on the owner, for it allows the buyer to offer less than the true market value of the business. In order to extract the highest possible value - and the highest possible post-exit income - an owner must illustrate the personal expenses (i.e. what comes out of the "piggy bank"). The onus is on the seller and their advisory team. A potential Buyer will not ask about a business owner's "piggy bank" money. Rather, he will gladly accept the low profit version of the books and offer a low price.

TYPICALLY, UNALTERED FINANCIAL STATEMENTS DO NOT REPRESENT THE TRUE VALUE OF A PRIVATELY HELD BUSINESS AND, ACCORDINGLY, THE OWNER MUST DETERMINE AND REPRESENT THE BUSINESS'S ACTUAL CASH FLOW TO THE NEW OWNER.

RECASTING FINANCIAL STATEMENTS

One way for an owner to effectively illustrate the company's true profitability is to recast the company's financial statements. Typically, unaltered financial statements do not represent the true value of a privately held business and, accordingly, the owner must determine and represent the business's actual cash flow to the new owner.

Accounting, in general, is a fuzzy business. Financial statements are at best an approximation of economic reality because of the selective reporting of economic [iii] events by the accounting system. In the context of private businesses, decisions are often made to reduce tax liabilities. Given the imprecise nature of accounting methods, one must

"normalize" the books for the purpose of a sale. Often, the owner's personal salary, perks, pension plan, depreciation, and one-time expenditures (non-recurring) can be adjusted to reflect actual and available cash flow. In other words, one must distinguish what constitutes the current owner's "piggy bank" and show its negative effect on the value of the business.

In the example included in this letter (see Appendix A) we show the operating statement of our fictional corporation SLE, Inc. The far right column represents the recast or revised financial statement for the business in 2006. The company's total selling and administrative expenses amounted to $685,587, reducing income before taxes to $189,025. Upon closer examination, we find several expenditures that do not, in reality, correspond to revenue-producing activities.

Specifically, for example, the owner reports $33,844 in telephone related expenses for the year. In actuality, only $23,691 of telephone expenses relates solely to business purposes. This is the figure a buyer should use to estimate annual telephone expense. This adjustment alone boosted cash flow by $10,153. Accounting for all adjustments, actual (revised) business expenditures amounted to $517,040 for SLE, Inc. -a reduction of $168,547, resulting in true income of $386,498. In this example, true profitability and return on investment are much higher than they appear on paper.

The preceding example introduces another important measure by which the "piggy bank syndrome" can affect the private business owner - how to calculate the owner's return on investment.

AN ACCURATE ROI CAN ONLY BE DETERMINED IF THE AMOUNT OF MONEY TAKEN FROM THE "PIGGY BANK" FOR PERSONAL EXPENSES IS ADDED BACK INTO THE PROFIT.

CALCULATING A RETURN ON INVESTMENT

The rate of return (ROR) or return on investment (ROI) is the ratio of money gained or lost on an investment relative to the amount of money invested. Return, or the amount of money gained or lost may be referred to as interest, profit/loss, gain/loss, or net income/loss. Return can also refer to the monetary amount of gain or loss on an investment. The money invested may be referred to as the asset, capital, principal or the cost basis of the investment.

ROI is also known as rate of profit and can rep- resent the return in a past or current investment or the estimated return on a future investment. ROI is usually given as a percent rather than a decimal value.[iv]

The way in which a business owner calculates his ROI presents a challenge. An accurate ROI can only be determined if the

amount of money taken from the "piggy bank" for personal ex- penses is added back into the profit. Only after doing so and re-calculating can a business owner accurately estimate his ROI.

After performing a thorough analysis of the owner's ROI, the owner can determine exactly how the business provided a return on the original investment. This return, once normalized, can also be shown to a Buyer as one data point supporting a higher (more accurate) value.

Consider the following example:

A required return of 25% per year for an investment in a privately held company is equivalent to a trading multiple of four times that company's current profit. By contrast, a public company expecting a return of 10% can trade at ten times its current earnings because of a reduced amount of perceived risk. Therefore, business owners should take a look at the risk associated with their business as an investment in their port- folio, putting aside that they also happen to work for their investment.

The ROI Calculation:

Sales Price:	$ 8,000,000
Less:	
Fees & Taxes:	<$ 2,000,000> $ 6,000,000
Plus:	
Excess Draw/yr, net of tax	$ 100,000 x 15 years $ 1,500,000
Total Return	$ 7,500,000
Initial Investment	$ 200,000
Investment Time	$ 15 yrs.
Annualized Return	**14.37 %**

For the fifteen years the owner ran the business, the Average Annualized return on his investment was 14.37%. These figures do not include the owner's "base salary"--only the excess draw (i.e. your "piggy bank" money) is included in the calculation.

Now, the risk/return measurement is easier to quantify. In other words, publicly traded securities may not be able to produce the same average annualized return, but the risk of the investment declines considerably.

This calculation also empowers the business owner to describe this "investment opportunity" in detail to prospective buyers or investors. In particular, a buyer of a business, all things being equal, should be willing to pay a seven (7) times multiple (100 divided by 14.37%) of earnings to own the company. Of course, the buyer will have his own ideas about the risk profile of the business opportunity without the owner's 'vested involvement'. Negotiation will come into play at this point. The key is the owner

starting point. He understands fully how much he returned on his investment--the business--for the time that he was at the helm. And he under- stands how much the buyer could return once he has exited the business.

UNLESS THERE IS A FORM OF CONTINUED PAYMENT BEYOND THE CLOSING, THAT BUSINESS OWNER WILL NEED AN "INCOME REPLACEMENT STRATEGY" TO SATISFY HIS PERSONAL EXPENSES AFTER THE EXIT –A WAY TO REFILL THE "PIGGY BANK".

III. INCOME REPLACEMENT RATIO

Once the business owner exits the company, he no longer exerts strategic or financial control over that entity. Furthermore, unless there is a form of continued payment beyond the Closing, that business owner will need an "Income Replacement Strategy" to satisfy his personal expenses after the Exit –a way to refill the "piggy bank". In other words, the "liquid" or "publicly traded" Capital Markets need to provide a stream of income that replaces the income received from the business (or Private Capital Markets).

Recommended considerations:

- Does the business owner have any experience with investments?
- Is there any awareness that a stock and bond portfolio can be designed to provide income to that investor?
- Has that business owner calculated the net-of-tax costs of his lifestyle after the business exit?

At this point, a business owner will fully realize how his personal "piggy bank" affected his lifestyle and living expenses. The following is an example of a typical situation a private business owner might face and
how this owner could replenish the lost income.

The owner of SLE, INC. drives a company car. Sometimes he uses it for "business travel"...but not always. The company makes lease payments of $ 500.00 per month. At the end of the business' fiscal year, the owner and accountant decide how to allocate business vs. personal use of the car. The business use portion is deductible as a corporate expense. But, regardless of the amount that is deducted, the business owner is accustomed to running that lease payment (and insurance payments, and fuel payments, and maintenance costs) through the business. The owner has come to rely upon the business as his "piggy bank" to pay for ordinary everyday personal expenses.

To understand the impact of this particular expense, one must determine how much pre-tax money the business owner needs to satisfy the same automobile payment after exiting his business.

Consider the following calculations:

Monthly Annual
Pymt. Pymt.

Corporate Revenue$500.00 $6,000.00
Auto Lease Payment-$500.00 -$6,000.00

Out of Pocket to Owner$0.00 $0.00

$100K investment in 6% coupon bond $6,000.00
Ordinary Income Tax at Owner's (Federal) Tax Rate < x .35 >

After tax amount $3,900.00

In order to replace the auto allowance ‘income’ from the business, a business owner--only spending interest income (not ‘dipping into' principal)--will need more than $100,000 in investable assets, earning 6% per year, to make the same payment. To calculate the interest income required for the replacement auto allowance expense, divide the annual payment by 1 minus the business owner’s tax rate:

$ 6,000.00/

0.65

$ 9,231.00

Then, divide the interest income required by the rate of return achievable:

$ 9,231.00/

0.06

$ 153,850.00

To conclude, an investment of $153,850.00 in investable assets is required to produce enough after-tax income to satisfy the car payment after the exit from the business. It is important to note here that this calculation does not account for growth in any investment, changes, or particulars, of tax laws; nor does it account for rising inflationary pressures in car lease payments. These issues, however, should in no way diminish the utilitarian nature of this exercise. The calculation should be performed for all expenses covered by the "piggy bank". The owner can then understand the amount of "liquid" proceeds (or continued income stream) that is required to fulfill an Income Replacement Strategy.

An exit strategy plan must make many special considerations that will affect the owner—and his or her spouse--for years to come. Often the spouse is as interested as the owner in the Income Replacement Strategy analysis, wanting to determine "what things will look like" once the business is no longer there to provide for them. So one can see how these conversations between advisor and owner (and owner's family) become quite personal in nature.

A business owner may not share this information with anyone except his spouse and his accountant. However, the income replacement assessment is a critical component to a successful exit strategy. At the end of the day, the owner wants to exit his business, confident in his financial situation and happy with the lifestyle he will live for the rest of his life.

Despite the importance of this process, many business owners do not come to the deal table armed with essential and valuable advice regarding the key elements of a successful business exit strategy. A typical owner hasn't determined the true economic value of his business. Nor does he know how much in assets he needs to retire comfortably. In effect, this handicaps him in the face of a buyer who will offer the minimum possible value and not a penny more. All too frequently, the owner "cancels" the deal and reverts to running the business so he can enjoy the "lifestyle" benefits that he and his family have come to depend upon. His "time and money freedom" has slipped away due to incomplete planning. Advisors, however, are in a unique position to step in and raise the owner's awareness of the situation before it's too late. Preparations can be made so that the exit strategy proceeds smoothly and reaches a mutually satisfactory end for buyer and seller.

IV. CONCLUSION

Business owners are, at their core, investors. They are shareholders in their business. They are the ultimate beneficiaries of higher profits. As such, in the context of business exit strategy planning, the first step in the financial analysis of a privately held business is to look at the business as an investment.

Business owner exits depend upon a visualization of a trade - Shares for cash. The basic transaction is not that different from what takes place in the public markets. However, the way in which it takes place can be dramatically and detrimentally different. It is crucial that the owner adopt a new perspective--that of a potential buyer or investor who wants to know today how much cash flow this business generates. The business owner needs to consider the following question: How much cash would he be willing to receive for operational and financial control of the business today? Sadly, the answer to this question is often twice the true value of the company. The owner's skewed view of his personal needs--i.e. The money he draws from the "piggy bank"—often inflates his estimate. Consequently, the owner's idea of what his business is actually worth is quite different from what a potential outside investor would pay.

An owner must be prepared to not only identify these misconceptions but more importantly, he must "learn" how to detach from his business and view it through an investor's eyes. It presents a challenge, no question. It will require a significant mindset change. After all, a private business owner of thirty (30) or so years has settled into a particular routine and lifestyle. It is this lifestyle that depends on the owner's ability to step back from his role as CEO and approach the sale like an investor. A fair and true value is worth the extra time and trouble. Therefore, a well structured exit strategy that analyzes the "Piggy Bank Syndrome" and offers creative means by which to overcome it will result in a successful exit and a satisfied owner.

HIGHLIGHTS

I. BUSINESS OWNER AKA INVESTOR

When a business owner thinks about exiting the business, he needs to consider whether he views the business as an investment or merely as a job. A perspective change may be necessary.

II. STEPPING INTO A BUYER'S SHOES

When beginning to plan a business exit strategy, the business owner must first shed his President and CEO hat. He must become Chairman of the board of directors, putting the interest of the company's shareholders foremost in his mind.

III. INCOME REPLACEMENT RATIO

The "liquid" or "publicly traded" Capital Markets need to provide a stream of income that replaces the income received from the business (or Private Capital Markets).

IV. CONCLUSION

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APPENDIX A **Add-back of Owner-Related Expenses to Operating Statement**

SLE Inc.			
Operating Statement	**2006**		
		Add Backs	Revised
Sales			
Service #1 Revenue	$ 1,632,718	-	$ 1,632,718
Service #2 Revenue	732,311	-	732,311
Credits & Allowences	(20,390)	-	(20,390)
Net Sales	2,344,639	-	2,344,639
Operating Expenses			
Salaries	880,520	-	880,520
Subcontracting Expense	26,459	-	26,459
Maintenance Expense	161,346	-	161,346
Depreciation	21,835	(21,835)	0
Insurance	38,134	-	38,134
Misc.	1,450	-	1,450
Payroll Taxes & Rel.	174,564	-	174,564
Travel Expenses	7,879	(7,091)	788
Equipment, Repair $ Maint.	8,455	-	8,455
Truck Expenses	149,385	-	149,385
Total Operating Expenses	$ 1,470,027	(28,926)	$ 1,441,101
Gross Profit	$ 874,612	$ (28,926)	$ 903,538
Selling and Administrative			
Salaries and Bonuses	188,751	-	188,751
Commissions	106,552	-	106,552
Consulting (Conlan)	5,488	-	5,488
Insurance	42,075	(8,415)	33,660
Misc	5,333	-	5,333
Payroll Taxes	21,602	-	21,602
Telephone Expenses	33,844	(10,153)	23,691
Office Equipment & Related	9,643	-	9,643
Rent & Related Expenses	18,544	-	18,544
Service Fees	13,896	-	13,896
Travel Expenses	19,184	(17,265)	1,919
Meals & Ent.	25,550	(12,775)	12,775
Accting & Admin Charge	187,965	(112,779)	75,186
Overhead Chargebacks	-	-	-
Bad Debt Expenses	-	-	-
Interest Expenses	7,160	(7,160)	0
Total SG&A Expenses	$ 685,587	(168,547)	$ 517,040
Income before Taxes	$ 189,025	$ 197,473	$ 386,498

Notes:

(1) Travel Expenses	Eliminate owner-related travel expense	(7,091)
(2) Insurance	Eliminate owner insurance	(8,415)
(3) Telephone Expenses	Eliminate owner personal cell phone & telephone usage	(10,153)
(4) Travel Expenses	Eliminate owner-related travel expense	(17,265)
(5) Meals & Entertainment	Eliminate owner-related meals expense	(12,775)
(6) Accting & Admin	Adjust Management Compensation to Fair Market	(112,779)

Are you ready for next steps? Click to complete our Business Readiness Survey and connect with our team.

i See IRS "Deducting Business Expenses", Publication 535, http://www.irs.gov/publications/p535/ch01.html#d0e414)
ii Id.
iii The Analysis and use of Financial Statements, Gerald I. White, Wiley (2002) iv Rate of Return, Wikipedia

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