103 - Entrepreneurs Save the World, Just Not Themselves
Episode Transcription

"Business owners and entrepreneurs change the world. Look at any device, it was created by an entrepreneur with capital. "

Paul Adams: See, a business owner has something on their balance sheet that an average, everyday executive doesn't have. Your everyday executive has things like a 401k, has things like a paycheck that comes in and a realization that they will not make a bunch of money if the company sells. Or when they retire, nobody's saying they're going to give them a big check. But, the thing that tranquilizes as many business owners from being in appropriate action with their personal balance sheet is they feel like the path to financial success on their personal balance sheet is going to be the sale of that business.

Announcer: Welcome to Sound Financial Bites where we help you with bite-sized pieces of financial and life knowledge to help you design and build a good life. The knowledge that has been shared from stages at conferences, pages of national business magazines, [inaudible 00:00:53] flipping across America. Our host, Paul Adams, now brings directly to you.

Paul Adams: Hey. I am so glad you could join us today. On today's podcast, I'm going to talk with all of you, sharing a little bit about what we've observed for business owners and entrepreneurs. One, how high the failure rates are. Two, how difficult it is, even if you're still around in five or 10 years, how difficult it is for that business to actually be fruitful enough to produce the financial future an owner would want, and then give you some practical tools to think about how strong does your balance sheet need to be if you're going to count on it to help you have the income that you want for the rest of your life.

So glad you could join us for this episode. Don't forget, you can give us a review on iTunes, and as a thank you for any just honest review, what we will do is send you a copy of Corey Shepherd, the President of Sound Financial Group's book, Cape Not Required. All you have to do is give us a review. Send us a screenshot of it from your mobile device or your computer, and email us at info@sfgwa.com with your mailing address, and we'll get that book out to you right away. We're so glad you could join us, and we hope that this episode is going to help you design and build a good life.

Welcome to today's conversation on entrepreneurs, business owners, what you don't know about your business and why your business is not enough. Now that can sound a little bit offensive, but what we're going to talk through today are the challenges we've seen actual business owner clients go through, both in the things that are said about their businesses and all the things that can go unsaid about their business that can really lead them down the path of actions that don't lead to their best future financial outcomes.

So, in jumping in, I think something that can be far, far overlooked is that business owners, entrepreneurs change the world. Look at any device, the device you might be listening to this on, created by an entrepreneur with capital. The ... Every computer program use the silly apps that you might have on your phone, even the ones that are just games, all of them started in the mind of an entrepreneur, all for the sake of moving the needle in some way to change the world. And business owners do an

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amazing amount of yeoman's work in innovation in our country, and it's not most of society. Most of society is not the business owner, entrepreneurs risking their capital and their livelihood to create a new product or service out there. And if you're not one of those people, that is okay. I think you're still going to find things that are going to be valuable to you in this podcast, but today, I want to zero in on what the entrepreneurs bump into.

Now, let's talk about how many people there actually are in the United States that are entrepreneurs. There's only six to 14 percent depending on the study. Now, one study that has to do with just the global entrepreneurship measure or GEM, that tool looked at people who were also at a job perhaps, but considering entrepreneurship, and their number gets as high as 14 percent. And then if you look at the Kaufman Study of people that are actually in business and employing people, growing, full concern, it is their full time occupation, may be as low as six percent, but somewhere between that six and 14 percent of society. Very, very small amount of the overall groups of people, and yet it's over 95 percent of businesses provide employment who have under 500 employees. Let me say it again differently. Companies that have less than 500 employees, employee over 95 percent of all the people employed in the United States. That is what a big deal being an entrepreneur, being a business owner is.

Now, what's also easy to overlook though, is the staggering failure rate. Now, let me share with you something that I pulled up that I think you're going to find valuable. Put this in the show notes. What you're looking at right now is a chart, and this chart shows how likely a business is to stay in business the longer it's been around. And you see that those numbers really dwindled. When you get out to 10 years or so, you have this very, very low survival rate of businesses, and depending on the measure, it may be only 20 to 30 percent of all the businesses that were started 10 years ago are still around today, and I'll give you a bigger statistic that's often overlooked. That just means the business is operational and maybe did a tax return but doesn't talk to the success of the business, and those numbers get far worse if, let's say, what you needed to do was qualify 10 years in for membership in an organization like the Entrepreneurs' Organization, which requires that you have over a million dollars of revenue in your company to be able to seek membership. Now those stats dropped even further.

To put it in real, concrete terms, I remember speaking to a group of entrepreneurs back in 2014, and one of the stats that I shared with them was for about 35 of them in the room, there were approximately 300 businesses that would have needed to have started 10 years prior for those businesses to still be in business. So, 300 people had to go into business 10 years ago to leave 35 business owners to be in the room listening to the topic I was talking about that day.

When we put a hurdle in on top of it, meaning that those companies didn't just have to be in existence, but they had to be in existence and have over a certain amount of financial success, in this case, a million of revenue, those odds looked more like 3,000 businesses had to be started 10 years ago for 35 entrepreneurs to be in the room today.

If you're an entrepreneur, you look every day to your right and left, and it seems like everybody's doing okay, because the ones that are failing, the ones that are not doing well, they're not a member of your country club. They don't live in your neighborhood. They don't come across town to be where you want to be. As a matter of fact, what they do is they're all off having success wherever else they're having success, and you see them moving around the community with you, and it looks like everything's fine. The ones that are not doing well, those that are off to the side of the road in the ditch, we don't see them because they don't live in our neighborhoods anymore. They're not a member of our golf club. They may not go to church at the same place we go because they've had to move, change their lifestyle, or they've got a job somewhere now. They're no longer an entrepreneur, and we forget about that failure rate and what people are actually up against to just try to have the level of success that they're after.

Now, in the show notes, we'll add the links both to this entrepreneur article that I've showed you that goes from the Bureau of Labor Statistics as well as this GEM study that really took away this idea that there's tons of people starting businesses. That's where a vast majority of the jobs come from in this country, and yet we can forget that that's the reason why they're so financially rewarded.

"Business owners are depending on the business and its ultimate sale to be what allows them to retire and have financial security."

Now, what do we mean by financially rewarded? If you are a business owner, odds are you have a chance to make more income than anybody else because there is no one limiting you saying, "Here's how much you can make." Or, "Here's what we can afford to pay you." It's an individual transaction with different clients, and then it's a matter of how efficiently you can run your entire operation, and that oftentimes provides a successful business owner with high levels of income. And yet those high levels of income don't translate to having enough money for the rest of our life, and it's because of a unique thing that occurs for business owners.

See, a business owner has something on their balance sheet that an average, everyday executive doesn't have. Your everyday executive has things like a 401k, has things like a paycheck that comes in and a realization that they will not make a bunch of money if the company sells. Or, when they retire, nobody's saying they're going to give them a big check. But, the thing that tranquilized as many business owners from being in appropriate action with their personal balance sheet is they feel like the path to financial success on their personal balance sheet is going to be the sale of that business.

I'm gonna say that again, slightly differently is that the business owners or depending on the business and its ultimate sale to be what allows them to retire. It is going to be what allows them to have financial security, and by simply letting that float in the back of their head, it's a little bit like a tranquilizing drip in your veins that has you relaxed, sitting on the couch, and unable to jump up and do something about it.

Think about this for a moment. You have ... If you put yourself in the shoes of being a business owner, and you're currently making $400,000 a year from your business. Now, for the moment, I'm going to leave off the table that when you're making $400,000 a year as a business owner of taxable income, you're probably making more than that, and you have some, what I would refer to as economic value, in having been a business owner. That means when you go on that vacation, you managed to look at some real estate or the opportunity to expand your business, and some of that trip gets deducted. When you go to conferences, you bring your family along, and there's some advantage to that. You may pay for cars through the business. All of that benefit the rolls

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back to you as a business owner, that's economic benefit you received the from the business that may or may not be taxable. That is above and beyond the 400 I'm referring to. So, I'm just saying $400,000 taxable income.

Now, if what you wanted to do was have the ability to have that income replaced, it would take a lot of money. It's going to take about $10,000,000, at a four percent distribution rate. We've got other podcasts. You can check out the four percent fallacy, but it talks about why the four percent distribution rate is what it is, and yet that four percent that comes out, replaces the income, takes $10,000,000 after tax of invested capital, not your home equity, not the vacation home. This is invested capital on your balance sheet for the sake of giving you enough income to have enough assets to have enough income for the rest of your life.

Most business owners do not have that handled. Now, part of why they don't have it handled and how they can begin to handle it, I'm going to come back to in a moment. Let me first take just a pause about the evolution of a business owner, that when that business owner goes into business, they're operating the business one way, and they grow into the ideal outcome of what it is to be a business owner working on your business, but let's take one quick pause and be right back for that.

Hey everyone, I want to let you know I'm interrupting this podcast for a good reason. If you're someone who's enjoying this podcast, if our philosophy is helping you better think about money, then this offer is for you. We've opened up a financial inquiry call for our listeners of Sound Financial Bites. Our financial inquiry call is 15 minutes where one of our team will ask you some key questions, understand your concerns, and if appropriate, schedule you for a philosophy conversation with myself or Sound Financial Group's President, Corey Shepherd. If you email us at info@Sfgwa.com with inquiry in the subject, we will reply back to you with a link to our team calendar so you can schedule a call at a time that's least invasive for you. Even if we're not a fit, the team member having the call with you, will point you in the direction of resources we have that can help you in whatever the next step for you in your financial journey is. Now back to your podcast already in progress.

Welcome back. I promised before that little break that what we would do is talk about the evolution of what a business owner goes through. So, when a business owner first starts, what they're doing is they're working at a job. Now it happens to be a job that they own. They own the job that is owning the construction company or owning the restaurant, and that requires that they probably do a whole lot of everything. Everyone's starting a business had this opportunity where you open the doors, and you are employee number one, employee of the month every month because you're it. The buck stops with you. You're working in the business. You own a job.

Now, the next stage is where somebody begins to grow their business a bit more, and now they have the opportunity, as Michael Gerber would put it, to work on their business, not just in their business. That's where they begin to think about what is the future of this business? What kind of systems and structures and training procedures should we put in place, where instead of being at the switch, making things happen in the business, the business owner starts to back off of that a little bit and starts working on the business, although they're still working in the business. This is the building a business stage.

So, first you own a job. Then you get to the point you're working on the business a little bit, which is building the business. Then eventually, you can pull far enough back and be running the business. You get to be the business owner. That's where you're working on the business 100 percent of the time and spending little to no time working in the business. And this is, by terms you might read about in things like the Rockefeller Habits or Scaling Up by Verne Harnish, or E-myth, by the legendary Michael Gerber. All of those books kind of make the peak, as good as it gets, is get to the point that you're working on your business all the time, because it also means that another business owner is more likely to be able to come in and buy that business and run that business as the person running it, not buying themselves a job, and that becomes like this pinnacle. Everybody is [inaudible 00:14:54] is where can I work on my business all the time? But there's a problem. That is not the pinnacle.

What we have to do, is some point as business owners, is be responsible for personal balance sheet, at which I would say is the next evolution, is where you're owning your business as one of your investments on your balance sheet, and now the game is how do we build and orchestrate an efficient and effective balance sheet to help our clients, or in this case for you so that you have a set of investments, and you have a set of assets that are likely to be able to continue the income that you want for the rest of your life. We want you to have a good life for the rest of your life, but it requires that design stage.

“Would you buy your life’s work and your business if somebody else built it?”

So, for you, going back to our person that's $400,000 a year. Now, if you're going to sit down with the paper and pad later, we're going to have a great download for you with this podcast, and all you'll have to do is go right to this podcast page on our website. It's going to be episode 103, episode 103. You'll see it in the show notes. You can link directly to it. Here's the worksheet. It's going to walk you through how you might look at buying your company if it wasn't yours.

So, let's go back to our example. The person making $400,000 a year from their business. To replace that level of income would require $10,000,000. To have a set of capital set aside to bring in enough money would, $10,000,000, to take four percent a year, 400,000.

Here's the overarching issue. That would mean you would have to sell your business for something like 12 million, to then pay taxes and then keep 10 million after tax for the business's sale to be enough to actually assure long term financial security for your family.

Said a different way, somebody would have to be willing to pay 30 times your earnings, depending on how you'd measure it, whether you measure it by seller's discretionary earnings or by EBITDA, you are going to be in the same boat that you would have to be paid 30X.

Now, why is it we think that, that's not unreasonable? Or it can float around in our heads? It's because those stories are legend. They are legend that people are out there, they're selling their businesses. It's a strategic acquisition by some huge company. They don't care about the financials. They're a strategic acquire, and they want to pay some huge multiple. And there are people like that out there, but they stand out like in a way that provides hope and a future, and it has so many business owners take the risks we just finished talking about.

The problem is most exits don't look like that. Most exits look much more normal. The normal amount that a business sales for is for between two and a half times seller's discretionary earnings, what the owner is making, all the way up to like six times EBITDA, and that can be a high valuation in many industries.

So, let's think about that for a moment. Let's go back to our $400,000 a year earning business owner. They do get a chance to sell the business. No joke. That is a wealth creation tool. In fact, it's probably the best rate of return that business owner's ever had in any investment their entire life was this concentrated stock position in the company that they owned.

That's all very valid, but if they sell it for six times 400,000, that's going to give them about 2.2 million, 2.4 million, 6X 400,000, $2.4 million sale.

Now, you're going to pay taxes. So let's say that takes it just to be kind of nice here with taxes, call it $2 million net. If we invest the 2 million, we have $80,000 a year. That is a big gap that we have $80,000 a year and what we were making prior was 400, and this is the reason why you'll see most business owners, as they age ... In fact, this is the reason why there are many, many, many businesses that there could be deals on to be able to go acquire as a small business, because these business owners have hung out, not getting the planning done, not getting succession handled, not getting their business prepared for sale, and the reason was that they found out they're only going to get, you know, in my example here, they're only going to get 2.4 million. They did the math on what it would provide an income, and it's not enough, so they would rather just keep running the business even if it means things like deferred maintenance, even if it means things like the business isn't prepared for the next decade of running because that owner is just going to take maximum profit off the table for the next several years, leaving a little bit of a hollowed out vehicle of a business to sell somebody else.

Well, that's not what we want for our business owners. We want them to be able to sell the business to garner their enterprise value and also have a strong and robust balance sheet behind it.

So, what you're going to be able to start to see if you work through this worksheet is you're going to see what we refer to as your enterprise capital gap. That is the amount of money that your business can ultimately sell for or is likely to sell for in the market. There's a gap between the enterprise capital at work that'll be created and the capital at work that you need to have on your balance sheet anyway. So, in my little example here of somebody wanting to create $400,000 a year of cash flow in their old age, that means that they'll sell their business great, but they need to also set aside parts of their income every single year on a consistent, ongoing basis that they're using to fund a wealth coordination account, which you can hear more about. You can go back to episode 45. It's going to help you to get re-briefed on what a wealth coordination account is, and then they buy assets. Assets being defined as something that puts money in your pocket now or has the ability to put money in your pocket in the future without changing your lifestyle. They will set aside enough assets to have both the exit from their business plus, in this case, seven or $8,000,000 set aside in capital at work.

Now, let's think about that for a moment. That requires that they set money aside diligently, just like any executive working for any company, and if as a business owner, you're wrestling with this right now, and saying, "Paul, but my business is the best possible outcome for me. My business is the best possible rate of return." It is. There's no question, and the most wonderful rate of return asset you could ever own that would be just an absolute like moonshot to you in terms of return, is probably still not enough. It's not enough to handle the total capital at work required to reproduce the amount of income that you were making when you were actively trading in the marketplace with your human capital earning and income, running that business.

So, think of it this way, I kind of gave you the statistics of what businesses normally sell for, but I want to put yourself in the buyer's shoes, and you're going to look at a business.

Now, let's imagine for a moment it's a twin business to the business you have right now, and I'm going to stick with the $400,000 a year example, but please, as you listen to my voice, I just want you to think about it as whatever your business is making you. And you know the ins and outs of your business. So, I want you to imagine you've done the due diligence on somebody's selling their business, and as you look at it, you're able to see all the moving parts inside. You're able to see where payroll's going well, how old the executives are. You're able to see all of it, and then you think to yourself, "Well, do I want to buy this other person's business?" And the questions you immediately ask as well, "I'm going to pay in this case, even if it's a good valuation, I'm going to pay two to 2.4 million for a five to six times valuation on this business."

And when you do, you're buying it from the perspective of I've got to take the risk when I buy it, I might have to work some things out in the business, I might have to get some training instituted that isn't there right now, and I've got to take the risk that things don't happen to the industry, et Cetera for me to be able to step in or write a check for this business. Plus I need to recover all my costs of buying it after tax.

So, you are naturally going to be wanting to press down the value if you were going to buy that company. So, you have to ask yourself the question, would you buy your life's work in your business if somebody else built it. And I want you to make that sobering assessment, not because I want you to think your business is not a great place to put money. It is. But, I want you to be able to reflect on when it comes time for you to release that money onto your balance sheet, that you have a super realistic way of thinking about it. Something that's much more in line from that two and a half to six times earnings from the business, to put you in the position to also build the rest of your balance sheet.

And here's the thing that could happen. You could accumulate that seven, $8,000,000 on your balance sheet and still sell the business maybe for a ridiculous price. Maybe to that strategic acquire of which legends are made, and you would still have both. You'd have some surplus wealth to be able to deploy to your children, to charities that you care about, or maybe just expand your lifestyle differently in your old age.

But the thing that all too often happens is that those business owners, they change the world. Dan Sullivan of the Strategic Coach Organization was recently quoted in saying that his philosophy is only about five percent of an entire country needs to be entrepreneurs, and that's enough to change the face of that country and continue innovation in it over time. I tend to agree with him. But here's the thing for all my entrepreneurs and business owners listening, I want you to not only be able to change the world, to be able to hire employees and teach them how to be even better executives for when they go onto their next company. To be able to pour into the leaders with intercompany or the young men and women and make them better fathers and wives and husbands and mothers because of what you did and the difference you made with them.

But, what I don't want our business owners to forget is that your family deserves to have a stable balance sheet. Your family deserves to not have you living in their basement, and yet if you watch for it, you start hearing the conversations of the people that said, "Oh, I used to own a business that." And what you'll start to notice is many, many, many people didn't have the exit perhaps they always had conceived of that was going to have their financial future work out. And what I want for you is that you have this stable platform of orchestrated, efficient finances that puts you in the position to both design and build a good life for you and your family for the rest of your life. Putting you in the position that you're in the driver's seat, and yes, this company, this individual stock you own, that happens to be in a company that you own and you control, is kind of out of your control in the way it gets valued. So instead, putting you in the position where you control at least what your balance sheet is.

At the end of this conversation today, what I want and hope you take away more than anything else, is for you and your life, where you are going to eventually have your financial independence will not be on your business balance sheet. It's always going to be what part of the rest of your balance sheet, your businesses balance sheet, that you transitioned to your personal balance sheet because that's where your financial independence ... That's where your ability to have security will lie is on your personal balance sheet.

The business should be a mechanism for increasing your personal balance sheet, not your personal life is meant to absolutely get flushed into the business, and you just hope it works out one day.

With that, I hope this has been a contribution to you being able to design and build a good life, and we look forward to hearing from you soon.

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