The TIP of the ICEBERG

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

Time to Re-Think Private Business Ownership

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Privately owned businesses are a hugely important part of the U.S. economy. By the reckoning of investment banker Dennis Roberts, cited in a recent NY Times article by Brent Bowers (8/13/09), there are some 1.2 million businesses in this country with revenues between $1 million and $500 million that together generate annual revenues of $8.8 trillion and represent a market value of $4.4 trillion. He points out that these businesses represent two-thirds of the entire GDP in this country. In spite of their importance to the economy, however, private business ownership is not well understood from one significant perspective: it is intimately connected with a business owner's personal net worth ***while they still own it*** and *not* simply once they have sold it. As such, it needs to be seen as something other than just providing a paycheck to owners.

To shed some light, consider the reasons people typically give for owning a private business in the first place: to be their own boss, do their own thing, to control their own life, to make business decisions that can benefit them directly rather than benefiting a distant boss or shareholders. Or, in some cases, they have an idea for a better mouse trap. In some cases they are motivated out of desperation to replace a paycheck after losing a job or burning out, and in some cases they want to "make money" although from my years of experience working with aspiring business owners, just what that means is often vague. Interestingly, while entrepreneurs are often motivated on some level by money, very few of them explicitly pursue ownership of a private business specifically as a means of creating significant ***wealth*** for themselves and their families…at best they see it as providing ***income***. These two things are not the same.

What is the difference between "income" and "wealth"? On a simple level, "income" provides a person with cash to pay bills, after which (hopefully) there is a little money left over to pay for personal enjoyments like vacations or other discretionary items. In the best of cases, people even manage to save a little of their income for a rainy day, although statistics on the rate and amount of savings by the average U.S. family suggest this is at best an afterthought, or a reaction to a market downturn.

“Wealth,” on the other hand, refers to a meaningful pool of assets above and beyond what is needed by an individual to pay for daily life, a pool which continues to accumulate over time. While there is no consensus definition of or monetary threshold for “wealth,” we might think of it as a pool of assets that is large enough to pass to and benefit future generations, and provide reasonable insulation from economic downturns. “Income” shows up most clearly in a person’s tax returns; “wealth” is most commonly tracked in terms of a person’s net worth. Interesting aside: some people with very high income levels have little or even a negative net worth, while sometimes people with significant net worth get into cash flow squeezes because their wealth is tied up in assets that are not easily converted into cash, or where doing so might produce serious tax consequences.

How does all this affect private business ownership? The vast majority of financial planners and wealth advisors, even to extremely wealthy families, tend to look at building wealth in terms of allocating a person’s net worth among conventional types of assets, things like stocks, bonds, cash or real estate. As people start to accumulate more actual wealth, they and their advisors start to diversify these holdings into less conventional (and less liquid) kinds of assets, such as collectibles (art, rare books, fancy cars, vacation houses, wines, etc.), various insurance products, hedge funds, perhaps angel investments, foreign currencies, etc. Interestingly, what is conspicuously absent in much of this financial planning or wealth management is advice on how to treat a privately owned business, for those families which in fact already own (or are thinking about owning) one. In cases where a family owns a business, they and their advisors may actually have gone to the trouble to get a professional valuation of the business done by a business valuation specialist (although from my experience, most have not even done that)…but even when they have, such valuations are often years old and would not really apply to the current or future state of the business or the needs of the owner. Most advisors to private business owners, and most business owners themselves, tend to look at the business as a mysterious black box that generates income which then needs to be managed, and they focus on doing that. There is no real understanding of what makes a private business truly unique among assets, and how to grow its value over time, and how nuanced in fact its “value” at any particular time actually is.

My point is simple: as individuals and families become more financially successful, wealth creation through the ownership and management of various classes of assets is an essential part of their financial health. Any decent financial planner or wealth advisor recognizes and preaches this. That said, one perspective which is seldom if ever fully recognized or preached is this: ***A privately held business represents a unique class of assets, and wealth creation through the ownership and management of such an asset (among others, of course) is probably the best reason of all to own a private business.*** What has been lacking to date, and what impedes advisors to business owners and wealthy families, as well as business owners themselves, when it comes actually to acting on this idea are the tools and context for understanding a private business in this way. It is time to address that void.

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