WHAT MAKES PLANNING FOR A PRIVATE COMPANY INVESTMENT UNIQUE?

Financial advisors frequently count private company owners among their best clients. Many have accumulated substantial wealth outside of their business, and the company usually has qualified plans for employees or insurance and other needs that offer attractive additional opportunities for the advisor. But most often the advisor is not involved in any way in managing that owner's largest asset: his wealth in his private company. Let's look at the unique characteristics of this investment, the challenges that accompany it, and the opportunities this creates for the advisor who is properly prepared.

Standard investment theory urges portfolio diversification, sufficient liquidity, and continual risk versus return analysis, particularly over time as life circumstances, needs, and goals change. Accordingly, most private company owners engage a financial advisor to assist them to achieve these goals. The owner's private company investment, however, is all too often excluded from this analysis because the financial advisor has little or no information about what this investment is worth, the annual cash flow return it generates, its level of risk or what legal restrictions or other factors affect its liquidity.

While this lack of information should be alarming, it becomes more so when we consider the following characteristics that commonly accompany a private company investment.

1. It is typically the owner's *largest* investment. That is, most owners of private companies have a greater portion of their wealth tied up in their business than anywhere else. While this

concentration may be appropriate, but somewhat risky for a 35-year old who is just building his wealth, it is much more risky for the 50-year old and could seriously threaten the financial security of the 65-year old. Investment theory strongly encourages portfolio diversification as people near retirement, but many if not most private company owners fail to consider this in their financial plan.

2. The owner's private company investment is the *riskiest* security in his portfolio, assuming he owns a typical blend of public company stocks and bonds. As Chapter 9 explains in detail, the private company's small size, relatively limited management, lack of access to capital and reliance on key customers among other factors creates a risk profile that typically demands a net cash flow return on equity of at least 20 percent. So private company owners commonly have their wealth concentrated in a single, relatively risky asset.
3. The owner's private company investment is his *least liquid* investment for several reasons. There is no public exchange where this stock can quickly be sold. This limitation is often made worse by the fact that most companies are not ready for sale on short notice and typically take about a year to sell, if they can be sold at all. In addition, it is often quite expensive (transaction fees, accounting fees, attorney's fees, etc.) to sell a private company.

Private companies are frequently heavily dependent on key owners and/or executives who possess unique knowledge, contacts, or skills that materially contribute to the company's success. While these factors reflect positively on the owner's contribution to the company, they can be a negative in the exit planning process. Buyers would generally be reluctant to acquire a company whose performance is highly dependent on key people unless it is certain that those people will stay with the company at least for a specified period of time after a sale. This can lead to the sad circumstance of the owner planning to sell his business and retire in five years only to find himself four and half years into this process and realize that he can only get a good price for the company by agreeing to work for three more years after the sale. Had he realized this five years earlier, he could have begun to work on building a management team that is available to replace him when the future sale takes place.

One or more other factors commonly are present that complicate any exit plan. The first is stock transfer restrictions in the company's by-laws or shareholder agreements. These commonly exist to prevent unwanted individuals or entities from obtaining an ownership interest in the company. While such provisions provide protection, they can sharply limit or virtually eliminate a shareholder's ability to sell his stock. These restrictions alone make annual review of by-laws and shareholder agreements in a private company an absolute necessity.

When there are multiple shareholders in a private company, shareholder restrictions can be further complicated by the needs and goals of the other shareholders. Some may oppose any change in ownership or lack the financial means to acquire any shares offered for sale. Others may oppose the company acquiring shares through a recapitalization and may use an individual shareholder's desire to sell his stock to extract a lower price or other concessions from him. Other shareholders may have no involvement in the company or even no knowledge of it or of their investment.

Timing a private company sale can also be a challenge. The shareholder who wants to leave in three or five years may find when that date finally arrives, the company or industry conditions have weakened substantially, greatly reducing the sale price. Others who are ready to sell may find that they face restrictions from supplier agreements or demands from customers that make exiting difficult except under adverse price and terms.

> The exit planning process cannot be approached solely from a financial perspective. Assessing an owner's mental readiness to exit is as, if not more, important.

Clearly, the sale of stock in a private company is very different from calling a broker to sell shares in Google, IBM, or ExxonMobil. The business owner must understand his company's value as well as the risk and returns that accompany that investment, and the unique characteristics that complicate transfer of any private company investment. Armed with this knowledge, the owner can include his private company investment in his overall portfolio planning to achieve appropriate levels of diversification and liquidity.