The Capitol Bay Group

A financial advisory practice of
Ameriprise Financial Services, Inc.

BRIDGING YOUR TWIN VALUE GAPS

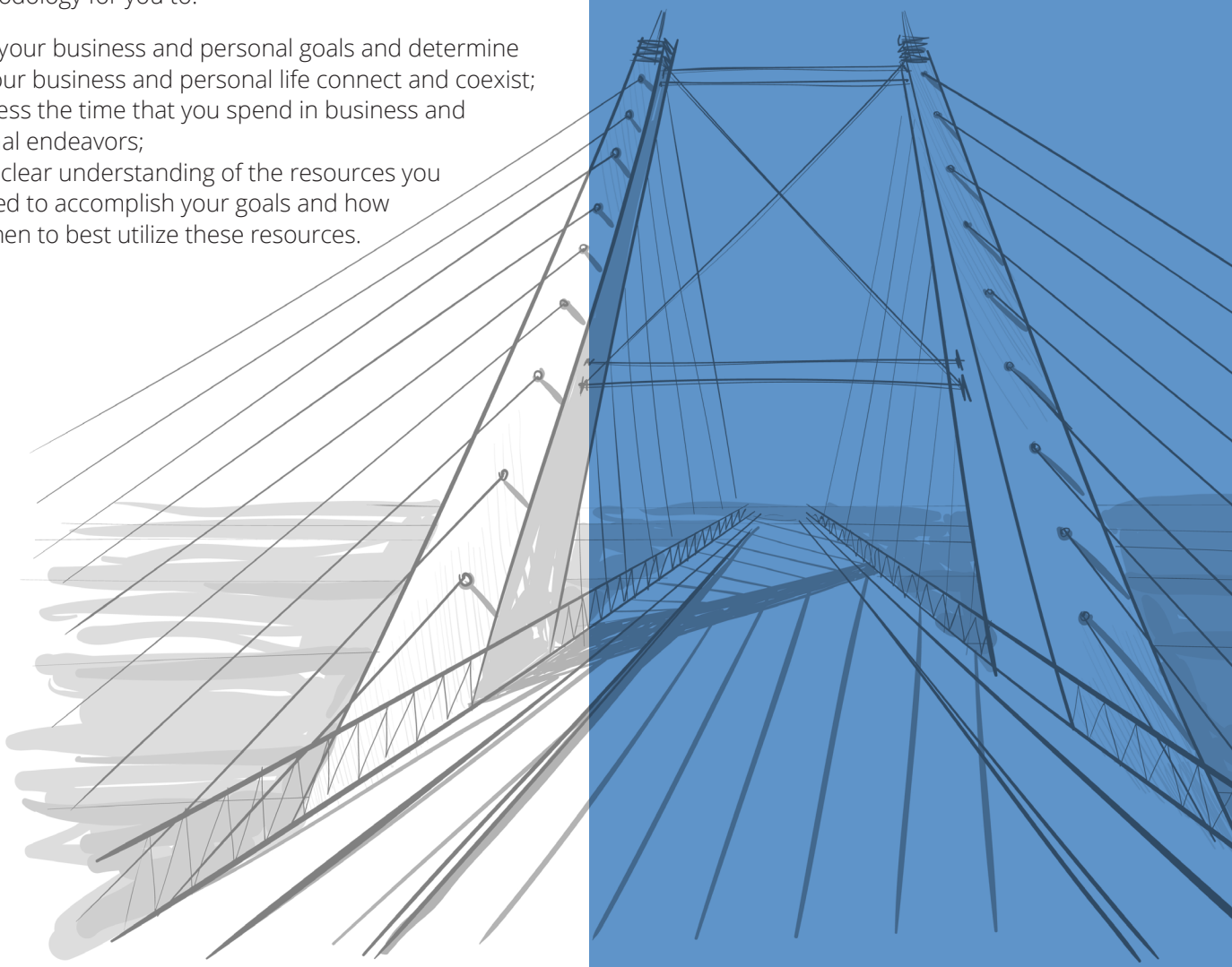
Aligning your Personal and Business Goals

Too Many Business Owners Never Realize Their Dreams and Visions.

The failure of successful business owners to reach their goals is often not due to a lack of effort or desire. In our experience, **one of the main causes of failure is lack of clarity around the big picture and a myopic pursuit of short-term goals**. Once set upon, there is a natural human tendency to stay on a path or charted course. Sir Isaac Newton said, "an object in motion tends to stay in motion." This law of physics applies to the behavior of people.

This white paper is the culmination of three decades of academic and market research by Charles Richards, the CEO of CoreValue software, and his team, which includes consultations with hundreds of owners of businesses of all sizes. The goal of this paper is to provide food for thought, as well as a clear methodology for you to:

1. Clarify your business and personal goals and determine how your business and personal life connect and coexist;
2. Re-assess the time that you spend in business and personal endeavors;
3. Gain a clear understanding of the resources you will need to accomplish your goals and how and when to best utilize these resources.



Taking Inventory

An important observation that we have made is that upon reflection, many people determine that they are spending far too much time in their business and not enough on the other important areas of their life. Most people aspire to happiness—but it is not until later in life that many find out what makes them truly happy. This is a reason that some of the great industrialists and many successful businessmen move from **success to significance** late in life. Think of Andrew Carnegie, John D. Rockefeller or Bill Gates—there are countless others who came to the same conclusion. For many people, **success comes at a cost**. They spend a substantial amount of time at work, which causes their lives to become out of balance.

How do you re-align your time allocation to provide more balance? How do you set up your life so that you can achieve all of your goals—not just your business goals? If you are like most of the business owners whom we talk to, your answers will probably lead you to the following conclusion: even if you love your business, you are spending too much time there and not enough on the personal side of your life. How do you rectify this imbalance?

Seeing that there is an imbalance between work and life, owners (especially baby boomer owners who are in their 50s and 60s) recognize the imminent need to have a plan to transition and monetize their business in the next 5+ years.

Exercise: What's Your Time Allocation?

In the first column write down what percent of your waking hours is spent in each area. In the next column write down how you would like to allocate your precious time.

Category	Current	Desired
Business		
Health & Fitness		
Spiritual		
Family		
Travel		
Learning/Reading		
Charity		
Hobbies		
Socializing		
Community		
Total		

How Does an Owner Go About this Transition?

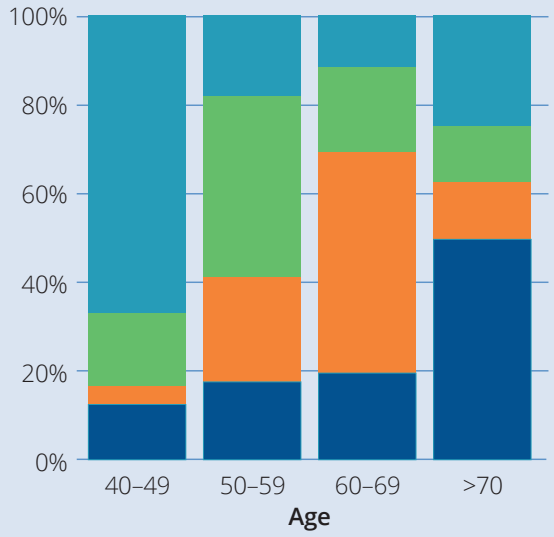
Creating a Formal Financial Plan

If you have enough personal resources now to support your personal goals and lifestyle...Congratulations!

All you have to do is give up some responsibility or turn over some control of your business to someone. For most of us, however, we do not have enough liquid assets saved and we will need to grow and monetize our business to achieve our goals. We may know this intuitively but usually have not developed a plan.

According to The Exit Planning Institute's 2013 State of Owner Readiness Survey, 83% either do not have a transition plans or have an a plan that has not been documented or communicated. In our experience, the reason for this lack of planning is twofold. Most owners believe that if they work hard enough and grow their business, everything will take care of itself. The second reason is that many people do not know how to go about formulating a plan that encompasses both their personal and business goals.

Nearly 50% of business owners want to transition in the next five years.

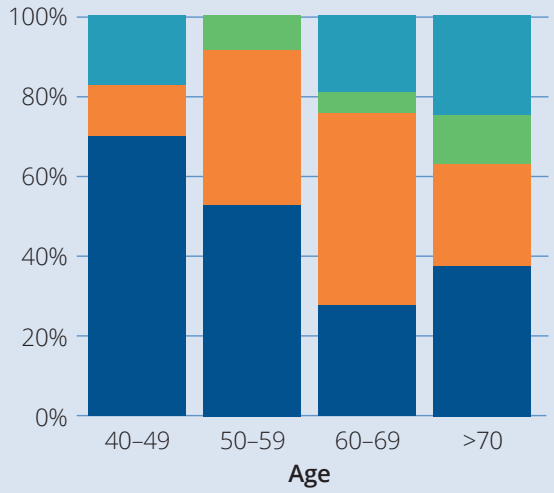


When are you planning to transition the company? (Overall)

- 1–2 years (20%)
- 3–5 years (28.2%)
- 6–10 years (27.4%)
- No plans (24.4%)

Source: Exit Planning Institute Business State of Owner Readiness© Survey 2013.

Yet, only a fraction of business owners have a formal transition plan.



What best describes your transition plan? Plan/Documentation/Communication (Overall)

- No Plan (48.6%)
- Plan, No Doc or Comm (34.3%)
- Plan, Doc, No Comm (5%)
- Plan, Doc & Comm (12.1%)

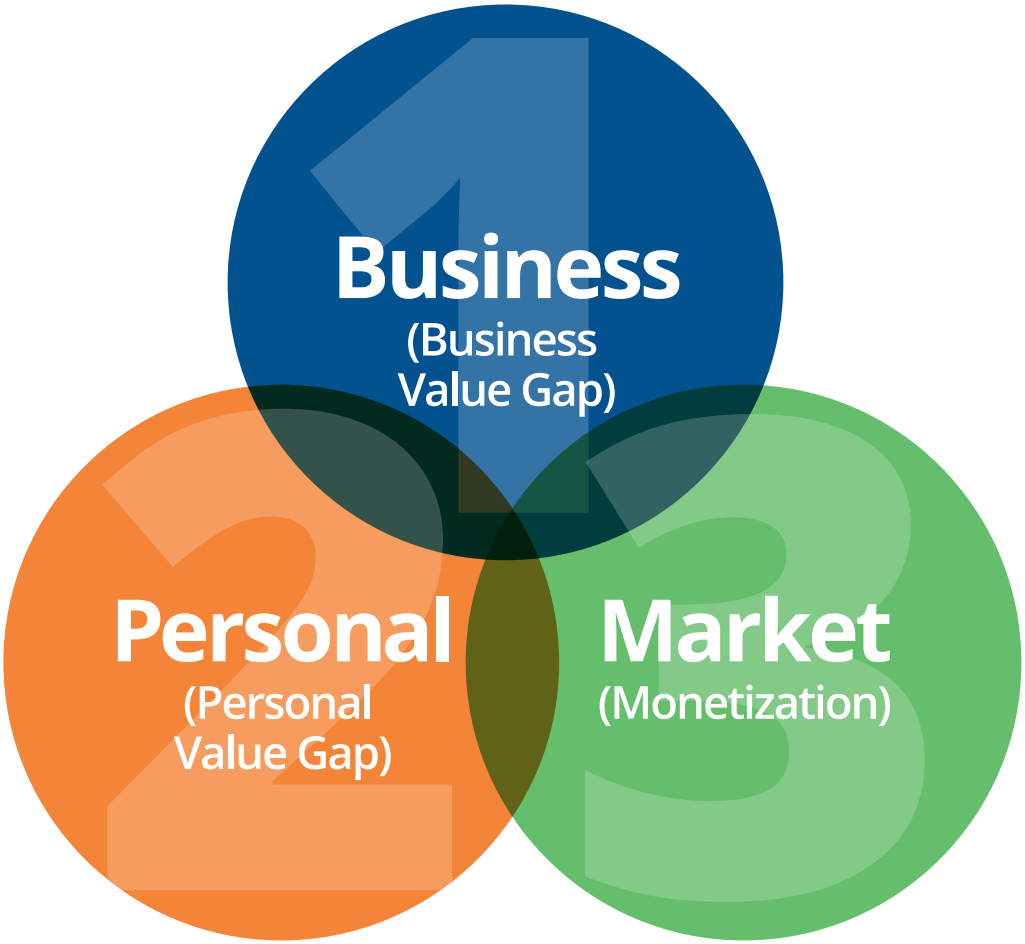
Source: Exit Planning Institute Business State of Owner Readiness© Survey 2013.

The Intersection of Your Personal Planning, Business Planning and Monetization

Your financial plan may show you that your goals can be met with the assets that you have. It may show that you simply need to grow your business and invest more cash, further it may show that you need to monetize part or all of your business.

In speaking to experts on monetization, there are three things that need to align for you to be ready to sell or transfer your business:

1. **Your business needs to be ready;**
2. **You need to be ready; and**
3. **The market needs to be ready.**



YOUR BUSINESS NEEDS TO BE READY

How Much is Your Business Really Worth?

A challenge we encounter when helping owners through the planning process is that their biggest asset is easily their business, but they don't have a realistic expectation of what that business is worth.

Most of them understand that their company is worth a multiple of their earnings or free cash flow. We may even have a professional appraisal in hand telling them what their business is worth.

The reality is that your business is only worth what someone will pay you, and this amount (the multiple you receive on your earnings) depends on a lot of variables, many of which are out of your control. Consider that many business owners overvalue their companies and are surprised when appraisals come in below their estimates. This is especially true in the heady days before major economic downturns, which create bad conditions to monetize your business asset. There are certainly enough imbalances in the world today to cause major financial and economic issues that could negatively impact your ability to sell or monetize your business asset.

Identifying Your *Business Value Gap*

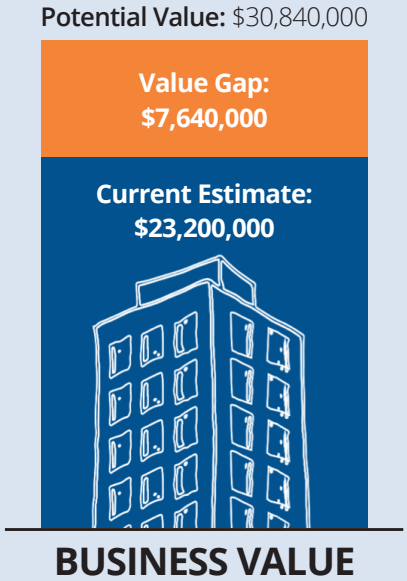
Making the business more valuable is easier than saving the equivalent cash required to close any shortfalls in the savings needed to meet your personal financial goals.

The difference between what a business is worth and what it could be worth if it were run efficiently is called the **Business Value Gap**.

Company Value: The Math

Source: CoreValue 2013.

Business Value Gap

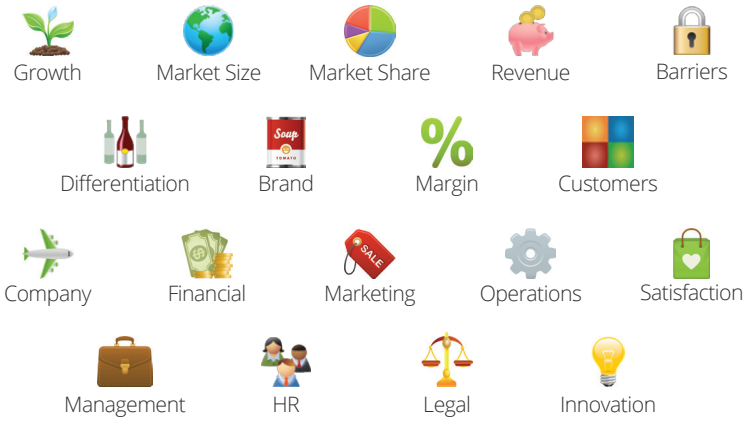


Source: This is a sample from a CoreValue "Discover and Unlock" report. Readers can find more information by going to corevaluesoftware.com.

This illustration is only intended to demonstrate mathematical principles, should not be regarded as absolute, nor does it represent any specific situation.

Enterprise Value Drivers

How can you effectively create a well-run company in order to obtain a higher multiple? Research from Charles Richards, when he was a graduate student at MIT, shows that there are 18 drivers of value for companies.



Source: CoreValue.

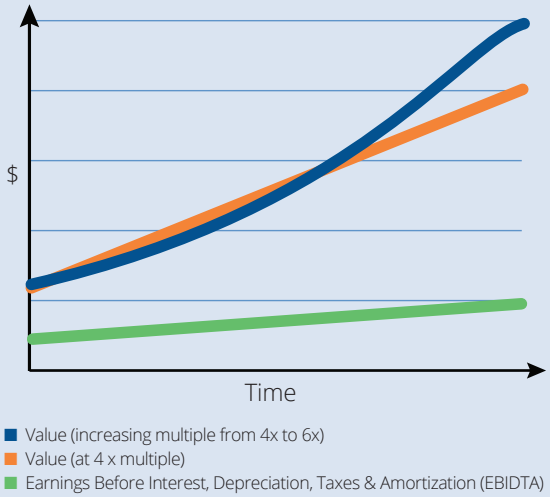
Your Business is an Engine That Drives Value

These drivers act as gears in your business engine. The output of the engine is revenue and profit. A reliable cash flow or profit stream is what may drive a higher multiple and in turn will reduce or eliminate your personal value gap.

Source: http://forecastadvisors.com/wp-content/uploads/2015/01/2013-State_of_Owner_Readiness.pdf

2015 Exit Planning Institute

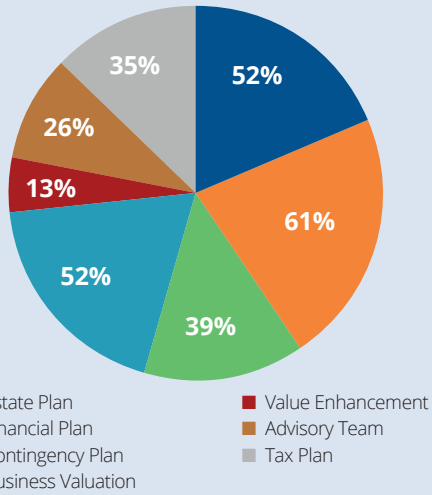
Research shows that better run companies sell for higher multiples.



Source: Core Value 2013. https://corevaluesoftware.com/uploads/record_files/1434643619_Quantifying-Transferable-Enterprise-Value-White-Paper.pdf

Alarmingly, data indicates that operational efficiency appears to be critical for getting your business transitioned or sold at a higher multiple, yet only 13% of the business owners surveyed stated that their plan involved value enhancement strategies such as operational efficiency as illustrated below:

What do your plans encompass?



Source: http://forecastadvisors.com/wp-content/uploads/2015/01/2013-State_of_Owner_Readiness.pdf
2015 Exit Planning Institute

The goal of these surveys was to ask business owners a set of questions around a broader and larger issue—how effectively (if at all) have you planned for the inevitable exit from your business. Key Demographics of Survey Respondents: The survey was sent to over 900 business owners nationally, 175 business owners responded, with 128 business owners completing the survey in its entirety.

Purpose-Based Lifestyle Planning—Identifying Your Personal Value Gap

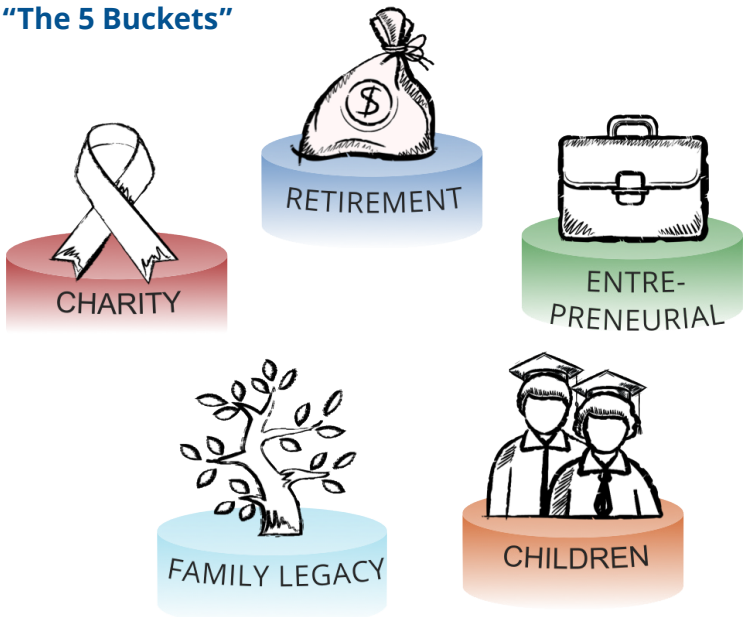
According to *The Wall Street Journal*, a CERTIFIED FINANCIAL PLANNER™ professional is the most significant credential for creating personal wealth. A CERTIFIED FINANCIAL PLANNER™ professional has passed a rigorous test administered by the Certified Financial Planner Board of Standards about the specifics of personal finance. They must also commit to continuing education on financial matters and ethics classes to maintain their designation.

Typically, the planning process, among other things, involves:

- Taking inventory of your assets and liabilities;
- Listing your goals, with a dollar value and what it will take to accomplish each of them;
- Listing the dates by which you hope to achieve your goals.

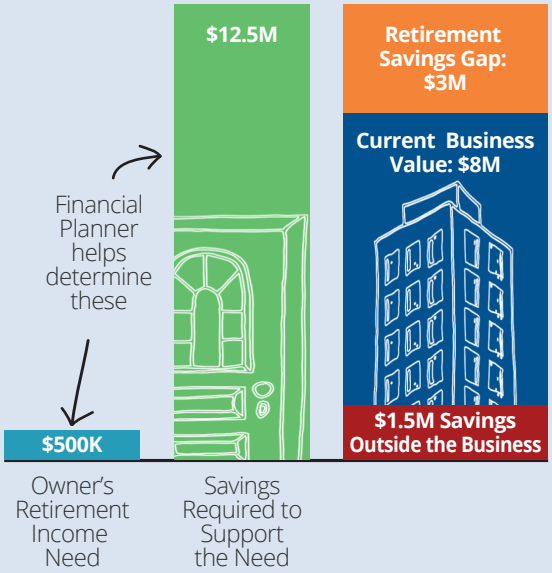
The probability of actually seeing your goals accomplished goes up by an exponential factor when you get specific and write them down. (*Source:* 1979 Harvard Study, "Why You Should Be Writing Down Your Goals," *Forbes*, 8 Apr. 2014.)

"The 5 Buckets"



Once your goals are determined, you may find you have a **Personal Value Gap.** That is the difference between the assets needed to fund your goals, and the liquid assets that you have saved.

The Owner's Personal Value Gap



Source: Doug Smith, Partner, B2B CFO, 2013.

This illustration is only intended to demonstrate mathematical principles, should not be regarded as absolute, nor does it represent any specific situation.

Exercise: How well do you know your Personal Value Gap?

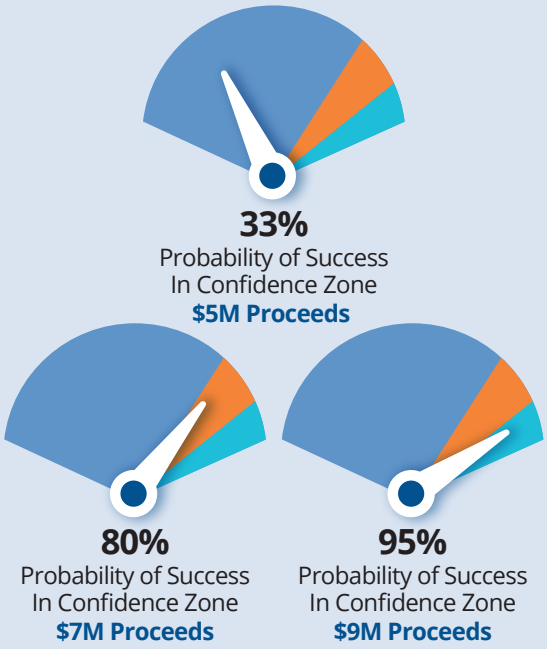
- ❏ I have a Personal Financial Plan—using a range of values for my business upon exit, and I will meet my personal goals.
- ❏ I believe that once I exit my business, the proceeds should be enough to meet my personal goals.
- ❏ I am not sure that my business will meet my personal goals.
- ❏ At this time, the business will not provide enough to meet my goals.

Personal Financial Plan

We recommend that our clients take the range of values for their business and use these values as inputs into a financial plan. Typically, we will run multiple scenarios that take into account different variables such as timing of exit from business, amount received upon exit, lifestyle, rate of return on investments, taxation and other factors. We will run each of these scenarios under three different sequences for the same return.

1. Straight Line—using the same return every year.
2. Stress Test—assuming that once you leave the business or retire, you immediately experience a bad market environment. This stress test uses Money Guide Pro Financial Planning software. It involves using a straight line Rate of Return based on risk tolerance having a 2 standard deviation down market in the 1st year and a 1 standard deviation in the 2nd year,then reverting to a straight line thereafter.
3. Monte Carlo Simulation—runs a large number of different sequences of market returns to determine the probability that your financial plan will work. We recommend that your plan has at least an 80% probability of success. This process can help tie the value of your business to your personal goals.

Likelihood of funding all goals



Source: Sample financial plan using Money Guide Pro Software, July 9, 2014.

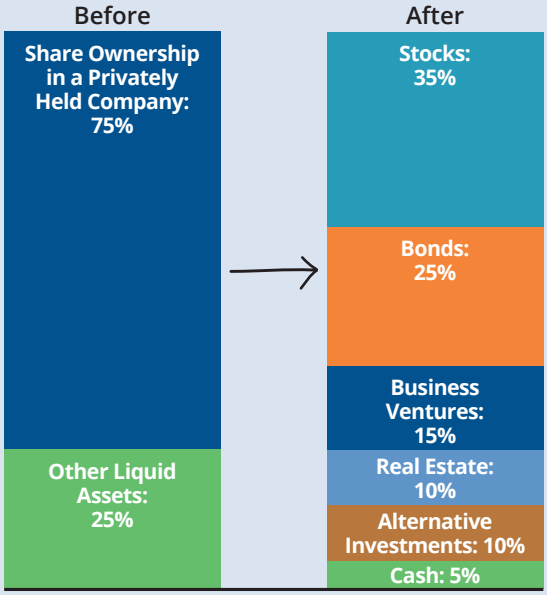
Based on hypothetical scenario: $500K retirement income need, $8M business valuation and $12.5M savings need.

Filling Your Gaps and Reducing Risks

> Diversification is one way to help reduce risk.

We discussed two out of three of the factors in planning for your business and personal value gaps. Your business needs to be ready and you need to be ready. The third factor is that the market needs to be ready. Many times this personal readiness happens as we get older and our priorities change. Reflecting on your personal goals, time allocation and doing a complete a financial analysis of your situation can help provide data for this extremely important decision. Another factor, which is often overlooked, is risk. With age we should generally reduce our financial risk since we don't have as much time to make up for mistakes, adverse market conditions, or other factors such as legal risks.

Business Owner Allocation Example



This is for illustrative purposes only. This is not a recommendation for a specific asset allocation.

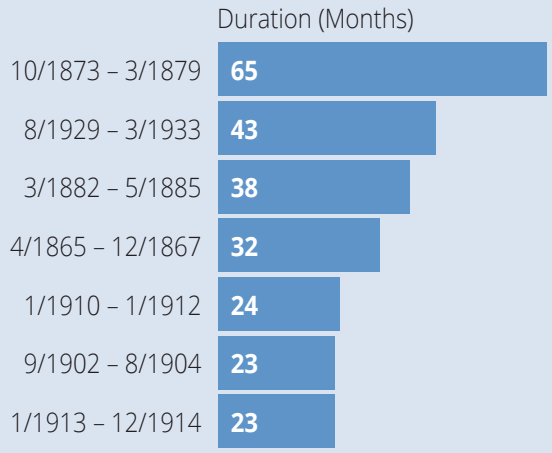
THE MARKET NEEDS TO BE READY

Timing for Monetization

"Baby Boomer Business Owners: Will There Be A Mass Sell-Off?" Commentary written by Caley McMann in September 2010 of SME Research LLC. Here are some key points from her article. The graph on the right shows the length of the longest recessions, but it does not show the depth and severity. For example, although the 2008 recession only lasted 18 months, we are still recovering from it. The depth and timing of these recessions factor into the valuation of your business.

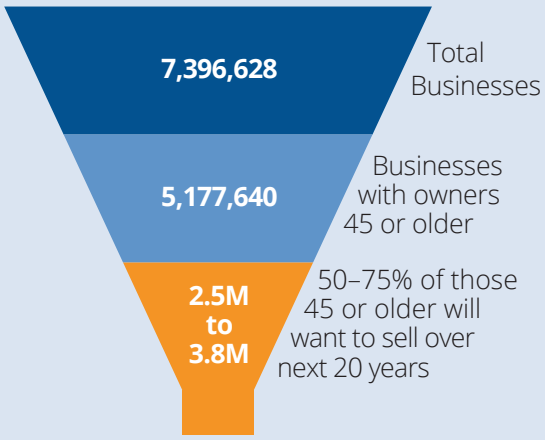
While many financial and economic issues are uncertain, one certainty is demographic trends. According to a study by Axial, a marketing and analytics firm, baby boomers owned 66% of private businesses as of July 31, 2014. They, like you, are going to need to monetize their business. Simple economics tells us that this could create a glut of businesses for sales and could depress the market.With such a large supply on market, we believe that there will surely be downward pressure on pricing and a potential consolidation in some industry sectors as existing businesses seek to take advantage of the glut to grow by acquisition at very favorable prices.

The longest economic recessions



Source: National Bureau of Economic Research. http://www.nber.org/cycles.html

The effect of demographics on your business



Source: 2010 American FactFinder Survey of Business Owners Study.

For this analysis, we identified the current business owners who were 45 or older in the 2010 American FactFinder Survey of Business Owners study and applied the same algorithm of 50-75% who will want to sell their business, which results in 2.5 to 3.8 million firms that could hit the market over the next 20 years.

The Effect of Interest Rates on Your Business

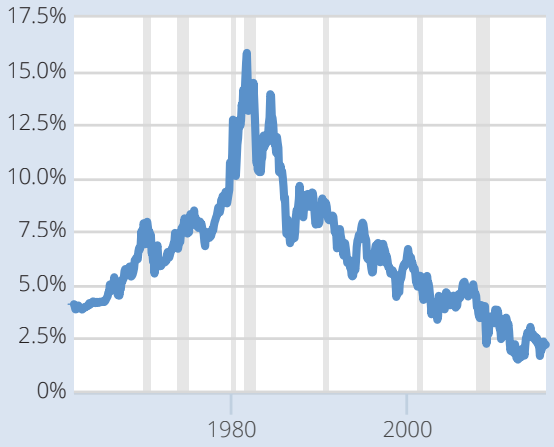
Finally, another factor to consider is the relationship between the value of your business and interest rates: there is an inverse relationship between interest rates and the present value of money. You don't need to know how to calculate present value; you just need to realize that if rates go up substantially, economic growth and the market for private businesses could be affected negatively.

Many interest rates, including mortgage, corporate and US treasury bonds as well as the Federal Funds rate, have been on a downward trend for 30 years. Many economists expect interest rates to start to rise again.

What could cause interest rates to rise? As stated in a commentary by JP Morgan, generally more demand for money, which is caused by a growing economy. At present, however, there is a factor that has never before been present to this degree—the size of the Federal Reserve's balance sheet. Our view is that at some point the Federal Reserve will likely reduce their holdings of bonds. Many economists believe that the effect of this "unwinding" of these holdings will be to raise interest rates.
(*Read more at: http://www.investopedia.com/articles/bonds/09/bond-market-interest-rates.asp*)

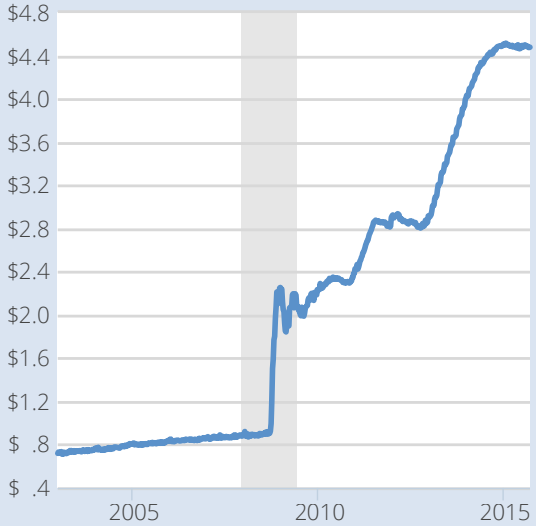
The Federal Reserve has printed trillions of dollars in what economists call 'Quantitative Easing.' What happens to the economy, interest rates and your business when this Fed policy is reversed?

10-Year Treasury Constant Maturity Rate



Source: https://research.stlouisfed.org/fred2/series/DGS10
Board of Governors of the Federal Reserve System (U.S.)
Shaded areas indicate US recessions—2015 research.stlouisfed.org

All Federal Reserve Banks—Total Assets,Eliminations from Consolidation (In Millions)



Source: https://research.stlouisfed.org/fred2/graph/?id=WALCL
Board of Governors of the Federal Reserve System (U.S.)
Shaded areas indicate US recessions—2015 research.stlouisfed.org

Creating a Business Advisory Team for Growth and Succession

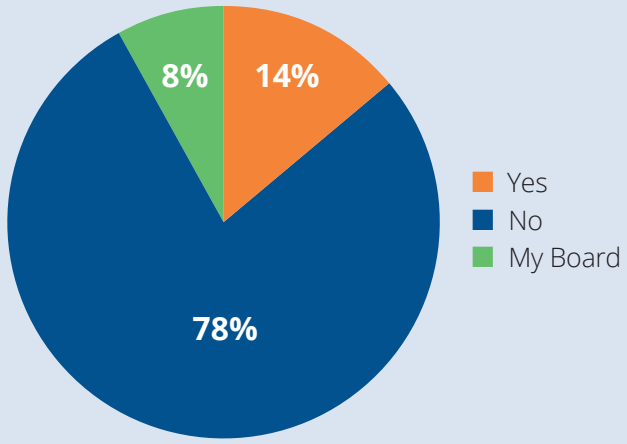
We recommend business owners find a business advisor and a financial advisor who can work together and have access to planning tools. It is also important that these advisors work with your existing advisors to create a plan that ties your personal goals and your business goals together in executing your plan. Part of this process is to find a "quarterback" who can work with all of the professionals needed to achieve your plan.

Have you established a planning/transition team?

When business owners were asked this, only slightly over 20% said they have created a team in this regard.

As part of this process you should take stock and re-evaluate all of your professionals. You may have outgrown some of your existing professionals, you may be missing some key players or you may simply not have effective coordination between them.

Have you established a formal transition advisory team?



Source: http://forecastadvisors.com/wp-content/uploads/2015/01/2013-State_of_Owner_Readiness.pdf
2015 Exit Planning Institute

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Exercise: Rate your existing business advisory team

Rating:
1 = Extremely Satisfied
2 = Somewhat Satisfied
3 = Neutral
4 = Not Satisfied
5 = Not Applicable

Advisors	Name	Rating
Business Advisor		
Financial Advisor		
CPA Personal		
CPA Business		
Corporate Attorney		
Estate Attorney		
Business Valuation		
Executive Coach		

The Time To Act is Now

Nobody can accurately predict the future but a case can be made that a window of opportunity exists while interest rates, the economy, geo-politics and demographic trends are in your favor. After all of the time, energy, sweat and resources you have poured into your business it makes sense that you should adopt the motto "Be Prepared." This entails re-assessing your work/life balance, and developing a plan to align your business and personal financial lives. This plan should take into account the resources you will need to achieve your goals, including a realistic valuation of your business. Lastly, you should find the right group of experienced professionals who can work together as a board of advisors to navigate whatever the future may hold and help make your financial dreams a reality.

> "If you don't know where you are going, any road will get you there."
> **Lewis Carroll**

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