

# Heart and Soul

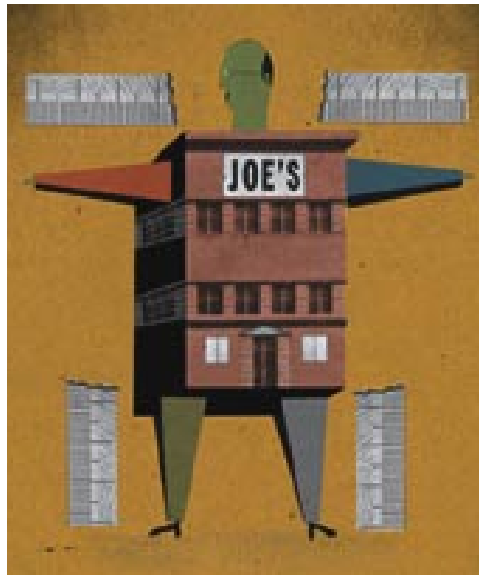
The lifeblood of most entrepreneurs' financial health comes from their closely held business. Make sure you continually monitor the pulse of this vital asset.

*William H. McAfee Jr.*

**F**INANCIAL PLANNERS HAVE been devoting more attention over the last few years to the business of advising owners of small- to medium-size businesses. Their efforts to serve this group typically focus on benefits planning and estate planning but often fail to address a much more important topic—how a closely held business functions within its owner's overall financial plan. To sufficiently address this topic, advisers must

understand the risks and returns associated with an asset that represents the most significant alternative investment held by the client. Why does this gap in financial-advisory services exist? Many advisers may simply lack knowledge of the issues faced by business owners in protecting and enhancing the value of their firms. Other advisers may not have methodologies for providing sound advice on issues other than benefits planning.

It is not surprising that advisers are taking a keen interest in serving the needs of business owners. The Alliance of Mergers and Acquisition Advisors, a trade group in Chicago that tracks midsize businesses, defines this potential marketplace as companies with 20 to 100 employees and



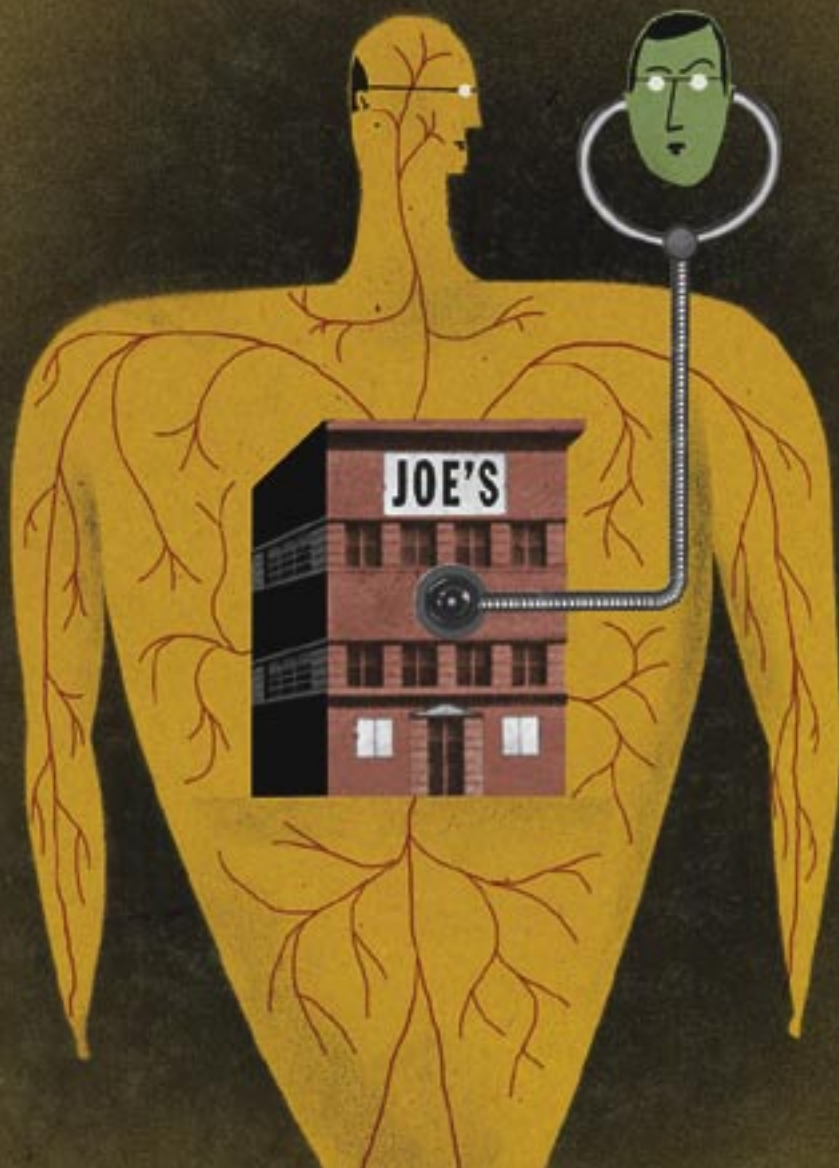
reports the following data:

- More than 90 percent of all business enterprises in North America are family owned.
- By the end of 2004, there will be 8.4 million privately owned businesses in the United States with annual revenues between \$1 million and \$100 million and with fewer than 100 employees.
- This market accounts for 78 percent of new job creation, 60 percent of total employment in the United States, and 50 percent of the U.S. gross domestic product.

This universe represents, in other words, a massive potential market for clients in need of comprehensive financial planning—planning that includes evaluating the business as an asset and considering its impact on the owner's plans and objectives. While financial advisers devote much time to clients' estate-planning and insurance strategies—not to mention their portfolio of marketable securities—many advisers pay little attention to how valuable a well-thought-out estate plan will be if the client's business suddenly fails or if it unexpectedly grows beyond the projected estate plan valuation. Business owners' personal goals are inextricably linked to the vision for their businesses and should be examined carefully in light of that vision.

A key ingredient for providing comprehensive planning advice to a business owner is a business valuation. Many planners suggest that clients get a valuation, but too often the valuations prove to be an ineffective planning tool. For

*William H. McAfee Jr., CFP, is a financial adviser in Columbia, S.C., who specializes in investment management, business valuation, and succession strategies for family businesses.*



note or other financing? Do they intend to continue to own the business after retiring and hire outside management to run it? What dividend income do they expect to receive?

Many clients may have already crossed the hurdle of hiring outside management and receiving net income in the form of dividends or interest income. Under these circumstances the business functions more clearly as an alternative investment. Nevertheless, an in-depth examination of a business as an investment is necessary in all cases, even for owners still involved in day-to-day operations. Gathering data and making risk and return measurements for privately held companies is much more cumbersome than doing so for public entities. But, given the role a privately held entity plays in the financial—and emotional—life of its owners, the analysis is crucial to the planning process.

Don't depend on the clients' accountant to perform the business valuation. Most accounting firms concentrate on recording the past, not analyzing the results or using data to plan for future scenarios. As a financial planner, you should be equipped with risk-return models to analyze privately held companies as effectively as publicly traded

## It does no good to develop a plan that doesn't account for the risk that the client's business may generate cash flow below expectations

example, a valuation conducted for the sale of a business to a strategic buyer will most often produce a different result than one conducted for estate planning or an intergenerational transfer. To determine the proper methodology, you must first have a frank conversation with clients about their vision for the business as well as potential exit strategies. Do they intend to sell the company? If so, to whom, and how soon? Is the potential buyer a financial suitor or a strategic one? Do they intend to leave the business to family? Are those family members involved in the business? What financing terms are the clients willing to accept in a transfer? Are they dependent on the income from the business? Would they depend on income from a promissory

stocks. Review the company's financial statements so you can identify trends and understand the financial drivers providing cash flow to your client as owner. For example, examine the year-to-year variance in revenue and expenses to determine the level of volatility in the business and factor this information into any planning you do for the owner as an individual. It does no good to develop a financial plan that requires the client's systematically investing over a period of time if that plan doesn't account for the risk that the business may produce cash flow below expectations. One relatively simple way to measure risk is to determine the level of variance in the business financials year-over-year.

The expectation of return should be discussed as well.

Some clients may not even think of their business as an investment and may have never taken into account the return it provides on the capital they've invested. In the context of the overall financial plan, you need to be able to determine what level of return is necessary to achieve the client's goals as well as what can be done to enhance return. Return data can also be particularly helpful in determining a growth rate for estate plan calculations. One tool that can be used effectively for examining a business's return on equity (ROE) is a formula developed by the corporate finance office at DuPont.

The formula, known as the Extended DuPont System for ROE Decomposition, breaks return on equity into various components that drive returns. The basic components are net margin, asset efficiency, and leverage (for simplicity, intermediate steps accounting for tax and interest burdens have been eliminated). Used to measure ROE for publicly traded companies, the formula works equally well with private entities, if the right financial information is obtained. The formula is as follows:

$$\text{ROE} = \text{Net Income/Sales} \times \text{Sales/Assets} \times \text{Assets/Equity}$$

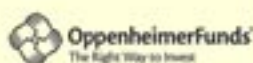
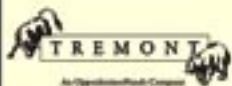
This formula is useful for understanding the underlying factors that drive returns. Once you examine those factors, you can advise the client on making adjustments to achieve a desired level of risk and return.

Lastly, examine the external framework of the client's business. Who are the competitors? How healthy is the industry overall, and what are similar size companies doing in terms of financial profitability? What impact do suppliers have on the business model, and how strictly do they dictate pricing and terms? Is the industry expanding, and if so, are there new entrants? What differentiates the client's business from its competitors? How long-term are the customers? These questions will provide insights useful to the financial-planning process.

No doubt, many of these issues are complicated. But for any adviser interested in offering truly comprehensive financial planning to the business-owner marketplace, this holistic approach is essential. Although the required depth of knowledge and time commitment are daunting, the potential rewards are great for your planning practice as well as your clients' financial well-being. **WM**



**THE SOURCE FOR  
ALTERNATIVE INVESTMENT SOLUTIONS**



With 20 years of experience and over \$9 billion in assets under advisement, Tremont Capital Management has long been the leading provider of hedge fund research and advisement.

Along the way, we have helped pioneer a strategic shift in asset allocation philosophy that has led to hedge funds becoming an essential asset class for leading investment professionals.

Along with OppenheimerFunds, we are able to lend our expertise to advisers serving a broad array of qualified investors. For further information, contact:

Robert Rosenbaum  
914-925-1146  
[www.tremont.com](http://www.tremont.com)

OppenheimerFunds  
888-673-7757  
[www.oppenheimerfunds.com](http://www.oppenheimerfunds.com)

©2004 OppenheimerFunds, Inc.