The Four Boxes of Financial Independence

And you thought your business was enough to get you to retirement?

By Josh Patrick, CFP®

Key Takeaways:

- Your business won't get you to retirement by itself.
- Your business lives in several value worlds simultaneously depending on who the buyer is.
- Using the four boxes will allow you to have a serious reality check with yourself about why business diversification is crucial for retirement.

I've been speaking and working with private business owners for over 15 years. Most owners have a dream of running their businesses for their working careers, finding a buyer and then riding off into the sunset with no other planning.

Unfortunately, this dream is a myth for the vast majority of entrepreneurs. For over 95 percent of the businesses in this country, the dream will become a nightmare unless business owners have other savings. It's a very small percentage of businesses that will get their owners to retirement by themselves.

Here's why it's a myth.

Let's look at some of the statistics around private businesses:

- There are approximately 6 million private businesses that employ people in the U.S.
- About 300,000 of these businesses do over $5 million in sales.
- About 150,000 of these businesses do over $10 million in sales.
- Private businesses, on average, sell for between three and six times their earnings before interest, depreciation and taxes (EBIDTA).
- The average private business has an EBIDTA of between 3 percent and 13 percent.

If we take a business that generates $10 million in sales and that has an EBIDA of 10 percent, we'll see the following in a sale situation:

Sales...$10,000,000
EBIDTA of 10%...$1,000,000
Sale price of 4.5 x EBIDTA...$4,500,000
Taxes and expenses on business sale – 35%....................$1,575,000
Net proceeds from sale..$2,925,000
Income available at 4% of investable proceeds……………...$117,000

This $117,000 or less is the conundrum that many private business owners face when they think about selling their business. In this particular case, the owner has been enjoying $1 million annually of cash flow before interest, loan principal payments, capital investments and taxes, significantly more than the $117,000 the owner can get from selling the business.

And this is a business that is doing $10 million per year, which makes it one of the top 2.5 percent of the businesses in the country based on revenue. Does your business create more than $1 million per year in EBIDTA? Are you in the top 2.5 percent of all businesses with employees?

The fact that business owners need to get a reality check is the reason I developed the **four boxes of financial independence.** I needed a tool that easily and plainly outlined the problem.

Start with a legal pad.

When you meet with your financial advisors, take out a legal pad and draw four boxes:

1. In **Box 1,** enter the value of the business. Take away taxes for selling the business and then put the remainder in the box. Use whatever drawdown rate you find sustainable and put it below the box.
2. In **Box 2,** take any investment real estate, and put the after-tax amount in this box. If you plan to sell your real estate when you retire, do the same as with selling a business. If you want to keep the real estate, write the income that you'll receive from the building at retirement below Box 2.
3. In **Box 3,** put any assets you have from your qualified retirement plan when you stop working. Again, take the sustainable drawdown rate from this amount and put that below Box 3.
4. Finally, **in Box 4,** take any other investments you have and do the same as you did for any real estate and business. If you can continue getting income from the investment, put that below the box. If it's a capital investment, take the sustainable drawdown and put that below the box.
5. Add all of the income levels up, and you'll have your real retirement income.

If you're like many business owners, you'll find that there is a major shortfall between what you want and what they're likely to get. This will allow you start a conversation about why diversification is really necessary. *Hint: It's not because their business is concentrated and the risk is high. Business owners never buy that argument.*

Make sure you understand the importance of your retirement plan.

I call this pre-funding a buyout. While the business is creating significant cash flow, take $40,000 to $60,000 of this cash flow and put it in a qualified retirement plan. If you are able to get a 6 percent return, and you fund a plan for 20 years with $50,000 per year, you'll have a retirement nest egg of approximately $1.8 million at the end of that time. This increases your amount of cash for retirement by about 60 percent.

Qualified plans are complicated beasts. There is a great deal of customized design that can go into a plan. It's important that you understand how retirement plans work and how they benefit private business owners.

Think about owning the real estate your business is operated in.

If it's possible, purchase the real estate in which you operate your business. Many business owners who own their own real estate will sell their business but keep the real estate and collect the rent.

Like a qualified retirement plan, starting early with real estate ownership is important. Many owners will buy the real estate in which their business resides and then pay rent to themselves for 15 years in order to pay off their mortgage. After the mortgage is paid off, the rent starts flowing to the business owner. Sometimes the income from rent is more than the income from the principal on the sale of the business. Business-owned real estate often provides the real means for a business owner to leave the business.

Know about multiple values for a business.

Businesses live in various value worlds at one time. If the buyer is a financial buyer, the price will relatively low. If the buyer is a strategic buyer, your client could get as much as double that for the business. If the owner has developed a strategic process that can be scaled, then the business price will have little associated with the cash flow it produces.

If the business is sold to family members or current managers, the owner might be able to get the best of both worlds. It's possible to arrange for a long-term buyout, where the owner gets to slowly ease out of being a business owner.

Learn how the various value worlds work, so you can have an intelligent conversation with your advisors about how much value your business will really have when you leave.

You should be able to start a conversation about financial planning.

A sad experience is when a business owner sells their business, thinks they are going to retire and then finds out four or five years later that they have to go to work for someone else. Talk about seller's remorse!

Doing a little financial planning before starting with a transfer strategy is always a good idea. The plan will tell you what your financial needs are before you start to plan the sale of your business. I like to use planning software that allows me to use various business value scenarios. This allows the owner to see the range that possible retirement incomes will provide.

Conclusion

Use of advance planning while you have strong cash flow can help you avoid the mistake of assuming you are okay. Once you sell your business, you don't want that assumption to come back and bite you.

About the Author

Josh Patrick, CFP®, *is a serial entrepreneur and wealth manager who specializes in working with owners of privately held businesses. He spent 20 years in the commercial vending and food service business. From there he entered the wealth management business, where he now works exclusively with owners of private businesses, helping them create value in their business. His goal is to help business owner clients create a better life. Josh can be found at Stage 2 Planning Partners.*