RETIRE FROM MY BUSINESS CASE STUDY

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RETIRING PROOF YOUR BUSINESS: CASE ANALYSIS OF CONTRACTOR DYNAMICS

As a business owner, retirement is not something that will happen by chance but one you have to plan for. Retirement planning often looks different for the small business owner than it does for someone with a job. This is especially true if the small business owner plans to use income from the business in his or her retirement portfolio.

This case study focuses on one of our client Contractor Dynamics a marketing firm focused on outsourcing marketing services to contractors. We worked with Joe Hughes the founder of Contractor Dynamics to design his exit strategy.

Joe's business was at the point where he was ready to work on this: cash flow was good; his business was presented with many opportunities and Joe was willing to do the hard work. However, Joe needed to learn how to focus his resources on efficient growth.

When we started the engagement, Joe enjoyed an annual growth rate of 30% with a profit margin of 20%. This was far from what Joe needed to accomplish his retirement goal: We determined to make the goal realistic; he will need to achieve a growth rate of 116% with a profit margin of 25%. Joe embarked on a five -year plan to improve current profit levels and create reliable revenue sources. Joe needed to become a $5 million-dollar business if he was going to reach his targets.

SCOPE OF THE PROJECT

To help Joe achieve his goals, we broke the project down into four modules namely:

1. Module 1: Business Analysis
2. Module 2: Financial strength
3. Module 3: Management ability and depth
4. Module 4 – monopoly

MODULE 1: BUSINESS ANALYSIS

A business ready for retirement planning must be in the position where it is generating excess cash. Without this business retirement planning becomes very difficult. Any business owner who has a negative cash flow will need to address this first before embarking on retirement planning.

Even though Contractor Dynamics (CD) was generating excess cash, we found in the business analysis section that CD was not operating as efficiently as could be.

We worked in partnership with Contractor Dynamics to:

1) Conduct and as is analysis- the current growth rate, how long the business was going to last if the business owner left now. When Joe came to us, he was fully involved in his business and was looking to sell in the next 5 years.
2) Next, we did a gap analysis which helped us break down his goal of selling into 3 sub goals of:
    a. Growth – grow at a rate of 116% with a profit margin of at least 25%
    b. Sustainability-improve the quality of recurring revenue and improve customer retention
    c. Transferability – allow the business to run without Joe.
3) We started out with creating a 5-year budget so Joe could have clarity as to what it will take to achieve his goals.

CURRENT BUSINESS VALUATION

In other to measure progress, we started the engagement with a business valuation. An investor is only willing to pay as much as he thinks he is likely to get back. An income-based business valuation called the discounted cash flow method was used to value CD. This means the business value is equal to the stream of future income discounted to its present value. We used the risk-adjusted discount rate for CD: The riskier a business is, the lower the discount rate. On the other hand, the more reassured an investor feels in arriving at the projected income, the more he will be willing to pay.

Risk Adjusted Discount Rate = Risk-Free Rate + Risk Premium

RISK-FREE RATE

The risk-free rate is the rate of return an investor will get if there were to invest in a guaranteed investment. For this project, we used the average 5-year return rate of 1.8% for a treasury bill as or risk-free rate

RISK PREMIUM

To help us arrive at the risk adjusted discount rate we used the **Schilt's Risk Premium Table**. The Schilt's Risk Premium Table (displayed below) is a method of assigning risk to a small business opportunity. This method was developed in 1982 by James Schilt. The discount rate is the sum of a risk-free rate of return plus a risk premium.

Category		Low Risk	Med Risk	High Risk
1	Established businesses with strong trade position, well financed, with depth in management, whose past earnings have been stable and whose future is highly predictable	6%	8%	10%
2	Established business in a more competitive industry that are well financed, have depth in management, have stable past earnings and whose future is fairly predictable	11%	13%	15%
3	Businesses in a highly competitive industry that require little capital to enter, no management depth, a high element of risk and whose past record may be good.	16%	18%	20%
4	Small businesses that depend upon the special skill of one or two people or Larger established business that are highly cyclical in nature. Future earnings are very unpredictable	21%	23%	25%
5	Small "one person" businesses of a personal service nature, in which the transferability of the income stream is in question.	26%	28%	30%

Starting out Contractor Dynamics risk premium was estimated at 20%: a business existing in a highly competitive industry that require little capital to enter, no management depth, a high element of risk but has a good past record. Our goal in this project was to cut his risk premium down to 11%. Remember the higher the risk, the lower the valuation.

*CD's current valuation was a little over a **$100,000**. To get to the **$5 million-dollar mark**, we had a lot of work to do.*

GAP ANALYSIS: THE VALUE BUILDER SYSTEM

To identify the specific risk areas to tackle, we used the Value Builder System. The Value Builder System was created by John Warrillow and identifies 8 key risk areas namely:

1. *Financial performance*: a history of producing revenue and maintaining profits. Also, evaluates the accuracy of record keeping.
2. *Growth potential*: evaluates the future growth rate.
3. *Switzerland Structure*: the dependence of the business on one employee, customer or supplier.
4. *Valuation teeter totter*: Evaluates cash flow
5. *Hierarchy of recurring revenue*: the reliability of revenue
6. *Monopoly control*: How differentiated the business is from competitors
7. *Customer satisfaction*: How likely customers will repurchase or refer your business.
8. *Hub & Spoke*: How well your business can perform if left for a period of three months.

Using this system, we were able to identify that CD's greatest risk existed in the following areas:

1) **Financial strength**: Joe's highest risk was found in his cost of goods sold. Joe's likelihood of enjoying the margins he was enjoying was very questionable. He had very little control over this area.

   Joe also was not using appropriate tools to manage his finances. He still was responsible for keeping his books and lacked the time to do it as frequently as needed.

   Furthermore, Joe did not have a cash management plan: He was not diversifying excessive cash to meet his retirement needs.

2) **Management ability and depth**– there was too much dependence on Joe and his key employee. If something happened to either of this people, the business was sure to suffer for it.
3) **Monopoly:** Joe lacked a clear position in his market segment. Joe sounded just like everybody else he was competing with.

On the other hand, Joe had a good past record of consistent growth. His customers were also happy with his service. There was a lot of potential in his market. He just needed to streamline to take advantage of these opportunities.

BUDGET

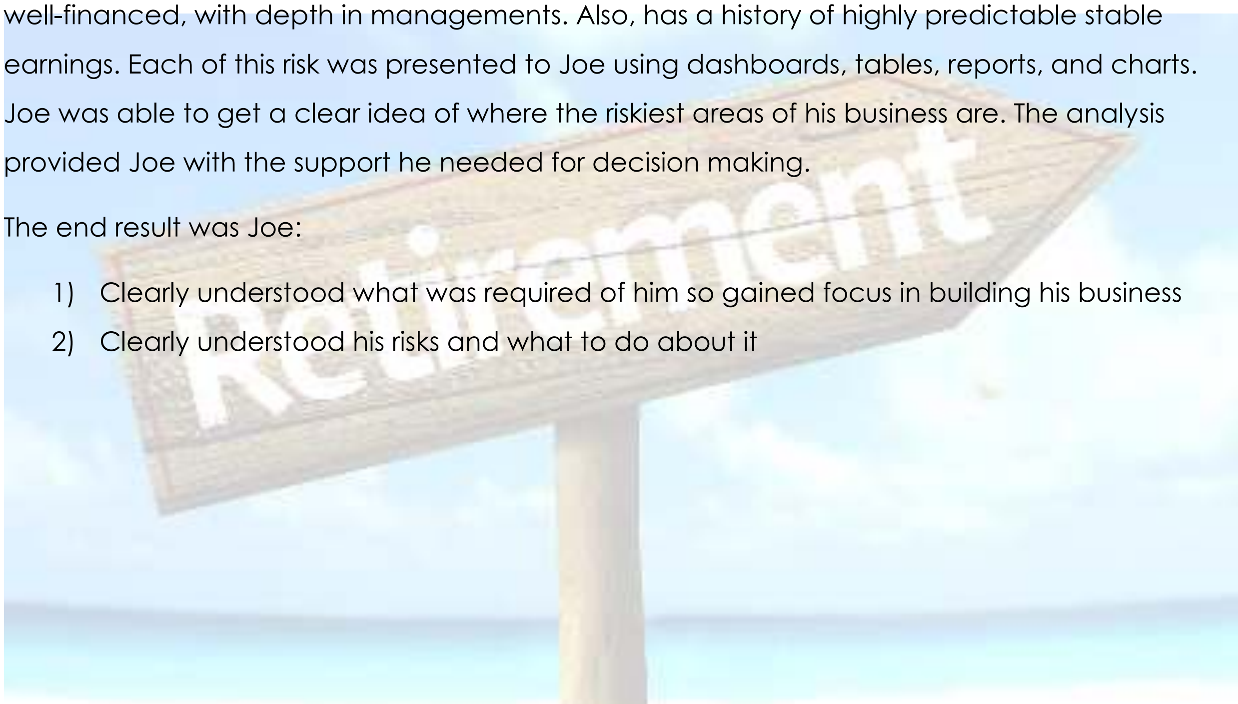
Once we knew the gap that had to be filled, we created a five (5) year budget to help us put numbers to the plan. In that way, we could clearly see what was required. Joe found this exercise both insightful and encouraging. Knowing that his goal was doable, made him very hopeful.

OUTCOME FROM MODULE 1

After the business analysis phase, we were able to identify CDs risk areas and set goals. Our goal was to cut this risk to half where CD will be an established business whose trade position is strong, well-financed, with depth in managements. Also, has a history of highly predictable stable earnings. Each of this risk was presented to Joe using dashboards, tables, reports, and charts. Joe was able to get a clear idea of where the riskiest areas of his business are. The analysis provided Joe with the support he needed for decision making.

The end result was Joe:

1) Clearly understood what was required of him so gained focus in building his business
2) Clearly understood his risks and what to do about it



MODULE 2: FINANCIAL STRENGTH

To address the CD's financial budget, we took a detailed look at Joe's financial statement. We created a 5-year budget that highlighted a number of customers and revenue CD will need to acquire at each phase of growth to reach its targets. We projected customer acquisition growth by month.

To ensure, that Joe's goal was not a pipe dream, we also evaluated his market. It is not uncommon to find entrepreneurs chasing a dream where the odds are against them.

It is much easier to swim downstream.

We determined that Joe's market was large and responsive enough to achieve his goals. The problem Joe was solving was one that his target audience needed a solution for. Sometimes, you could have a large market but an unresponsive audience because the problem you solve is not a big enough pain.

We also:

1) Picked key performance indicators to monitor progress towards these goals
2) We went into detail as to what it will take to achieve these goals
    a. How many customers will need to be served
    b. How many employees will need to be hired
    c. What the internal process should look like if this goal should be achieved.

d. What the retention rate should be
e. What the acquisition rate should be
f. Gaining more control of cost of goods sold
g. Improving profit margin
h. Appropriate alternatives for record keeping

OUTCOME FROM MODULE 2

Even though Joe scored well in the reliability of revenue stream. We still looked at the reliability of revenue, acquisition, retention and recurring revenue. This is because these are forerunners of a profitable business. There is a saying that goes, "Good marketing is the cure all for all business diseases". You can't have financial strength without a reliable source of revenue.

The end result was we were able to create CD's revenue equation. The revenue equation provides clarity in the growth process.

In addition, Joe was able to strengthen his business finances by:

1) **Improving acquisition**: We developed a benchmark for service. Only customers who met this benchmark will be accepted as customers. Joe can now focus his attention on recruiting customers he knows he can help. There is no need onboarding clients you cannot help. Benchmarking also helps improve retention. Customers are more likely to stay when they benefit from your services.
2) **Improving retention**: We also addressed the future risk of customer retention: As Joe grows; there was the likelihood of a dwindling retention rate. We devised various activities that keep clients coming back. **Recurring revenue is a PLANNED activity and does not happen by chance.**
3) **Improving cost of goods sold**: In addition, we discussed Joe's lack of control for his cost of goods sold. We devised a plan of attack which I shall not discuss here due to the intricate nature of the problem.
4) **Improving record keeping**: We discussed moving to a better platform that will be able to provide the information Joe needed to grow his business.

We highlighted the fact that these are long term goals that do not have to be focused at once but should be when the right time comes.

MODULE 3: MANAGEMENT ABILITY AND DEPTH

Even though CD enjoyed a good growth rate, Joe had failed to create an environment that could thrive without him. Joe was the "Superman" for his business. He was the center of every decision made in the business. While he had an adequate amount of people working for him, there was very little cross- training. These factors make the business non-sustainable. If anything happened to Joe or his key employee, so goes the business.

It is important to point out here that simply having standards of operation, or delegating tasks to contractors or staff does not count as having management depth. The key test to knowing whether or not you have built a management team is **not how much physical work you put into the business but how much brain power you still put in the business.**

In other words, if you are still at the center of making decisions anytime anything goes wrong, or a big decision needs to be made, you are yet to build a management team.

A good management team requires a retention and succession plan. Let's face it life happens, and while you will like your good staff to stay forever with you, it will not always happen that way. **If your decision to retire from your business is based on your current team, then you do not have a plan.**

BUILDING MANAGEMENT DEPTH

There were many facets we needed to address in building CD's management team. This was an area Joe really needed to work on. We broke this issue into multiple steps to effectively address the problem:

1) Freeing Joe from working in the business

2) Improving employee retention while reducing reliance
3) Creating a consistent employee onboarding process

FREEING JOE FROM WORKING IN THE BUSINESS

To see where Joe was stuck in his business, we took a look at CD's internal systems. This process is not only helpful in freeing up Joe but only finds areas where cost can be reduced. We **monetized all processes** and found areas where the same functions can be delivered at less cost.

We were able to identify areas in the internal processes that could be performed for less by:

1) Delegating
2) Automating
3) Eliminating

By evaluating processes, we also found areas where the offerings could be tweaked so the business has the most potential to grow efficiently: Your internal processes determine how effectively you can deliver your offer. One of the few things you must make sure you do efficiently before expanding is fine tuning your internal system. If you grow with inefficient systems, you reduce your margins.

IMPROVING EMPLOYEE RETENTION WHILE REDUCING RELIANCE

While we want good employees to stay as long as possible. We have to face the fact that life happens: Good employees do leave. This makes it necessary for the entrepreneur to create a system where no employee is indispensable. Your business should not significantly slow down for an extended period of time because of loss of one staff. You want to retain good employees as long as possible but make it easy to transition in case they are dismissed or leave on their own.

We were able to highlight key areas; Joe will need to work on to build a sustainable environment:

1) **Increase employee retention by creating incentives:** One way to retain staff is to create incentives. Joe had no employee retention incentives. We suggested creating incentives like profit sharing, retirement benefits, health benefits, etc. to keep employees over the long haul.
2) **Increasing employee retention by empowering employees:** Every person wants to feel they are making a significant difference. When employees feel they have a voice, they are more likely to stay. Moreover, empowering employees is important to sustain a dynamic workforce capable of changing with the times. When phrases like "we have

always done it that way" become the theme of daily conversations, you know your business is on its way to the grave.

3) **Reducing reliance by creating standard procedures and processes**: Joe already had lots of his processes documented for CD, but however, CD lacked procedures to follow. There was no employee manual, financial procedures, strategic procedures, etc. These are areas often overlooked as the entrepreneur thinks managing the workflow is the most important thing to the business.

   However, **you cannot walk away** if there is no one responsible for managing the finances, dealing with the bank, handling employee complaints, strategic planning process/ frequency, budgeting techniques, etc. These functions are what I call silent time bombs: when they are done no one notices, but when they are skipped everyone notices the chaos.

   Joe also lacked documentation of organization history, what has worked or not worked. This is information that is very important for c-level staff and should be part of any succession plan. If this is not done, once the last staff who worked with Joe leaves, the business begins to crumble.

4) **Reducing reliance by creating a mentorship program:** Moreover, CD needed someone to manage all these processes. This person will be responsible for making sure the business runs smoothly. In other words, CD will need a C-level executive position. Given the nature of CD's work, it was decided that the best person will be someone who had been trained internally and moved up the ranks. This executive will also be responsible for the future strategic direction of CD. It was recommended that Joe hired someone he could mentor to that position. Moreover, the mentorship program has to be ingrained as part of CD's culture.

CREATING A CONSISTENT EMPLOYEE ONBOARDING PROCESS

An improved system of onboarding new employees was needed. The onboarding system has to be fast enough to match CD's acquisition rate. To address it was recommended that CD:

1) **Build an employee profile:** Once the right profile has been created, CD could then create a system to ensure the right employees are brought on board. It is important to create a work environment where employees feel empowered.
2) **Create a standard process for hiring and firing**: Joe needed a welcome package for each new employee. This package should let the employees know what to expect, what to do if they have questions or grievances, etc. Sometimes, entrepreneurs are guilty of

hiring employees and have them dive right into their functions without teaching them what the business is about or why their job is important.

OUTCOME FROM MODULE 3

Joe could clearly see where the holdup was in freeing himself from the business. While we agreed that not all of these goals should be addressed at once, these goals need to be addressed during strategic planning meetings.

A business is a living thing and is constantly changing: finding internal ways to manage this change without the owner is essential for long-term survival. As an entrepreneur, the first step in having a thriving organization is making the decision to become one. Then the rest is just a matter of setting goals and implementing them on an incremental basis. Some of the goals we set are:

1. Reducing the percentage of time working on a business.
2. Scheduling the workflow with more efficiency so there are no extensive backlogs. I also recommended that Joe invests in project management software that better handled work schedule.
3. Develop the processes & procedures necessary to hire and onboard new employees in 10 weeks
4. We created a list of processes that needed to be documented and set a goal to periodically work on this. Joe currently has 75% of his processes documented.

Management depth is built with long-term staffs who understand what roles they play within the organization and a management team who understands how to direct the staff in the right direction. Developing management depth is not a check the box action item, but must evolve with the times. By having a system of mentoring and a workforce that can adapt to change, Joe will have the confidence to know he can walk away and things will still run without his interference.

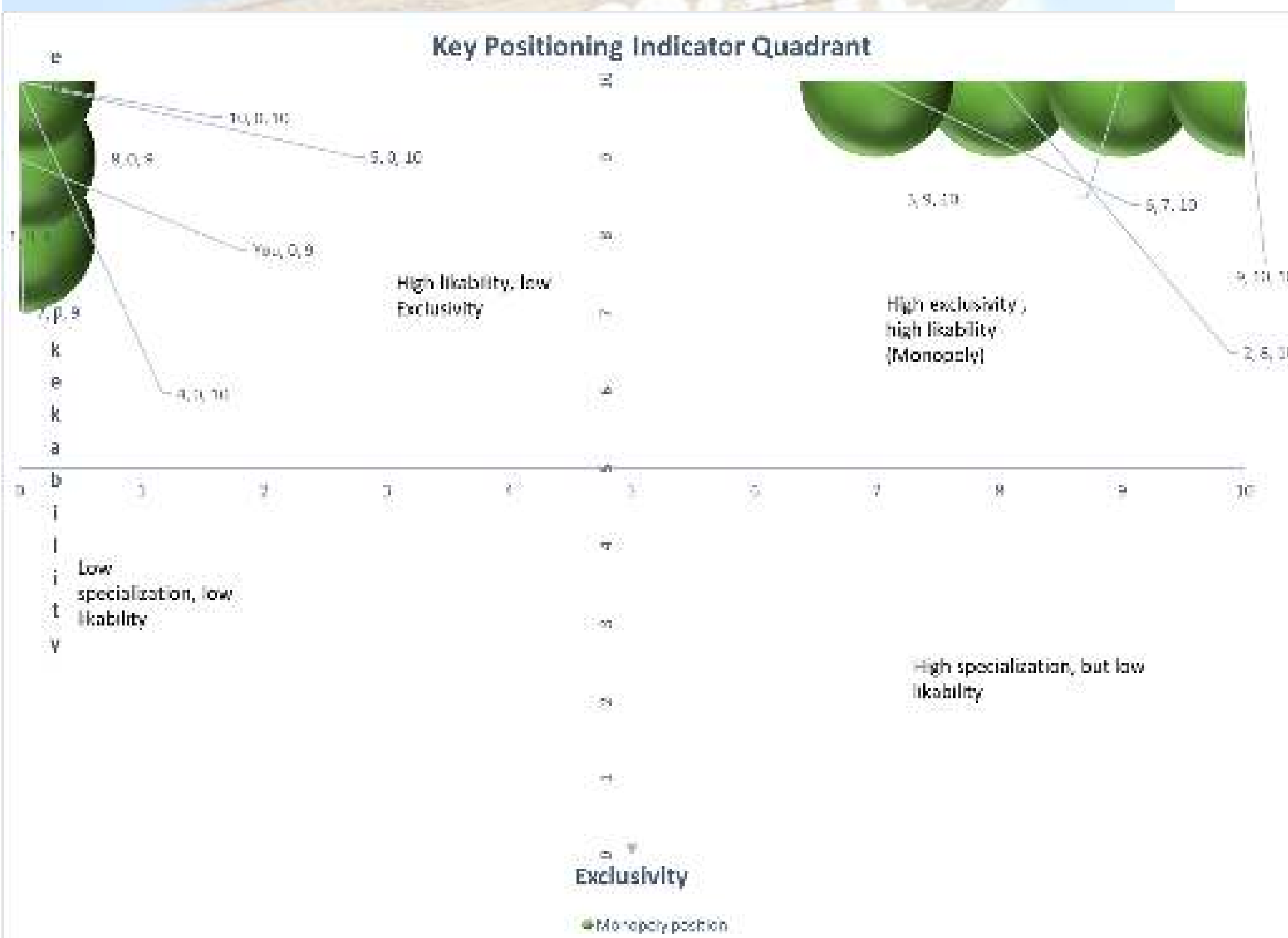
I will like to caution here against walking away too soon. Think of your business as a child: You do not walk away from your business just because it can now talk, walk and feed itself. A business has to fully develop its own personality before the owner can send it off to the world. It does not matter how many systems have been created and how automated things are: If your business does not have a personality of its own, it will not survive your departure.

MODULE 4 – MONOPOLY

Correctly positioning your products in the mind of your potential customers is vital as it helps customers quickly differentiate you from the competition. A good positioning strategy gives you a monopoly in the minds of your customer. Whenever they want a certain benefit from a product or service, they will automatically think of you.

Customers must care about the position you are trying to assume

We surveyed Contractor Dynamics competition and constructed its key position in the market using the key positioning indicator quadrant (see below). CD market landscape is highly competitive. We found from our research that CD fell in the first quadrant – high likability but low exclusivity. This means that he provided a service that customers needed a solution for but there was for little to tell him apart from his competition. Joe discovered that he had to be more exclusive in his offering.



Being in a highly competitive industry is not necessarily a bad thing because this usually corresponds with high demand. However, you must be exclusive to survive.

OUTCOME FROM MODULE 4

With this information, Joe was able to further refine his offering to be more exclusive to his target market. He did not have to waste his time marketing to people he did not enjoy serving. He was now able to focus his attention and get better results. We were able to fine tune the strategy so he could double his revenue with less stress.

CD also updated its website to reflect the new strategy.

FINANCIAL MANAGEMENT NECESSARY BEFORE WALKING AWAY

The goal is to grow your overall wealth: Choose the option that first maximizes your wealth and then minimize taxes (not the other way around)

One of the most important factors to building retirement income is to have idle cash. In this session, we re-visited how Joe had managed his margins to ensure his business was moving according to plan. We then turned our attention to the cash management. As a business grows, it is not enough to just manage profit but active asset management must be part of the long-term strategy. We did not extensively discuss cash management as part of this project but discussed this as part of a future engagement. The main areas of cash management applicable to Joe are:

1. How much cash to retain in the business? Retaining cash for future expansion and acquisitions. Any cash not needed for the immediate future should be put invested in ways appropriate to the business.
2. Funding Joe's retirement as part of his compensation package
3. Engaging in tax planning to minimize taxes along the way

Our next goals are to build up his assets and change his mindset from that of an operator to that of an investor: That is we need to build enough assets both in and out of the business, so Joe will not have to work another day in his life even if his business went flat.

BUILDING WEALTH OUTSIDE BUSINESS

When Joe walks away he earns passive income from his business. It is important that at this point, he is not receiving wages as these are normally taxed at a higher rate. Wages are compensation for service done. So, once service stops wage income should stop also.

Joe has three ways to earn cash once he becomes an absentee owner. **The first way is primarily from the business:**

1. Earn distributions from the business: This will provide the income he needs to support the lifestyle.
2. When he reaches the age of 60, also have a retirement fund in which to pull from: It is important to build a safety net for your older days. For instance, if the business tanks when Joe is 42, the probability is he still has the strength to pick up the pieces and start again. However, if the business tanks when he is 60, Joe may not be as strong as he is right now and may not have the energy it takes to build a business at that age.

The second way is earning income through diversifying the funds he earns:

3. Diversifying some of his income into other investments that generate passive income: the goal here is to build up assets so if anything happens to the business; income is still generated from other sources.

SUMMARY

In summary, to successfully walk away from your business, your business must possess these attributes:

1) **Growth and Scalability** – build a track record of consistent growth.
2) **Sustainability** – dependable revenue sources and good cash flow.
3) **Transferability**: First the business owner must build a work environment that employees love and feel empowered. Secondly, he/ she must create repeatable systems that do not depend on him/ her

Whether you choose to sell or become the absentee owner is irrelevant, the point is you want a business that can survive your departure.

As Joe saw the potential of his business, he realized he **did not want to sell**. He did rather become an absentee owner. Joe can make a whole lot more over the long run by keeping his business and being the absentee owner. With proper cash management, both in and out of his business, Joe can build assets that keep generating income to support his lifestyle.

The project allowed Joe to chart a long course of action. By knowing what is required, Joe was able to focus his attention on what mattered most to meet his goals. As a result of this project, Joe has been able to re-evaluate and fine tune his business strategies and his way ahead of the goals we set initially. There is no doubt that he will attain the $5 million valuation goal.