



Ownership in an Operating Business

A new approach to consider when constructing a stable retirement

By David L. Blain

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There was a time when the three legs of the retirement stool were Social Security, pensions, and personal savings, but those days are gone for good, and the stool needs new legs. Paper assets and real estate are classic asset classes that can help fill the void, but where else can investors turn for the stable income they need?



I suggest that investors adopt ownership in an operating business as the crucial third leg supporting their retirement. By ownership of an operating business, I mean ownership in a privately held company—one not traded on a public exchange. Private ownership is important, because it means the company isn't subject to the vagaries of public shareholders or to the volatility of the stock market. As part of a properly allocated investment strategy, such ownership can provide a reliable, alternative source of steady income, and it carries the potential for high returns if the business is sold.

Such companies can be found in all industries and using many different organizational models. Some of these companies, such as Mars Inc., can be quite large. Others, such as your local service station or coin laundry, can be quite small.

Size doesn't matter; success does.

Another key to private ownership in an operating business is that you don't necessarily have to go to work on a daily basis. Sure, you may have some responsibilities within the business, but chances are you won't have to show up at an office everyday in order to generate income. The important thing is that, as an owner, you are entitled to a portion of the company's ongoing profits.

Now that we know what is meant by ownership in an operating business, let's take a look at how to participate as an investor. As it turns out, becoming an investor in an operating business is pretty straightforward and typically fits into one of five scenarios.

1. Start the company, but delegate day-to-day operating responsibility. This is probably what most people have in mind when they think of owning a company. It's



easy to picture a founder turning over day-to-day operations of his or her company to a third party while continuing to collect a share of the profits.

2. Inherit all or part of a family-run enterprise. Inheritance is another common way to obtain ownership in an operating business. And, as I discussed above, you don't always have to show up for work to generate income.
3. Buy or otherwise receive an ownership stake over time. Ownership in this scenario may be achieved through a stock purchase program, acquiring equity through partnership, or ownership as a reward for performance.
4. Buy all or part an existing company. While there are a variety of ways to do so, a share of a company is typically bought directly, through friends and/or family, or as part of an investment group.
5. Invest in a private equity fund. If you don't have an opportunity to follow one of the other scenarios, you can achieve proportional ownership in an operating business or businesses through a private equity fund. The farther away you are from the company's decision-makers, however, the more the investment behaves like a paper asset.

Now that you know the options for investing in an operating business, it's important to understand how to maximize the benefits of your participation. Three criteria that must be met:

1. The business must be privately owned. As we discussed above, this helps shield the company from vagaries of shareholders and the volatility of the stock market. It also guards against dilution of ownership and supports growth in your income.
2. You must have proximity to and/or influence with the decision makers who run the company. Adding your industry expertise or general business acumen to the mix can have a positive effect on profitability.
3. The business must produce income for you now. It's not enough just having a chance to sell the business for a profit later. As we saw during the financial crisis in 2007 and 2008, there are simply too many factors that can adversely affect the future value of a company, and that value can drop dramatically in a very short period of time.

Like any investment, ownership in an operating business presents risks that must be carefully evaluated before investing. Some risks, such as fire, floods and similar natural disasters can be managed with insurance. Economic, competitive, financial and market-related risks can be minimized by hiring qualified, experienced staff. The sudden death or disability of an owner, partner or key employee can be handled with a strong and concise



succession plan. The bottom line is any company in which you invest should have strong risk-management practices.

While acquiring an ownership stake in an operating business isn't for everyone, as part of an overall asset allocation, it can help the right investor build a better foundation for a healthy, ongoing and increasing stream of income for retirement.

David L. Blain, CFA, earned his Bachelor of Science in Engineering from West Point in 1989. Prior to becoming an adviser, he spent 10 years in the Army Airborne, Ranger and Delta Force units. David is currently the president and chief investment officer at D. L. Blain & Co., LLC.

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