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Working "on" versus Working "in" the Business

One of the key issues to understand when you own and manage your own business is the difference between working "on" the business and working "in" the business.

This article addresses the following topics:

- Business owners must work both on and in the business — a key to success is doing these in the right proportions.
- Creating an ownership strategy is a foundational step in pursuing business — and personal — success. It can be used to establish a plan that can help you achieve your goals, identify and address obstacles, and measure your progress.
- Taking strategic action across a range of interrelated areas (capital structure, talent depth, organic growth and M&A, governance, and conflict resolution) will help position you and your business for success.

While most of your time is spent working in the business, most of the high-impact decisions you make pertain to working on the business. Oddly, the time spent on these decisions is typically inverse to their importance.

UNDERSTANDING IN VERSUS ON

Working in your business is critically important. It is all the day-to-day tasks you do to ensure the business is operating efficiently and cost-effectively and that customers are kept satisfied. Failure to keep an eye on all of these tactical activities can result in a larger business failure.

Contrast that to working on the business. These are strategic actions. It is time spent finding ways to maximize business value through expansion, creation of proprietary intellectual property or growing market share. Time spent on the business can feel like a luxury because it does not address equipment malfunctions, creeping materials costs and customer complaints. It also does not deliver a more immediate sense of accomplishment in the same way addressing day-to-day challenges can. Frequently, time spent working on the business is sacrificed to make more room to work in the business.

Business owners frequently delay working on the business until they are ready to transition away. The complication this presents is that the strategic actions taken while working on the business may have a multiyear horizon and may not produce results in the time frame desired. Working on the business needs to be an ongoing process throughout the business' life cycle. It enhances the value of the business during the course of its existence and helps prepare it for unexpected headwinds or a surprise offer to purchase the business.

> Ultimately, success is about perseverance and adapting to changes during the journey that are beyond your control.

To understand why working on the business needs to be a priority, consider this very important question: Why are you in business?

Properly answering this question requires dissecting it into two parts:

- What are your life goals, and how does the business help you to achieve those goals, whether they are financial security, happiness, family harmony or enjoyment of time well spent? You can make more money, but you can not make more time.
- How does your business strategy enable you to achieve your life goals? The business is an asset and should be used to help you to achieve those personal and family goals.

IDENTIFY YOUR PATH FORWARD

Answering the questions above makes it easier to define a process to help you achieve your life and business goals. And with a defined path forward, it is possible to measure progress and identify obstacles when they appear.

Experience has demonstrated the following strategic actions to be effective at building a solid foundation that can help lead to success.

1. **Develop your ownership strategy.**
   You may already have ideas of what you want out of life for yourself and your family. But if you do not, it is recommended that you develop a statement of life goals. These goals often focus on financial security, happiness, ownership succession, management succession and family issues. The clearer you make those goals, the easier it is to envision what you can do to reach them and how the business must perform to contribute to your success.

   See "Getting to Your Number" on page 4 for a deeper dive into what this means.

If business change is needed and you are the sole owner, the decisions are yours to make. If you have capital partners, whether they be family, friends or outside investors, then a discussion is required. It is best to resolve these questions up front. These decisions should be memorialized in your business by-laws or operating agreement to remove the chance of conflict later. In the best business relationships, you have well-written documents but never need to review them since the partnership works well for all parties.

2. **Define the business strategy.**
   Once you set performance metrics for the business, you should flesh out the business goals and strategies that will produce winning metrics. This is usually something like: "I need to get the business to $X EBITDA and sell it to achieve financial security." So how do you get to $X? This is where you get serious about working on the business. The ideas you generate need to be able to deliver the business growth you require to reach your number. While developing these ideas and waiting for them to produce results requires more lead time, the value they help create makes the investment of your time worthwhile.

3. **Assess capital and talent. Is it reasonable to think you will be able to execute any business growth idea while also continuing to run the business?**
   Do you have talent in-house that can help with executing your plans? If you do not, you may need to hire talent. And if the talent does exist in-house, will you need to backfill that position to create capacity so the person can work on this new opportunity? Also consider how much financial investment is needed to bring the plan to fruition. Is current cash flow sufficient to fund what is needed, or are additional funds required? How much, and by what structure, do you need to fund the strategy?

4. **Address organic growth and M&A. How much of your anticipated future growth will be organic, and what is needed to make it happen?**
   If organic growth is not enough, acquisitions may need to be considered. If you need to make acquisitions, what are the targets and how will you successfully acquire and integrate those targets? The organic growth versus M&A decision needs to align with the business strategy discussed earlier or you risk driving results that do not support your goals. A frequent mistake business owners make when considering their options is having too rosy an outlook on the company's strengths to address gaps. Objectivity can be influenced by biases developed over years of owning and operating the business. Objective input from a third party looking at your business with fresh eyes can be helpful.

5. **Assess and develop governance structures.**
   A useful approach to gathering objective third-party input is to establish an advisory board or board of directors. Not only can such a body provide an unbiased perspective, it can also help establish a culture of accountability across the management team. While the focus of a board needs to be on helping the owner grow value, attention also needs to address managing risk. A board is uniquely positioned to provide oversight and perspective on risks as well as opportunities, and it can help the owner determine whether sufficient controls are in place to manage the different types of risk affecting the business. Creating and developing a board requires thought and time. It is an added responsibility on top of running the business, but it provides many benefits to the business and the owner.

6. **Anticipate conflict. Conflict is inevitable in business.**
   The biggest issues typically occur within the ownership group and then within management. How you handle that conflict is what counts. So what do you do when people do not agree? Start by reviewing the governing documents to see if specific mechanisms are stated to resolve conflicts. If your governance system does not provide mechanisms for addressing conflict, then you will need to figure things out when conflicts arise. In this case, it may again help to get an unbiased third-party opinion on how to deal with conflict by speaking with outside counsel or other professionals.

Getting to Your Number.

Two key concepts that link ownership and business strategy are known as the "magic number" and the "walk away" number. The magic number is the amount of cash needed to provide lifetime financial security. The walk away number is the net proceeds after all fees, taxes and expenses that an owner receives from the sale of a business. Getting the walk away number to exceed the magic number should be a key goal for any business owner with plans to transition away from their business one day.

For example, a business owner has a $25 million revenue business. Her financial advisor has informed her that she needs to have at least $20 million in assets to fund her personal goals. So, $20 million is her magic number. She then needs to know her walk away number and build a business strategy that ensures it is greater than her magic number ($20 million).

To build the business strategy, she will need to work backwards. She knows she needs to receive net proceeds of at least $20 million for the business strategy to be desirable.

Assume in this example that the type of business involved typically produces 8% EBITDA, and businesses in her industry are valued in the range of 5X–6X EBITDA. Her industry is growing and dynamic, and she has a demonstrated competitive advantage. She sees that with the right capital and talent, she can grow her business to $100 million revenue in about five years, which aligns nicely with when she would like to retire.

A $100 million-revenue business at 8% EBITDA, which sells at 6X EBITDA, produces an enterprise value of $48 million ($100 million x 8% x 6). Assuming a 25% capital gains tax rate and typical fees and expenses, the owner would receive net proceeds in the range of $30 million to $35 million. If the business has bank debt, those amounts would be paid from the proceeds of a sale transaction. In this scenario, there is a good chance the owner would achieve her $20 million magic number if she executes the business strategy, is not over-leveraged and certain other assumptions hold true.

Perseverance and determination have always been requirements for success, although they alone are not sufficient. A good plan, adequate resources and adaptability are required for success, since markets are fluid and dynamic.

By creating an ownership strategy — articulating the goals you have for yourself and your family — and defining the role the business plays in helping you achieve those goals, you can establish a solid foundation for pursuing success. This foundation better positions you to understand how you need to work on the business — whether that involves decisions on business strategy, capital, talent or risk management. And the foundation provides clear motivation to help you stay focused on working in the business. Business owners who have sold their businesses repeatedly emphasize the impact that creating an ownership strategy had on their success. It set a path for them to follow and identified priorities that helped define their success.

To learn more, contact your Financial Advisor or CNR Senior Investment Consultant or Portfolio Manager.

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