THE FREEDOM POINT

A Financial Planning Guide for Business Owners

The ValueBuilder System™

Foreword

If you're like most business owners, your desire for freedom is hardwired into your psyche. You could get a job with a fancy title, a lucrative salary, and comprehensive benefits, but the desire to call your own plays has led you to the road less traveled.

However, starting a company may not be enough to facilitate the freedom you imagined. Just because you're the boss, that doesn't mean you are liberated from demanding customers or needy employees undermining your freedom. For that level of independence, you may need to sell your business and create a pool of cash that can generate the kind of income you need to fund the lifestyle you aspire to have.

Selling your business may seem far off into the future, but if exiting your business now would give you the financial resources to do whatever you want, it may be worth considering sooner than feels natural.

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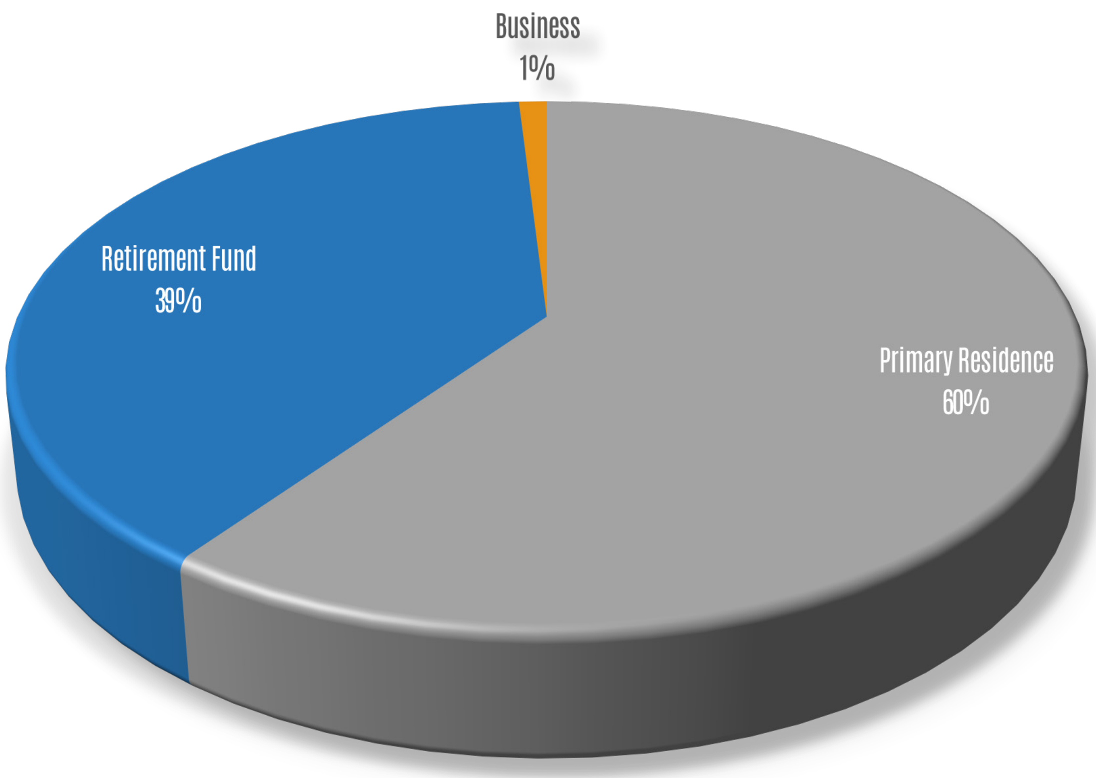
Are You “Risk On”?

Not only are you potentially past the point of not having to work but you may be risking the freedom you've earned by hanging on to your business too long.

When was the last time you calculated the percentage of your net worth tied to your company's value? When you started your business, it was probably negligible. Unless you purchased or inherited your company, it wasn't worth much when you opened your doors, but over time, the proportion of your assets tied to your business may have crept up.

Let's imagine a hypothetical business owner named Tim, who starts his company at age 30. He has a little bit of equity in his first home and a small retirement fund. When he starts his business, it's worthless, so by definition, it doesn't really factor into Tim's net worth calculation.

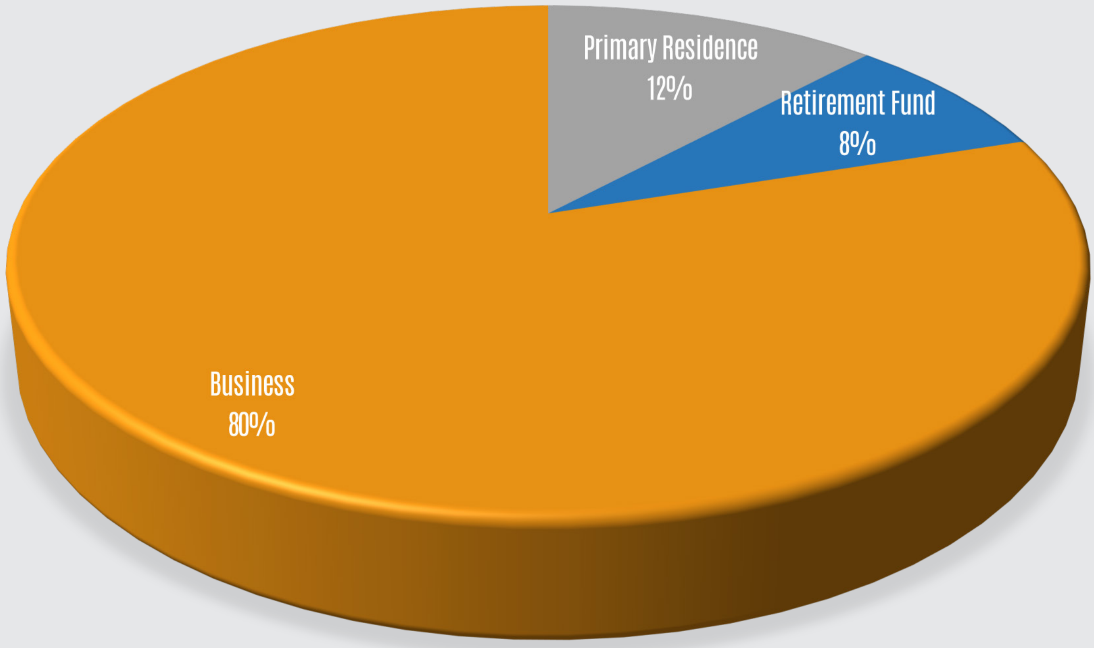
Tim's Net Worth



*For illustration purpose only.

By the age of 50, however, Tim has built up $600,000 worth of equity in his home, his retirement nest egg has grown to $400,000, and his business has blossomed to be worth $4,000,000. Over two decades, Tim's company has crept up to represent 80% of his net worth.

Tim's Net Worth



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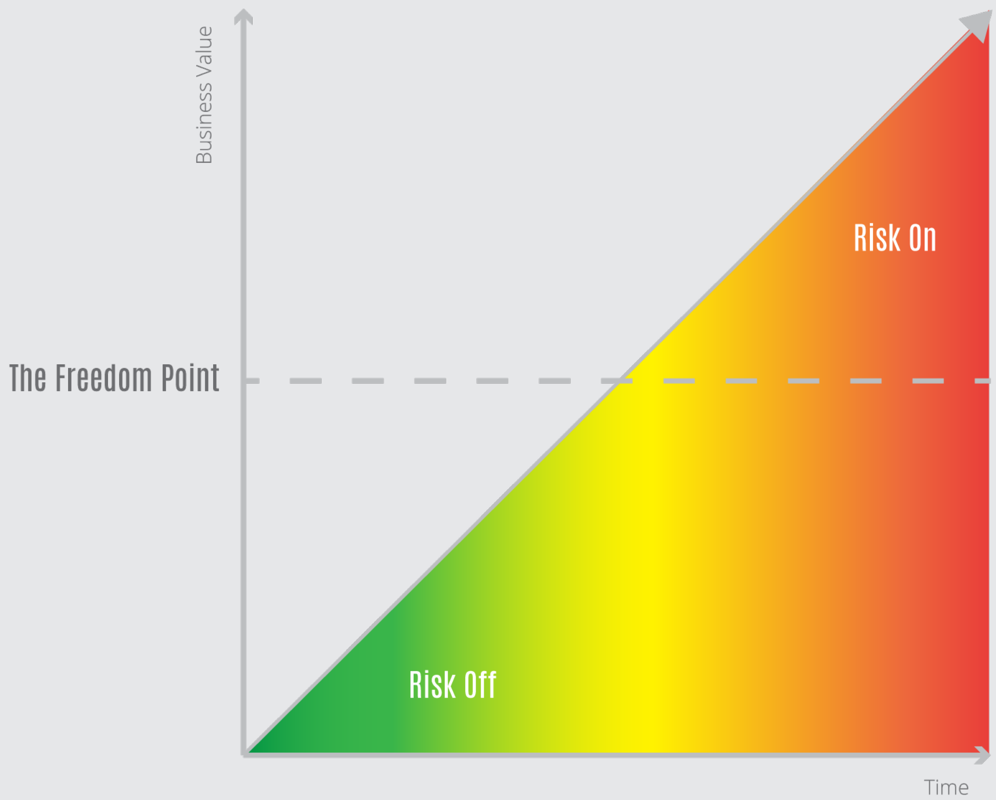
Tim knows the first rule of investing is to diversify, which he is careful to do with his retirement account. Still, he has failed to achieve overall diversity given the success of his business.

What's more, he may have unconsciously passed something called The Freedom Point, which is when the net proceeds (i.e., after taxes and expenses) of selling his business would garner enough money for him to live comfortably for the rest of his life. In the parlance of Wall Street traders, Tim has moved "risk on"—a situation where he is taking on considerable risk.

"Risk On" Factor



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When you pass The Freedom Point, your biggest risk may be a drop in the value of your business, but there are other risks to consider that exit planners refer to as the 4 Ds:

1. **DIVORCE**: Always messy, this is particularly troubling when you and your spouse work in the same business.
2. **DEPARTURE**: You or one of your partners decide to resign from an operational role in your company.
3. **DISABILITY**: Something happens to you, making it impossible for you to work.
4. **DEATH**: Along with taxes, it's inevitable, and burdening your beneficiaries with operating a company they do not know how to run means they'll likely destroy the value you've created.

How to Calculate Your Freedom Point

f you're curious to know when you might crest The Freedom Point, use the following guide.

STEP 1

Estimate the income you will need to fund your freedom.

This is a subjective thing. You may aspire to live in a cabin in the woods or jet set from one exotic island to the next. The goal is to calculate the income level at which you will feel totally free without restraint, so err on the high side and you can always scale things back later.

STEP 2

Multiply by 33.

You've likely heard of the Four Percent Rule, which is based on a study[1] that illustrates you can safely withdraw 4% of your nest egg in retirement without running out of cash. According to Investopedia:

> *The Four Percent Rule was created using data on stock and bond returns over the 50-year period from 1926 to 1976. Before the early 1990s, experts generally considered 5% to be a safe amount for retirees to withdraw each year. Skeptical of whether this amount was sufficient, financial advisor William Bengen conducted an exhaustive study of historical returns in 1994, focusing heavily on the severe market downturns of the 1930s and early 1970s. Bengen concluded that, even during untenable markets, no historical case existed in which a four percent annual withdrawal exhausted a retirement portfolio in less than 33 years.*

The Four Percent Rule is actually more of a rule of thumb and depends on a few factors, like your asset mix, the state of the market when you begin drawing on your nest egg, inflation, and the length of retirement you need to finance.

Your goal is to calculate the point where you will feel absolutely free of worry about money, so we suggest[2] using a 3% withdrawal rate instead. Using the three percent rule, you can calculate the nest egg you need by multiplying your income needs calculated in Step 1 by 33. (If you'd like to use the Four Percent Rule, multiply by 25.) Consider the result the funds you need to finance a long, carefree retirement.

1. https://www.investopedia.com/terms/f/four-percent-rule.asp#:~:text=Origins%20of%20the%20Four%20Percent,retirees%20to%20withdraw%20each%20year.
2. We recommend talking to a financial advisor before making any decisions.

STEP
3

Calculate your wealth outside of your business.

Now estimate how close you are to The Freedom Point by assessing how much wealth you've created outside of your business. Do not include your primary residence in this calculation, because you'll have to live somewhere after you sell your company. Include anything (other than your primary residence) that could be sold reasonably easily, such as stocks, bonds, commercial real estate, etc. Once you have calculated your assets outside of your business, deduct any debt you have on those assets.

STEP
4

Get an estimate of value for your company.

Let's imagine you want $100,000 of income a year, which means you need to accumulate $3,300,000 ($100,000 x 33) of wealth outside of your primary residence, and you've accumulated $400,000 outside of your business. To reach The Freedom Point, you'd need to net $2,900,000 ($3,300,000 minus $400,000) from the sale of your business.

Therefore, you need to estimate what the shares in your business might be worth to a buyer. While you may have heard a valuation rule of thumb in your industry, it's best to check with a professional, so talk to your Certified Value Builder™ or find one **here**.

STEP
5

Estimate the cost of selling your company.

There are a number of expenses to consider when selling your business. For example, you'll need to pay tax on the proceeds of your sale. You may hire an intermediary (business broker or M&A professional) to sell your company, and they generally work on commission. The commission a broker charges varies from one broker to the next. In the example that follows let's imagine a broker who charges 10% commission. You'll also need to pay a lawyer to paper your agreement. While the costs of selling your business will vary, here's a typical example on a $4 million transaction:

Frictional Cost of Selling

Sale price	$4,000,000
*Business Long-Term Debt**	*- $200,000*
Intermediary Commission[3]	*10%*
Legal Fees	*2%*
Tax[4]	*20%*
Total	***32%***
NET Proceeds[5]	**$2,520,000**

*For illustration purposes only

STEP 6

Add any long-term debt on your business.

When you hand over the keys to your business, you'll likely have to do so free and clear of any long-term debt. Therefore, you need to add the amount required to pay back any business loans to the total funds you need to accumulate to reach your Freedom Point.

STEP 7

Calculate your Freedom Point.

Take the wealth you have outside of your company (estimated in Step 3) and combine it with the after-tax proceeds you expect to gain from the sale of your company while subtracting any long-term debt you need to pay back (estimated in Steps 5 and 6). When they add up to a number greater than the nest egg you'll need to fund a carefree retirement (estimated in Step 2), you've reached The Freedom Point.

THE FREEDOM POINT = (Value of Investments + Net Proceeds of Selling Your Company) > Desired Income x 33

3. Intermediary commissions vary. Oftentimes an intermediary will charge a 10% commission on the first $1 million of value, 8% on the second million, etc.

4. Talk to your accountant now about the tax you can expect to pay on the sale of your company in the future. There may be strategies your accountant can recommend now to lower your overall tax burden when it comes time to sell.

5. Assuming you own 100% of your business

The Freedom Point Calculator

Let's use Tim, our hypothetical business owner, as an example.

Part 1 of 2

Let's start by calculating the gap between where Tim is today and his Freedom Point.

Desired Annual Income

Assuming today's spending power, Tim can estimate the annual income level at which he will feel totally free without financial constraints.

$100,000

Withdrawal Rate (4% Rule)

3%

Financial models suggest people have a high likelihood of sustaining a 30-year retirement using a 3-4% inflation adjusted withdrawal rate.

Size of investment portfolio required based on a withdrawal rate of 3%

$3,333,333

Wealth outside of Tim's business (e.g. Stocks, Bonds, Investment Properties, etc.)

Estimate of Tim's net wealth created outside of his business.

$660,000

Outstanding Personal Debt

Estimate of Tim's personal debts, not including the mortgage on his primary residence

$40,000

Tim's Gap to Reach The Freedom Point **$2,713,333**

Part 2 of 2

Let's calculate how much Tim's business needs to be worth to bridge his gap to The Freedom Point. We start by estimating his personal net proceeds from the sale of his business.

Gross Sale Price	**$3,637,736**
Ownership Percentage Tim's ownership portion in the business.	100%
Outstanding Debt Minus Cash on Hand The value of any outstanding long-term business loans you owe to third parties	**$200,000**
Professional Fees and Commissions (12%)* Professional fees and commission rates vary based on a variety of factors.	**$446,070**
Gross Proceeds	**$3,391,666**
Tax on Proceeds (20%) This is calculated based on Tim's location and the various tax strategies Tim chooses to employ.	**$678,333**
Tim Will Reach His Freedom Point When His Business Is Worth Net Proceeds After Taxes and Expenses	**$2,713,333**

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What to Do When You Hit The Freedom Point

When your business makes up most of your net worth and selling it would garner enough money to live carefree for the rest of your life, there's no financial reason to continue owning your business. You may enjoy the challenge, the social interactions, and the creative process of building a business, but looking strictly at the numbers, keeping it may be unnecessarily risky.

Think of it this way: Every day you retain ownership in your business beyond The Freedom Point, you are risking your freedom. If your business were to falter beyond The Freedom Point, you would jeopardize everything you've worked for.

When you've crested The Freedom Point and want to diversify but not necessarily retire, you have some options:

Sell a Minority Stake

In a minority recapitalization, you sell fewer than half of your shares. Often sold to a financial investor such as a private equity group, a minority recapitalization allows you to diversify your net worth while continuing to control your business.

Sell a Majority Stake

In a majority recapitalization, you sell more than half of your shares to an investor who will most likely ask you to continue to run your business for many years to come. You get to diversify your wealth, keep some equity in your business for when the investor sells, and continue to run your company.

Earn-Out

When you sell your company, you'll likely have to agree to a transition period of sorts. One of the most popular is called an earn-out, where you agree to continue to run your company as a division of your acquirer's business for some time. Your earn-out may be as little as a year or as long as seven, but the average is three years. Therefore, if you're past The Freedom Point and can see yourself wanting to step down in the next three to five years, an earn-out may be worth considering.

Building a successful business can be inherently rewarding, but when your personal balance sheet gets out of whack and you've reached The Freedom Point, it may be worth considering the risk you're shouldering and the options you have for sharing some of it.

Conclusion

Once you crest The Freedom Point, it's worth asking yourself why you're continuing to shoulder all of the risk. You have options for diversifying your wealth, and you may be even closer to a carefree life than you think.