Announcer (5s):

Welcome to the Maximize Business Value Podcast. This podcast is brought to you by Mastery Partners, where our mission is to equip business owners to maximize business value so they can transition their business on their terms. Our mission was born from the lessons we've learned from over 100 business transactions, which fuels our desire to share our experiences and wisdom so you can succeed. Now, here's your host, the CEO of Mastery Partners, Tom Bronson!

Tom Bronson (36s):

Hi folks. I need to give a quick disclaimer, before we start this podcast, the person you're about to hear was originally scheduled to be on one podcast, but the content was so good and the conversation went a little longer than most of our podcasts. So I made the decision to break it up into two podcasts. Part one this week and part two next week. So grab a pen and paper because you'll want to take notes and then enjoy the first half of my conversation with David hammer. Hi, this is Tom Bronson and welcome to maximize business value. A podcast for business owners who are passionate about building long-term sustainable value in their businesses.

Tom Bronson (1m 22s):

In this episode, I'd like to welcome our guest David Hammer. David is a very close friend who was an investor in one of my businesses that we exited in 2018. David is one of the best business and MNA attorneys I know, and he sat on my board for many years and even served as our general counsel. David is also one of the founders of Business Owners Ed, a nonprofit based here in the DFW area that provides an amazing education to business owners on how to grow, scale, and exit their business. David and his wife, Kay, loved baseball like Karen and I do.

Tom Bronson (2m 4s):

And Karen and I always make time to go to a ball game with them nearly every year. So I am so thrilled to talk with David today about business transactions. He's the best possible person to learn from. So perk up and take some notes. So welcome to maximize business value. David, thank you, Tom, for shaped the opportunity to talk about business and mergers and acquisitions and especially to talk to you. Excellent. Excellent. It's so good to have you. We gotta take in a ball game sometime next season. So assuming the strike ends well, you always have that, right. So, so can you give us a little history on your background and why you settled on business and M and a law?

David Hammer (2m 52s):
My undergraduate degree was accounting and several months before graduation, I accepted a position with Deloitte. One of my early assignments at Deloitte was to be the junior member of the due diligence team on the acquisition by Chase Manhattan, bank of doll finance company of the due diligence teams. There were three of us, went around the country doing short due diligence investigations of several dozen offices of doll finance as, as part of the overall due diligence investigation by chase and that acquisition. So that was my first introduction to M & A.
David Hammer (3m 32s):
I met my first attorneys in my lifetime while I was at Deloitte. I was intrigued with what they did. And when I began to consider going to Deloitte, after I obtained my CPA license, I started thinking about the aspects of the law, where knowledge of financial statements and accounting and tax would be valuable, settled on a business transactions. And it was much to my good fortune that the law firm that I joined after graduation from law school had two weeks before I arrived, picked up a New York stock exchange client, which was one of the largest companies in the world and mainframe software.

David Hammer (4m 21s):
And because I was the only one they hired that year, not having expected to pick up that client. I was thrown into everything that that company did. The securities were domestic and international software licensing. And most importantly, for my career at the mergers and acquisitions and being one of the largest in the world, it was a large acquire later, whenever it directed, redirected the focus of its business, it became a significant divestiture as well.

Tom Bronson (4m 51s):
There you were doing work on both the acquisition side and the divestiture side. That's correct. Wow. That is, that's a lot of amazing experience for a guy just out of law school, right?

David Hammer (5m 4s):
At the time that client was sold in 1987, I had personally been responsible for closing over 30 transactions for that New York stock exchange company.

Tom Bronson (5m 15s):
Wow. So boy, talk about jumping in the deep end. You know, you're not dabbling with small acquisitions here. You're doing a big acquisitions with, with, with a big publicly traded company. And, and what I love about this story, and one of the things you know, that I love about you is that you, you keep your CPA license current. And so when folks are talking with you about M and a transactions, you always have that eye toward what are the tax consequences, right. Okay.

David Hammer (5m 47s):
Taxes are one of the things that we all have to pay. One of the things that none of us likes to pay, but one of the, that are significant factors in the consummation of a business transaction.

Tom Bronson (6m 4s):
Yes. And, and you can help clients minimize those taxes while we have to pay them. There are ways to do that along as long as you think in advance and, and work with somebody knowledgeable. So we're going to get into all of that kind of stuff in just a bit, let's get into the nuts and bolts of M and a, a couple of weeks ago,
you spoke at biz owners ad like you do every year on the important things business owners need to know about selling a business. So in that talk, you said, and I, and I chuckled when I recall this, you said, and I wrote it down that there are three things that enable a business to be sold.

Tom Bronson (6m 45s):
What are those three things?

David Hammer (6m 47s):
Those three things are earnings, earnings and earnings. So, and when I formulated my biz owners, ed presentation, years ago, I came up with that line. Oh, and it was men at the time to be somewhat facetious. And it is, but you don't have to look any further than the PTE column of the wall street journal opposite every listed public company to see how important a factor that really is. And if it's the way public companies are valued at stands to reason that it will also be the way that private companies are valued.

Tom Bronson (7m 25s):
Well, and not only that, but so many business owners really don't understand valuation. And, and as a side note, you know, I completely agree with, you know, your assessment here, that earnings are the most important, or one of the most important things because nearly a hundred percent of transactions are based on earnings. You know, businesses are valued and, and transactions are made based on earnings. It's somewhere around 98%, 99% of all transactions are based on earnings, but in the interest of full disclosure, David has recently experienced a transaction that closed based on recurring revenue.

Tom Bronson (8m 8s):
Now I caution that recurring revenue transactions are very rare, but having recurring revenue absolutely improves business value. So why is that David?

David Hammer (8m 21s):
The, the reason is because most businesses start on January 1st and they have to make their first dollar in sales for that year. So every year they're starting from zero and, and building up to what their, their

cumulative operating result will be with a, a business that has annual recurring revenue. They have contracts in place that obligate their customer base to pay them throughout the year. And so on January 1st of each year, they have enforceable contracts that allow them to predict the amount of revenue they will generate from those contracts over the next 12 months, many cases and predictability, according to Jack Welch is the most, in fact, important factor in being able to manage a business effectively predictability avoidance of risk and profitability in that order was Jack Welch's quote, as it related to the, his management of general electric a public company.

Tom Bronson (9m 28s):
Right? So, so I want to back up and just give a little bit of an explanation here. The, when, when an offer comes on a business, it's based on past performance, but that's not what the buyer is buying. They're not buying the past performance. They're looking at the past performance as an indicator of the future, that what they're buying is the future performance and the future cashflow of that business. And having recurring revenue makes that future business way more predictable than ha than selling widgets. And, and as David said, you sell a hundred widgets last year.

Tom Bronson (10m 8s):
Well, you got to sell a hundred this year just to match last year and then, and then have growth with recurring revenue. It falls in that category like, like a Warren buffet would say it compounds it compounds over time, and it continues to grow so long as you continue to retain customers. And a recurring revenue just gives that I would say outs, but it's really pounds of predictability to a buyer that the revenue is going to be there into the future rather than having to go out and produce, am I, am I capturing that? Well enough,

David Hammer (10m 44s):
The narrow sliver of businesses that are valued on recurring revenue are often described as software as a service businesses or SAS businesses for short of you don't have to look any further than the regular checks that we all ride to apple for cloud services, with our iPhones or Microsoft for cloud services on one drive to see the shift among even very large companies toward an annual recurring revenue model, because they're, they're valued differently because they don't have to start at dollar one each year. They have a number of dollars already locked in

Tom Bronson (11m 27s):
What I loved about having a recurring revenue business and you and I together. And, and one of my businesses built their recurring revenue engine. And what I loved was on the first day of the month, you know, every month we push a button and it charges our customers. And I knew that everything I had was already paid for for that month, right. And that's a, that is a beautiful thing and helps business owners sleep at night. But, you know, certainly there are some nuances to creating a recurring revenue businesses, and we've got some expertise in that. And I happen to believe that every business can have some component of recurring revenue. Sometimes you just have to think a little deeper to get there.

Tom Bronson (12m 8s):
So, so we could talk about recurring revenue all day. Why is it important to carefully think about legal structure of a business long before the business anticipates in exit?

David Hammer (12m 23s):
The, the most important reason is the taxation of the exit, your tax consequences vary depending upon the type of organization that you have and your buyer's tax consequences will be dependent upon the type of structure of, and the transaction that they undertake given the, the form of organization that you chose. So it is, it is largely tax driven.
Tom Bronson (12m 53s):
So, so give us some examples of the different types of tax structures that you can have for a business. And, and, and perhaps what that might mean in a transaction.

David Hammer (13m 5s):
The easiest way, I think to understand the, the tax consequences of any transaction is to think about two different aspects of any business. The first aspect is ownership, and whether it's stock in a C Corp or an S Corp, or whether it's a partnership interest in a partnership or a membership interest in a limited liability company, that's that's ownership. And that's one way that a business can be sold is through the conveyance, by the individual owners of their ownership, interests in the business. Oh, the second possibility for acquiring a business by any buyer is to simply buy the assets of that business.

David Hammer (13m 54s):
So when a buyer buys assets, rather than deal with the individual owners of ownership, interests, the buyer deals with the entity and the tax consequences can vary depending upon the type of entity that you have. There was a, a change in the internal revenue code about 15 years ago that has, has made the purchase by buyers of assets, of any entity, the preferred method for acquiring company. And the reason is because our economy is according to the wall street journal, about 70% service-based service-based businesses typically don't have massive amounts of buildings or machinery or land.

David Hammer (14m 44s):
They don't have large amounts of fixed assets. And because the internal revenue code requires bars, sellers of assets to allocate purchase price on based on categories of assets, the buyers and a service business can allocate most of their purchase price to intangibles and Goodwill. Now, those two categories are capital assets taxed at capital gains rates to the entity of buyers. And this is the code provision that made this so prevalent buyers have the ability to write off the purchase price of those businesses over 15 years, to the extent that purchase process allocated to intangibles at Goodwill.

David Hammer (15m 31s):

So it doesn't hurt the seller to do assuming they're in the right organization, doesn't hurt the seller to sell assets, and it's a tremendous benefit to the buyer. And so buyer and seller ownership interests are aligned unless you're talking about one particular type of organization where I'm selling assets is penalized, but type of organization is that that type of organization is known as a C corporation. The audience is probably familiar with C corporations and S corporations. The, the reason they took on those names is because of the particular sub chapters of the internal revenue code that deal with the tax consequences of those entities, C Corp's are dealt with in subchapter C and escorts are dealt with in subchapter S and if you want to talk about taxation of partnerships, you could facetiously ask what subchapter that is.

David Hammer (16m 31s):

It's not subchapter P it's Chubb sub chapter K for whatever reason, but if you're a C corporation and you sell assets, your entity is subject to taxation. Oh, up until the tax reform act of 2017, the tax rate on the entities gain on that transaction was 34%. When the after tax proceeds are distributed to the shareholders of the C corporation, the shareholders pay another 20% in tax. And so if you're a C corporation and you have a buyer who wants to amortize purchase price over 15 years of you have a really difficult negotiation, because the buyer just won't give up the tax benefits of amortizing, intangibles, and Goodwill over 15 years.

David Hammer (17m 20s):

And you as a seller, don't want to get taxed twice. So it's a, it's a tremendous problem if you're a C Corp attempting to exit. So you got to have those things clearly identified and agreed to in the transaction. Yes. And, and the problem with the organization piece of it is that that probably almost always needs to be done right up front. Many times upfront is not the point at which owners began to contemplate the sale of their business. Sometimes owners will start a business work for several years and then decide. And if they happen to form as a C Corp, initially now they're in a certain amount of difficulty in attracting a buyer that, oh, we'll give them a favorable tax result at exit

Tom Bronson (18m 13s):

C corpse versus pass through entities and, and everything else. The S some chapter ass LLCs, you know, limited liability partnerships, things like that. Those are all passed through a corporate, right?

David Hammer (18m 27s):

Yes they are. And what pastor means for the audience is those entities pay no tax on their operating results, the ownership, or the operating results of those entities pass through to the individual tax returns of all of the owners of the entity has an obligation to inform the IRS what those pro-rata allocations of operating results are. They do it on a form called form K one, and each individual has the responsibility for including their pro-rata portion of profits and losses on their individual tax return. And the IRS will check.

Tom Bronson (19m 8s):

Yes, they do. Yeah. So most business owners, if they're a pass through entity, they're getting K ones and things like that. But if they're, if they're not, if they're a C Corp, then they're not. Now, I typically advise clients. We work with clients typically three to five years before they attempt to, to go to exit. But one of the first things I have them think about is go and visit with your attorney and CPA and look at your tax structure to make sure that it's the most efficient, because I want them to do that as soon as possible. But you know, the reasons why, why would you want to do that at least five years before you transition a business?

David Hammer (19m 48s):
The, the primary reason for five years is if you are a C corporation, you have the ability to change your tax status from C Corp, where the entity pays tax every year to S-corp Congress, didn't much like the idea of being deprived of double taxation. And so they wanted to make it difficult for people who started as C to change to S and so they devised a concept called built-in gains. And what that means is if you sell your business within what is now, five-year period started off as a 10 year period.

David Hammer (20m 32s):
But if you sell your business within five years after you change from a C to an S you still have to pay double tax on your built in gain. So you determine how much built-in gain there is. As of the date, you make your election to change from C to S and that amount sits out there as a calculation. And if you sell your business within five years, you pay tax twice on the building gang.

Tom Bronson (20m 59s):
So it's commonly referred to as a look back, right? Is that the IRS does a look back for those years so that you could be potentially taxed on that? That's why

David Hammer (21m 12s):
Correct. Yeah. They keep track of the, they keep track of a timeframe that has elapsed between when you change from C to S and when you sold your business. And if you do that within five years, they will come calling, looking for a built-in gain. And there they're double taxation on built-in gain in your deal. Because to the extent of that built in gain are treated just like a C Corp having sold your S selection has ignored.

Tom Bronson (21m 45s):
So that's why it is so important folks to look at that. Now there are reasons why businesses are and should remain C Corp's. I'm not going to get into any of that stuff here with David, but, but it's, it's always worth investigating and doing it as early as possible. Let me give you a little side story on that. You know, the, the company that David invested in that I had was an S-corp, I'm currently an LLC with an S-corp tax election, but, but it was an S Corp. And through the years we took on additional investors and inadvertently, we took on a non-qualifying investor, a foreign entity as an investor in our business.

Tom Bronson (22m 32s):
And inadvertently then we were immediately became a C Corp in the business. Now, had we been intentional in thinking about this, that was in 2010, had we been intentional about thinking about it? We could

have avoided that if we'd paid attention, but we didn't pay attention until it was too late. And so when we sold, we were a C Corp. However, we were one of those fortunate C corpse that when the tax laws changed in 2017, it had our, the after detailed analysis from the buyer, they decided to switch from an asset purchase to a stock purchase.

Tom Bronson (23m 16s):
And therefore we were able to avoid the double taxation now. And the good news is, is we had, we had some carry over loss that would have eaten up at least a portion of the, of the game that we had in the business. But, but it was very fortunate for us that the tax laws changed when they did, and it caused our buyer, which was a publicly traded company to rethink their tax strategy and, and give us the benefit. So, so it can even happen to people who are savvy about this stuff. So paying attention to what it is, and visit with your attorney and CPA about what the most tax efficient structure of your business should be.

Tom Bronson (24m 0s):
And take action on that right now, because if you sell this business in the next five years, and you convert from a C to an S-corp, it could be detrimental to your tax situation. So, yeah, yeah, enough said about that. That would probably went further than I wanted to in that line of questioning, you know, solid let's, let's talk about more things that that business owners should think about directly from your talk. So solid financial statements to me are the cornerstone of any well-run business. And you have some thoughts about financial statements. What do you think about financial statements as it relates to running a business and selling a business?

David Hammer (24m 44s):
You, you stated that a little bit earlier that the best predictor of future success in a business is past success. Oh, unless you have timely and accurate financial statements, your buyer is unable to predict the likelihood of your future success. So financial statements are essential to knowing where you've been, how you're currently doing, where you're going, every buyer looks at it. There's also an old saying that is true outside the M and a context. And that's the fact that you can't manage what you can't measure.

David Hammer (25m 25s):
And if you don't have financial statements, you are not measuring your operating performance. And if you're not measuring your operating performance, you can't manage your business information is essential.

Tom Bronson (25m 38s):
I agree completely. You actually use the term in the talk. And I love this, that the financial statements are the scorecard.

David Hammer (25m 47s):
Yes, they absolutely are. And you, you don't even have to think about how important the score is. Would any

of us spend what it takes to go see a baseball game? If the parties announced in advance, they weren't going to keep score. Nobody would do that. Keeping score is essential. And, and you say that in an athletic context, and it's, it's humorous to the point of ridiculousness. Oh, and yet there are still people in business who don't produce timely financial statements.

Tom Bronson (26m 23s):
I, you know, honestly, I'm astounded by the number of business owners that I talked to, you know, because we talked to lots and lots of business owners every day, every week, every month here. But the number of them that don't see a financial statement until their tax return is produced every year. And I, and I always ask the same question, how are you your business? How do you, how do you know what you're doing? If you really don't look at financials or folks that don't get financials for four months after the end of a period, you know, I always say, look, a financial statement is a history book.

Tom Bronson (27m 4s):
It tells you what you've done, and it can give us some indication of where you're going, but it is a history book. And, but you can't act on history unless you have that information in a timely fashion. So you may discover something that happened last month that you can fix. If you have your financial statements early in the month, that, that if you don't get your financials for another six or eight weeks, then that time period has lapsed. And there's nothing you can do to kind of change the outcome. So it's sort of like, you know, so many businesses, don't budget, I'm a big fan of budgeting because that gives us something to measure our scorecard against.

Tom Bronson (27m 47s):
Right? And so, so I'm just fascinated by business owners that don't really manage their financials. But I think it sort of goes to my next question, and that is many small businesses use cash financial statements as opposed to a cruel. So what do you recommend cash or accrual financial statements, and why?

David Hammer (28m 7s):
Let me take a step back and make one comment on timely financial statements for the audience. Timely financial statements are typically finalized 20 days after the end of the calendar month being reported upon. So if, if you're in the 20 day window, you're doing everything you should be doing in the context of preparing timely financial statements. If, if you're waiting three or four months of those are not timely. And as a result, they are reduced to ineffectiveness in terms of using them for managing your business, same way with a budget. Don't wait until halfway through the current year to adopt a budget.

David Hammer (28m 47s):
You adopt the budget before the current year commences with her.

Tom Bronson (28m 52s):

Well, so before, well, before you go on, I do want to make a comment about that because I hear so many times from business owners. Well, it's just too hard. There's just too much to do. They can't produce the financial statements. You, you say the 20th day, my rule is the 15th day. You should have your financial statements by the 15th and to any business owner who says they can't do that. I challenged them because in our last business, the business that you and I owned together, along with our other shareholders, we had our financials by the eighth day, every month, every month. And it was because our finance team was disciplined and closing the month down, making the accruals that needed to be made, making sure that all the billing was done, all of the bills were captured.

Tom Bronson (29m 43s):

And we had, they produced a draft statement now, by the way, that business had three operating divisions in three, so three different types of businesses that we were in. And we had a consolidated financial statement. So we looked at all of those individual units and on a consolidated basis. So we had our draft financial statements by the fifth of every month and our division managers, our GM's of each of our divisions, the retail restaurant and winery divisions had two days to comment and, and ask questions and make changes. And the statements were finalized on the faith on the eighth day, so that we had timely financial statements at, you know, that we can act on eight days after the close of the period.

Tom Bronson (30m 32s):

And so, so to me, any business owner says we can't do that. We did that. And we had a three person finance team running a middle-market company. And so, so it's all about discipline. It's all about having a process to follow, to close it. Every company on the planet can produce financial statements that fast you're giving them. I think you're giving them a pass by saying they have to have it by the 20th.

David Hammer (30m 59s):

I'm attempting to accommodate the companies that are heavy and inventory. Many of those companies will get an invoice dated the last day of the previous month, the second week of the following month, under gap accounting, they would need to record that invoice in the last months operating expenses, but they can't do that if they don't get it till 10 days after the end of the month. And so a lot of them will, will not meet the timeframe that you're talking about just because they have those kinds of really significant billings that come in to them that need to be recorded as expenses in the prior months.

David Hammer (31m 42s):

But they can't be because they don't know about them until they get them.

Tom Bronson (31m 46s):

Yep, absolutely. So, so, so there are some reasons to, sorry, now back to our original question cash versus accrual and cash versus accrual. Yeah. So w which do you recommend and why

David Hammer (31m 59s):

Accrual accounting is generally accepted accounting principles. Every other form of accounting is not, oh, whether it's cash basis tax basis modified cash slash tax basis. None of that is generally accepted accounting principles. Public companies are required by law to present their financial statements on the accrual basis. The IRS permits cash basis, accounting for smaller companies. And I believe the threshold for permitted cash basis. Accounting is 10 million in annual revenue. Once you surpass that threshold, even the IRS requires you to go to accrual basis accounting.

David Hammer (32m 46s):

So it's probably better and easier to start with accrual basis accounting than it is to start with cash basis accounting, and then attempt to convert at some later date.

Tom Bronson (32m 60s):

Oh no, to me, it's really about managing the business and using a cruel. It gives you a much clearer picture about what's going on with the business, because there might be cash events that move. You know, you, you get a, a, you make a payment on next month early, or you receive a payment a day late cash just makes it more difficult to, to manage what's going on in the business. In my opinion, now pay your taxes on cash if you want to. But if for most small businesses, they use QuickBooks, it's a button, push the button, manage your business based on an accrual basis, which is the generally accepted accounting principles or gap that folks have heard about.

Tom Bronson (33m 44s):

And it just makes it easier to see what's going on in the business too many times. I look at folks that are using cash basis financials. And I can't tell what's going on in the business because they're they're billing, but their cash doesn't come in. And so they only account for it once they receive the cash. I can't tell how the business is doing because the clients are just not paying us on the day we invoice for the products. Right?

David Hammer (34m 13s):

You can't tell how it's doing because you don't know what you don't know. You don't know. What's not there.

Tom Bronson (34m 19s):

That's, that's exactly right. And so, so, so manage your business, using a girl. And if you're a client of ours, you already know that, but if you're not a, and you become a client of ours, I'm going to make you do it anyway. So you might as well start. So, so, Hey, you mentioned something else in that talk and you, you talked about the number one reason that businesses fail. What is that? David?

David Hammer (34m 42s):

The number one reason that privately held businesses fail is that they simply run out of cash. That's a documented fact, going back decades, they simply run out of cash.

Tom Bronson (34m 58s):
Yeah, she is king. So many times folks run out of cash in their business and you can't cash is the lifeblood of a business. You can't run a business without cash. You can't pay for the lights. You can't pay for your people. Can't pay the rent. You can't pay yourself. And, and cash is so very important to understand that that's perhaps why so many business owners want to use cash counting, but now we use the accrual accounting, but always monitor the cash. I'm a big fan of KPIs as well. And setting up those key performance indicators or metrics they use to measure your business. You know, when David met me and, and throughout the, my entire career, the first thing I want to know as a business owner every day is what is my cash position.

Tom Bronson (35m 49s):
I want to know how much cash is in the bank. What is committed? What is, what is our AR so that I can formulate an opinion about what our cash is, what payrolls are coming up, things like that, but it's, but it's the most important metric that I always followed is what is cash? And if it's not going up, then I've got a potential train wreck coming. You know, I also use cash forecasting and our clients use cash forecasting. Now we were a little bit more diligent about this because we had, we were doing a lot of acquisitions. So we had future payments. Many of our sellers were giving us, we were requiring them to carry a seller note.

Tom Bronson (36m 31s):
And I knew that I had notes due in quarters that were coming up. So we actually projected our cash for three years. We did a 36 month cash projection so that I would see a cash shortfall coming long before I came. And it's easier to solve a cash shortfall. If you see it three months or six months in advance than it is when you find out that morning that you have no more cash. Am I right?

David Hammer (37m 1s):
All goes back to using financial statements to manage your business. One, one financial statement, especially that is often overlooked in privately held businesses is as the statement of cash flows. It's the, the third financial statement required under generally accepted accounting principles after the balance sheet and the income statement. A lot of, lot of entrepreneurs don't use the statement of cash flows the way they should, because the preparation of it is, is relatively complicated. But if, if you master the use of that statement, it's a very effective tool managing cash on a month to month basis.

Tom Bronson (37m 44s):
Yes it is. Yes it is. Yeah. Well, and it gives you an indication of where your cash is going and where it's coming from, right? Yes. And that's so very important to running any business, certainly a small business. So, so folks, you heard it here first, the number one reason, small businesses fail is, is they run out of cash. Don't let that be. You manage your cash appropriately. That doesn't mean managed by the checkbook, but it means to manage the cash, know where it's going, where it's coming from and, and pay attention to that. Hey, one last question. Before we cut to a break here, let's talk a little bit about risk management. So what

types of risk should every business owner be concerned about?

Tom Bronson (38m 25s):
Pretty much all the time. And of course, as they're thinking about an exit strategy,

David Hammer (38m 31s):
The one that is of most concern to most of my clients is the customer concentration. Having any customer whose revenue comprises more than 15% of your total revenue is a threat to your business. Oh, that customer can realize how important they are to you. And they can demand pricing concessions that customer can run into difficulty and you lose that revenue and your businesses in trouble. It is very, very important to manage your customer base so that no customer comes to dominate your business.

David Hammer (39m 15s):
I'll offer you my own version of the old saying about pools and boats. The happiest day in your life is when you get the biggest customer in your space. The second happiest day of your life is when you get rid of them. That's precisely. The reason is because customer concentrations are a tremendous threat to your business because you can't control what goes on in that customer. And yet their size relative to your business's size can control you.

Tom Bronson (39m 46s):
Yes, absolutely. Now, are there some, there are some other kinds of risks cost. Now, by the way, you use the rule of thumb 15%, I would argue that, that you should be able to measure your profitability by customer right now, that is, that assumes that you're, you're able to do that and use your financial statements in your financial accounting software, to be able to do that. I argue that I might have a 20% customer that only accounts for 10% of my net profit or my profitability. And I would argue that that customer does not put me in as higher risk as a 20% customer.

Tom Bronson (40m 26s):
That's driving 20% of my profitability, right?

David Hammer (40m 29s):
But the 20% customer that's driving, 10% of your profitability might be one. You want to get rid of exactly. It's a lower margin customer by definition,

Tom Bronson (40m 39s):
If you're lucky enough to, and this never happens, but if you have a 20% customer driving 50% of your margin, then, then, then you're doing something, right. So

David Hammer (40m 49s):

Get them super bowl tickets. Exactly.

Tom Bronson (40m 51s):
As you should. So awesome. Now, what about other risks? Like suppliers,

David Hammer (40m 56s):
As far as the part concentration is, is a concern as well, especially if you're in a manufacturing business, if you're in a manufacturing business and you have a, a supplier of a component that is essential and the automobile companies are experiencing it right now, as it relates to semi-conductors, if you don't have multiple sources of supply, you can be shut down for one of inventory of the components necessary to produce the product that you're selling. So having sources of multiple sources of supply is very important. You can play favorites, nothing wrong with that, but buying enough from multiple sources of supply to keep all of them interested in your business, protects your business in the long run.

Tom Bronson (41m 45s):
I agree. I agree. How about a bank? Are there risks associated with banking

David Hammer (41m 52s):
Once upon a time? We didn't think so. And maybe once upon a time goes all the way back to 1929, whenever we had the first massive bank failures in the 20th century, since then, we've had a number of banking crises when banks got into trouble because of the composition of their loan portfolios, defaulting borrowers, and, and the like, and that's the reason why it's important to cultivate multiple bank relationships. Very, very much along the lines of multiple suppliers, because you just don't ever know whenever your bank will get in trouble.

David Hammer (42m 34s):
And if your bank does get in trouble, you don't want to be the customer whose loan is called. You don't want to be the customer whose loan is not renewed, and you don't want to be the customer whose loan rate goes up at renewal. So keeping multiple sources of banking relationships in your business is, is important. Every bank wants to be your exclusive bank, but what your bank wants is not always in the best interest of your business.

Tom Bronson (43m 5s):
On so many times, people don't have a personal relationship with their banker. You know, if you bank with a big bank, then it's probably the banker are do sure. Right. You know, the, they rotate people in and out. I say that it's so important to have a relationship with, with at least two folks that are stable in their banks. And typically that means smaller banks, right? It doesn't mean you have to go all the way down to the community bank. You certain certainly can because they didn't do a great job for you. But it's about, you know, banking is about relationships as well. And when, when it's down, and I remember a time when you and I sat in a, in

a local bank here that we were relatively unfinanceable, but we got financing from that bank because of the relationships that we had.

Tom Bronson (43m 55s):
And, and we spent a whole day looking at their agreements and, and whatnot together. But so it's important to develop that relationship before. The last thing is one of my favorites litigation risk. And let me, before you tell us a little bit about that, let me just tell you a fun story. When David was our general counsel and David's a business attorney, he doesn't do litigation, but he can certainly play in the right direction. When, when he first became our chief counsel, we had a little bit of a litigation matter that came up. And so I called David and said, who do you recommend? And he said, well, that depends. And I said, what do you mean? He said, do you want to settle this amicably? Or do you want to go for the juggler?

Tom Bronson (44m 37s):
And I said, well, I think I want to settle this one amicably. And so he referred me to an attorney that was able to do so if on the other hand, I wanted to go for the juggler. It would have been a different attorney that David would have referred me to, to, to do that. So I, that's kinda my fun story, but what about litigation risk as it relates to, to business value and, and, and selling a business,

David Hammer (45m 3s):
It's often said that litigation is simply a cost of doing business. My question is it really, there are, there are certain things that you can do, like documenting process and procedure behaving consistently as it relates to employ relationships and the, like that significantly reduce your risk of litigation. But if despite your best efforts, you find yourself heading toward litigation. You, you need to remember that litigation is not about truth, justice and fairness. It's about winning and losing and winning and losing comes with a cost.

David Hammer (45m 47s):
The lawyers for both litigants do really well. The litigants don't do so well because they're usually paying the lawyers and people who litigate over the principle of the matter are asking for extended attorney bills over an extended period of time, not to mention the time out of their schedules that have to be dedicated to the litigation itself. It's generally an UN unprofitable position. My advice as a business attorney to clients has always been litigate only over six figures or their survival of the business.

David Hammer (46m 29s):
In 2013, a long client of mine was sued in a family dispute over a business. And the, the plaintiff actually was seeking the breakup of the business. Well, that's survival. And they spent several hundred thousand dollars in legal fees to survive totally justified, but short of survival, it's really difficult to justify that kind of attorney bill for just about any kind of dispute that you might have. One thing that I think has helped in that respect is a rule that's been adopted in Dallas county, for sure.

David Hammer (47m 10s):

And perhaps even throughout Texas, that requires business disputes to be after filed with the court to be submitted to mediation. Oh, I never did think much of mediation as a technique because it's voluntary. And if the parties haven't able to agree to the point where one is filing a lawsuit, I didn't understand how they could be persuaded to agree in a mediation setting, but I've seen it happen twice of in seemingly intractable family business disputes. And if it can happen in those circumstances, it can happen anywhere.

David Hammer (47m 52s):

But the point is you don't have to follow lawsuit in order to avail yourself to mediation. If, if you believe that there's a possibility of resolving a dispute, take every opportunity to do it before you get to the courthouse. And don't wait until somebody files and you have attorneys with a vested financial interest in controversy because anytime anyone has a vested financial interest in controversy, there will be controversy. And the lawyers will be the beneficiary.

Tom Bronson (48m 22s):

Yes, they will. And I, you know, I would, I would love to sit here and share with you my own stories on that. These are lessons I had to learn the hard way. I so hope that you enjoyed the first half of this conversation with David hammer. You can find David hammer at DW hammer dot DW hammer, co.com. And you'll hear the second half of this amazing interview next week. You won't want to miss it. This is the maximize business value podcast, where we give practical advice to business owners on how to build long-term sustainable value in your business. Be sure to tune in each week and follow us wherever you found this podcast.

Tom Bronson (49m 6s):

And give us a comment or suggestion. We'd love to hear your suggestions on a future podcast. So until next time, I'm Tom Bronson reminding you that if you listen to this podcast, there's a lot to know before you pull the trigger on that exit strategy. But in the meantime, keep maximizing business value

Announcer (49m 30s):

Tuning into the maximize business value podcast with Tom Brunson. This podcast is brought to you by mastery partners, where our mission is to equip business owners to maximize business value so they can transition on their terms on how to build long-term sustainable business value and get free value building tools by visiting our website, www.masterypartners.com that's master with a Y mastery partners.com

Tom Bronson (50m 15s):

That was perfect. I wouldn't make any changes.