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Private vs. Public Securities; Exiting Means Liquidity

Owners of privately held companies often times have the majority of their wealth tied to their business. These owners are well served in understanding the challenges faced in converting an illiquid asset into cash. For example, unlike the valuation and liquidity for a publicly traded company, the value and ability to cash in a privately held business is a more subjective and complex matter. This newsletter is written to highlight the differences between public 'liquid' and private 'illiquid' securities. By having this level of understanding, owners can more accurately understand the differences between private and public stock ownership and the challenges faced with turning their illiquid business stock into cash that they can use in retirement.

No Open Market Exists for 'Illiquid' Shares

The most obvious difference between 'liquid' and 'illiquid' company shares is the lack of an established 'open market' through which shares can be traded for cash. When a company's shares are owned by the investing public and there are shares traded on an exchange, then liquidity has been achieved and the owners of those shares can cash in at any time, based on the current market price.

Privately held businesses do not have this luxury. In fact, the owner of a privately-held company needs to, in effect, create their own market for the sale of their shares. Buyers need to be identified and a valuation will be based on a negotiation that takes place during that process.

Private Ownership = Ultimate Control

So, while there is a sacrifice to liquidity for a private business owner, the advantage is being able to enjoy the benefits of control over their business. In fact, private company owners often do not report the performance and activities of their business to anyone except for the government and, perhaps, their bank. By contrast, if your business was publicly traded there would be requirements to report on a regular basis the company's performance to non-controlling shareholders.

Private Business Ownership Limits Portfolio Diversification

A private business owner pays a certain price for control in the form of personal risk. That owner has a concentration of personal financial risk within one investment, their business. By contrast, holders of publicly traded shares can buy and diversify their holdings, creating an investment portfolio that insulates their wealth from industry/segment-specific fluctuations.

A Lifestyle vs. an Investment

An important difference between public and private ownership is in the management of a business and the owner's motives. Public company management motives are fairly simple—increase shareholder wealth by producing the highest possible profit in order to increase the price of the stock. To the public shareholder, the entity is a mere investment.

By contrast, private company managers and owners are usually one and the same. And ownership represents a whole lot more than an investment; it's a personal wealth builder. For instance, the private manager will often-times look to 'suppress' the profitability of a company in order to manage his or her personal tax liability. Beyond tax savings, the owner enjoys lifestyle benefits, such as a company car, additional compensation, premium benefits, extended vacations, and the personal satisfaction that comes with complete control over the entity.

Balancing the Benefits of Private Ownership with the Need for Liquidity

So the advantages of control and privacy are off-set by a lack of liquidity. These contrasting points come to a head when it is time to design and execute an exit plan from the business.

In order to attract a buyer for your company's shares, an owner will need to disclose how their business is run – this includes the good, the bad and the ugly of how you handle your company's management, strategy and finances. The owner also needs to accept that many of the perks of running the business will come to an end for them someday. For many owners, it is a challenge to share with others how your privately held business is run. Think of the analogy of selling your home – the place where your family lives and memories are made – and then the uncomfortable process of having strangers parade through your living area with judging eyes determining if they too want to live there one day.

The way that an owner can balance the privacy that they enjoy with the need for future liquidity is to set a plan for their future exit and understand how and when certain items will be disclosed.

Concluding Thoughts – Making Your Private Business Marketable to Someone Else

The exit planning process is about anticipating the needs and demands of your future owner so that you can prepare yourself and your business for this transaction and transition. An effective exit plan recognizes both the benefits and limitations of private business ownership. A well-prepared owner will not only understand these differences but will be in a position to explain them to a future buyer – much the same way that public companies disclose their business dealings. Such preparedness helps to assure the protection and preservation of the wealth that is 'trapped' within your privately held business.

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