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When Selling To Insiders Cash Is King

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If you contemplate transferring your business to an insider (employees, children or co-owner) and you want to get paid the value of your business, then, generally speaking, the value of your business cannot exceed four times or five times the true cash flow of the business.

The Definition of Cash Flow

What is “cash flow?” You've probably heard others say that your sale price should be a five or six multiple of your cash flow. Well, that all depends on the definition of “cash flow.”

The devil truly is in the details, or in this case, in the definition. There are several definitions or measures of cash flow, each with a potentially significant and substantive difference. Typical measures of cash flow include:

- **EBIT:** Earnings Before Interest and Taxes.
- **EBITDA:** Earnings Before Interest, Taxes, Depreciation and Amortization.
- **True Cash Flow:** The amount of pre-tax money distributed to owners via salary, bonus, distributions from the company such as S-distributions, and rental payments in excess of fair market rental value of the equipment or building used in the business.

Each of these measures of cash flow can produce a different cash flow amount. Add to these measures, the need to recast cash flow by using “add backs” such as excess rents, salary or bonuses paid to the owner and his or her family.

We have defined true cash flow as the amount of pre-tax money distributed to owners via excess salary, bonus, distributions from the company such as S-distributions, and rental payments in excess of fair market rental value of the equipment or building used in the business.

Let's look at how cash flow determines the sale price to insiders.

Christine Roberts, owner of three floral shops, desired to sell each of her shops to each of the three store managers. The total "true cash flow" was $250,000 per year and Christine wanted $1.5 million, pre-tax, for her three businesses which, in total, grossed approximately $1.5 million. She had heard that "six times cash flow" was a fair way to value her type of a business and $1.5 million happened to be what she needed to meet her financial exit objectives.

Let's assume that Christine's employees want to buy her business. Let's further assume that these employees share a trait common to most employees including, probably, yours: *They don't have any money*. That cold fact limits the purchase price Christine can look forward to receiving.

The payments Christine's employees make must come from the business. Her employees do not have enough money, nor can they borrow — without exit planning — the purchase price. These employees take the post-sale cash flow of $250,000 deduct taxes from that distribution and then pay Christine the net after-tax proceeds of approximately $150,000 per year ($250,000 cash flow less 40 percent in combined federal & state taxes equals $150,000 of net after tax cash flow).*

Christine pays a capital gains tax upon receipt of the $150,000.

It will take Christine ten years to receive full payment of the $1.5 million purchase price. This, of course, assumes that Christine is willing to wait 10 years for full payment (an assumption no sane business owner would make).

And let's not forget interest. Assuming that Christine would insist upon being paid interest on this long term promissory note, consider that a $1.5 million promissory note using an eight percent interest rate (compounded monthly) and limiting total payments to $150,000 would take just over 10 years to pay.

The bottom line

Cash flow cannot support a purchase price at the level desired by the owner. If, however, the purchase price is reduced to $1 million, Christine can be cashed out in just under seven years. If that time period is still too long, Christine can employ other exit planning tools and designs (along with the more realistic purchase price) not only to reduce the timeframe to perhaps four to five years (or even less in some circumstances) but also to receive the full purchase price. How? That method is the topic of a future issue of this newsletter. For now, remember that the future cash flow of your business determines — and — limits what you can expect to receive if you sell your business to an insider.

** Tax rates vary depending upon applicable federal and state taxes.*

advice that you need.

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