Cash Flow Forecasting: The Ultimate Reality Check

You understand why third party buyers as well as sellers of closely held companies think cash flow is important. Without a healthy cash flow, buyers will likely move on in favor of purchasing a "good" company with less risk.

Let's Start with a Definition of Cash Flow

Business cash flow is the portion of the annual net cash flow from operating activities that remains available for discretionary purposes (after the basic obligations of the business have been met). Because we are discussing cash flow in the context of exiting your business, the "discretionary purpose" referred to above is the purchase of your ownership in your company.

How to Forecast Cash Flow

Orders have started pouring in. Revenue is skyrocketing. Your hard work and dedication are starting to pay off. Your business is growing, but is the *value* of your business growing? Top-line revenue growth doesn't tell the whole story. Is the value of your business also growing, or are you just churning more dollars without a commensurate increase in profit, cash flow, and business value?

In a sale to insiders (employees, co-owners, or children), cash flow may be the source-the sole source, at least initially-of payments to you. Insiders may not have enough money of their own with which to pay you. Without significant planning and implementation, insiders may not be able to quickly acquire or borrow that cash. So you can see why having a cash flow forecast is critical.

If you choose instead to sell to a third party, the valuation upon which buyers make their offers is likely to be based on a multiple of cash flow.

First, Prepare a Cash Flow Projection

Let's say you plan to sell part or all of your business in Year 1; your advisor should make cash flow projections for Year 1 through Year 5.

If you are preparing your own cash flow projection, resist the temptation to create an overly-optimistic forecast. Your projection must be grounded in the reality of actual past performance rather than in your hopes for the future. To avoid this temptation, owners usually ask their advisor to create these forecasts.

With a realistic cash flow projection in hand, you can begin to plan the most tax-effective way possible to achieve that future cash flow.

It bears repeating here that the future cash flow of the business may be your buyer's only source (at least in the early years) of funds to pay you. If the company, under new ownership, cannot achieve the cash flow numbers that you project, you may not receive the payoff that you expect.

Second, Calculate Cash Flow Allocation

Forecasting cash flow is the first step. The second is to calculate how that cash flow will be allocated during the ownership transition. Determining the net after-tax distribution to you is the goal of this exercise.

To do so, you must calculate, for each year of your exit plan period, the expected available cash flow reduced by: 1) reasonable compensation to you, and 2) the cash the company must retain (for growth, working capital, etc.).

The remaining cash flow is distributed to the shareholders, you, and - to the extent you have sold part of your company - the new owners.

New owners use that distributed cash to pay you for shares of ownership. If the projected cash flow to new owners is insufficient to pay you through an installment note, your exit is at best temporary.

Cash Flow Forecasting is Foundational to Planning Your Best Exit Strategy

A successful exit plan minimizes taxes for both seller and buyer and keeps sellers in control (and minimizes their risk) until they receive full value for their ownership. All plans begin with an informed understanding of current and future cash flow and require considerable planning and action to achieve these goals.

Your plan is founded on your exit objectives (when you want to leave, how much money you want and need, and who should own the business after you) and on the likely future cash flow of the business. Forecasting the amount of cash flow and determining how that cash flow is used is, indeed, the ultimate reality check for your business exit.

For more information or to learn how L. Harris Partners can help you plan your exit:

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