Cash Flow: How Critical is it to Planning Your Exit?

We have often said that cash flow is "king" for a closely held business. But with today's low interest rates, the abundance of private equity capital, and a slowly improving economy, some may wonder whether this emphasis on cash flow is outdated. It's not. In the day-to-day world of planning for privately held companies, cash does still matter. Furthermore, it's still the top attribute sought by buyers.

What Makes Cash Flow So Important?

Cash flow is especially important when you're planning to transfer ownership to insiders (e.g. children, employees, co-owners). Cash flow is the fuel that powers the entire transition process. While surveys disclose that a large percentage of owners plan to sell the business to an outside 3rd party, a large majority won't be able to locate bona fide third-party buyers and will, instead, sell to insiders.

Essentially, business cash flow is the amount of the annual net cash flow from operating activities that remains available for discretionary purposes or reinvestment in the business. As you consider a transition out of your business using any type of ownership transfer method, it is imperative that you secure an accurate future cash flow projection.

Why? In a sale to insiders, cash flow may be the source -- the only source, 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.

Should you plan to sell part or all of your business beginning in any given year, you'll most likely start by using an objective approach to convert anticipated future business performance to a projected cash flow for at least five subsequent years. This analysis requires a combination of top line business forecasting (revenue) with bottom line cash flow results of operations. Working with a qualified advisor to do this analysis gives it a credibility and reliability that a mere guess just doesn't have.

If you prefer to prepare your own cash flow projection, resist the temptation to create an overly-optimistic forecast. You will only be fooling yourself in the long run. Buyers will separate fact from fiction. Consider best-case and worst-case scenarios and the results that derive from each. Your projection must be grounded in the reality of past actual performance rather than through colored glasses. To avoid this temptation, we encourage owners to work closely with a highly skilled financial forecasting advisor.

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, during and after a transition to new ownership, cannot achieve the cash flow that you projected, you will likely not receive the payments that you expect.

How Will You Use Projected Cash Flow?

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

To do so, you must calculate, for each year of your exit plan implementation, 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; this means you and--to the extent you have sold part of your company--the new owners.
New owners may use some or all of their share of

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 on a reasonable timeline, your exit will be, at best, temporary.

Finally, a word about your "risk free" business partner - the IRS. A successful exit plan minimizes taxes for both seller and buyer and keeps sellers in control until they receive full value of their ownership. All plans begin with an informed understanding of current and future cash flow and require considerable planning and action to achieve owner goals. Commonly used, non-controversial tax-minimizing strategies can help keep more cash in the stream heading toward current and future owners, making an exit potentially more achievable. Keep in mind that cash flow utilization strategies and tax minimization strategies over a period of time can be combined to provide you with the value you want and need while efficiently putting the company into the hands of your intended successor owner, with you in the driver's seat all the way.

Your exit plan is founded on your exit objectives (e.g. 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. Projecting the amount of cash flow and determining how that cash flow is used is the ultimate key to the success of your exit.

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

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