Reducing Risk Now Will Pay Off at the Closing Table

When considering the idea of selling your company, it's important that you understand the risk / cash flow relationship will always be the main consideration of the company's value. Depending on the size of the company, Seller's Discretionary Earnings (SDE), EBITDA or EBIT are all standard levels of adjusted cash flow that potential buyers will look at as the basis for determining value.

Ultimately, it's the present value of future cash flow that a potential buyer is purchasing. The buyer also has to assess the risk associated with the company's ability to generate that future cash flow. To determine cash flow, the Income Statement should be normalized by adjusting for discretionary (personal), non-recurring, and non-business related expenses. These items are often referred to as add-backs or adjustments. Traditionally, larger companies usually have very few "adjustments" during the normalization process, whereas smaller companies generally are the opposite.

It is easy to mistakenly make the assumption that the more cash flow, the more valuable the business. This is not necessarily true. For example, if you have a company with a declining sales trend and a variety of "personal adjustments", such as auto, travel, entertainment and non-operating salaries, to their Income Statement, this would indicate a significant financial risk. The business would likely be valued lower than another company with cleaner financial records (fewer "adjustments").

As a business owner, it is important to understand that risk will impact your company's value. Risk can come in many forms such as financial risk, management risk, technological risk and industry risk to name a few. But wherever risk can be identified, the severity of that risk will have an effect on the company's value in one way or another. Since profitability and resulting cash flow is the most significant driver of a company's value, it is important to eliminate as much risk associated with the company's cash flow as possible in advance of selling your company.

If you are considering the idea of transferring your business ownership, make one last investment before you place the company on the market. Take the time to prepare the company for sale. Organize your facilities (inside and out), re-negotiate vendor contracts, reduce customer concentration, secure key employees, and most importantly clean up the company's Income Statement. A well-organized company and clean set of Tax Returns showing strong profits will significantly improve the value of your company. Do not let increased taxes be an excuse! The increase in value resulting from your time and effort in preparing the company for sale will far outweigh the taxes you will pay.