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Ask a VR Intermediary

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How will Reducing Risk Pay Off at the Closing Table?

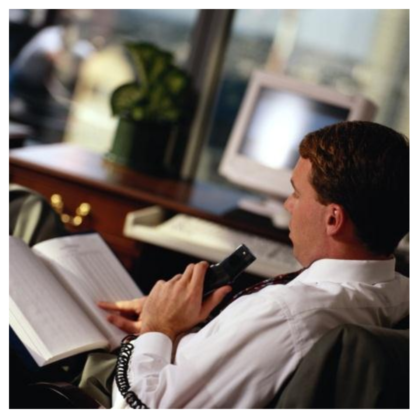
When considering the idea of selling your company, it's important that you the owner (and your business intermediary) understand that the relationship between risk and cash flow will always be the main consideration of the company's value. Depending on the size of the company, Seller's Discretionary Cash Flow, EBITDA, or EBIT are all standard levels of cash flow (adjusted) 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 subject company's ability to generate that future cash flow. When determining cash flow, normalizing the Income Statement is generally the first step, where the subject company's Income Statement is normalized to eliminate or adjust for discretionary (personal), non-recurring, and non-business related expenses (add backs or adjustments are common terms for these items). Traditionally, larger companies usually have very few "adjustments" during the normalization process, whereas the smaller companies generally are the opposite.

It would be likely to make the assumption that the more cash flow there is the more value there is but that's not necessarily true. Here is an example where there are two companies being listed for sale and both are identical in every area except risk.

Here is a summary of the Income Statements for each:

	Company A	**Company B**
Sales	$5,000,000	$5,000,000
COGS	$1,000,000	$1,000,000
Gross Profit	$4,000,000	$4,000,000
SG&A	$3,750,000	$3,950,000
Taxable Income	$250,000	$50,000
Excess Officer Sal.	$250,000	$250,000
Depreciation	$150,000	$150,000
Interest	$100,000	$100,000
Auto		$50,000
T&E		$50,000
Non-Op Salaries		$100,000
EBITDA	**$750,000**	**$750,000**



After normalization, both have an EBITDA of $750,000. When looking at the Income Statement of Company A, we find that the only adjustments made were excess Officer's Salary, Depreciation, and Interest (where Depreciation is a non-cash charge and the buyer is purchasing the subject company on a debt free basis). When looking at the Income Statement of Company B, we find that in addition to excess Officer Salary, Depreciation, and Interest, there is an additional $200,000 worth of adjustments, which include personal auto expense, non-business related travel & entertainment, and non-operating salaries (for the owner's family).

In the scenario above, which company do you think has more value? Company A would be the correct choice. Company A has cleaner financial records and cleaner financial records result in less risk, which leads to more value. Let's say in this same example that Company B has been in a declining trend for the last two years, where Sales and EBITDA have dropped by 25%. Combine that trend with the $200,000 in additional adjustments and you have significant financial risk, which might result in a very conservative valuation.

Let's take the same scenario accept change the dynamics. In this example let's assume that both companies are identical including the $750,000 in EBITDA where the only adjustments being made are excess Officer Salary, Depreciation, and Interest.

The Income Statements for both companies are shown below.

	Company A	Company B
Sales	$5,000,000	$5,000,000
COGS	$1,000,000	$1,000,000
Gross Profit	$4,000,000	$4,000,000
SG&A	$3,750,000	$3,750,000
Taxable Income	$250,000	$250,000
Excess Officer Sal.	$250,000	$250,000
Depreciation	$150,000	$150,000
Interest	$100,000	$100,000
EBITDA	**$750,000**	**$750,000**
Top Customer	40%	8%

In this example Company A generates 40% of its annual revenues from the same customer. When compared to Customer A, the top customer represents only 8% of annual sales. Which company is more valuable? Company A carries more risk because of a customer concentration issue. If Company A were to lose that key customer, $2,000,000 of annual sales (and corresponding profit) would be eliminated, something that the company might have a hard time recovering from in a short period of time. This increased risk would likely result in a lower value. You might think that this would be an obvious result, but you would be surprised the number of people that might overlook this key piece of information.

As a business owner or business intermediary the one key element to remember is that risk will impact a 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 (above and beyond the general risk associated with investing in privately held companies) 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's important to eliminate in advance as much risk associated with the company's cash flow as possible before selling your company.

If you're considering the idea of selling your company, make one last investment before you place the company on the market. Take the time to prepare the company for sale. Common activities include organizing the facilities (inside and out), re-negotiating vendor contracts, reducing customer concentration, securing key employees, and most importantly cleaning up the company's Income Statement. All of this may take anywhere from one to three years, but it's worth it. A well-organized company and clean set of Tax Returns for three years showing strong profits will significantly improve the value of a company. Don't 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'll pay.