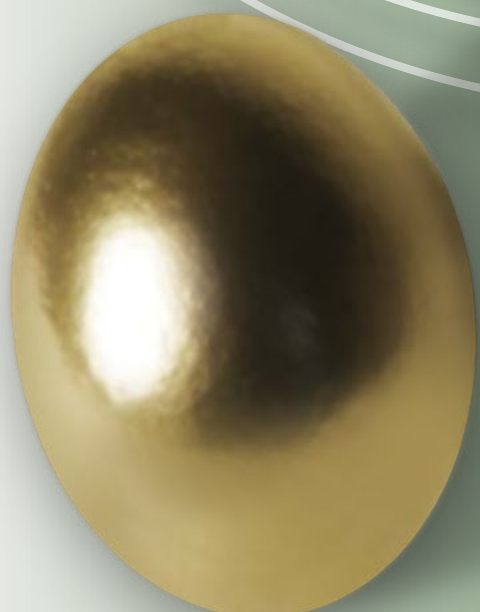
Stuffing the Golden Goose

Because Your Company may well be Your Retirement Plan



A step-by-step resource to help you determine when to sell your company, and for how much

by Chuck McKay

Why Sell the Golden Goose?

As a business owner you need an exit strategy. It should be the next thing you do, even if you only started the company yesterday.

You see, we're entering a period of great opportunity.

Incredible opportunity.

So many options that we'd best start looking at our goals and choosing the path, which will take us there, and not somewhere else.

At some point, most of us look forward to taking equity from the firm for our own personal reasons. To travel. To endow education. Go back to school. Support a cause. Provide for family members. Start a different company.

But without making the "when" decision, how will you know which of the incredible opportunities to pursue?

Determining your cash needs at closing are the first step in transitioning the Golden Goose into your biggest retirement asset. And that's what the resource you're holding will help you to do. Fill in the blanks to determine "how much," then choose your "when."

Now you have direction and parameters in which to guide your company.

I wish you great success.

Your Fishing for Customers Guide

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Your Company

Time Horizon

How much time do you have to prepare your company for sale? Three years can be enough. Five to eight years is much better.

The same factors which make your company attractive to a buyer will also make it a valuable asset to hold and operate long term. So, the goal becomes developing a company that buyers are eager to pay top dollar for. Perhaps you'll sell. Maybe not.

My name is Chuck McKay. I'm a business consultant, in the field of marketing. I'm a specialist in helping the owners of professional practices and owner operated businesses to boost their top line sales and grow their companies. A few years ago business owners started coming to me to help them get to specific growth goals in order to take maximum cash out when they retire.

And when looking at what makes a company ultimately saleable, I've found that it also makes that company healthy in any economy. Here's what buyers want:

Predictable Cash Flow

Buyers look at the dollars and cents invested in the purchase of your company as the price of future flows of free cash landing directly into their pockets. How much cash will there be? How sure are you? Historical earnings are the best evidence.

Consistent Growth / Few Surprises

Warren Buffet, likely America's best known investor, ranks predictability of revenue above every other factor. Great variations in income show a company subject to changes in the economy. Or worse, ineffective management reacting to those changes rather than planning for them.

Operational Excellence

This is a philosophy which measures key processes, and uses systems to improve those measured performances.

I can help with the first two. You have to handle the third.

OK. Your systems are in place? Good. Let's calculate your selling price. We'll start with the cash you'll need to maintain your lifestyle.

Your Retirement Plan

Determining Your Selling Price

Whether you've taken it as "salary," or as "profit," the income you've been pulling from your company will have to be replaced. For the purpose of this discussion, let's say you're currently paying yourself $125,000 per year, and that's the income you want to maintain after the sale.

Income

There are two ways to turn the cash from the sale of your company into long-term income.

The first is to assume you'll live directly off the proceeds of the sale, maintaining your lifestyle by spending the cash you received at closing.

Of course, miscalculating your life span could be catastrophic. Assuming that you need income until you're 90 years old could leave you in desperate circumstances should you live to be 98. And health issues become more likely as you age. They will require more of your resources.

Finally, spending the principal makes it harder to leave some wealth to your heirs.

Sum to Invest

A far safer strategy is to leave the principal untouched. Instead, invest a sum into future cash streams which are sufficient to support oneself. How much? That's pretty much a function of the lifestyle you presently lead.

And, of course, interest rates. Forget what you used to think you could get from a cash investment. That all changed in the great recession. Today, the reality of ROI to expect from your cash will be close to 4.0 or 4.5 percent.[1]

So, to replace your current $125,000 annual salary while leaving the principle untouched, you'll need to invest a sum of $3,125,000.

"Selling your company is very much like killing the goose. It ends the income stream you've been living on."

Your Company

[1] Your actual return will be, in part, based on your risk tolerance. Seek the advice of an investment counselor.

Commissions, Accounting, and Legal

But you can't simply sell for $3,125,000, because you won't get to keep it all.

You'll need to pay the broker a sales commission of approximately 5.5 percent.[2] Add another 2 percent for lawyers and accountant fees. Humm. The number you need has now increased to $3,400,000.

Taxes

And, the proceeds of your sale are taxable.

Cash at Closing	**$4,370,000**
- Less Federal Taxes	655,500
- Less State Taxes	262.200
- Less commissions	240,350
- Less professional fees	87,400
Net Proceeds of Sale	**$3,124, 550**
Invested at 4 percent	**124,982**

Fortunately for you the bulk of the equity build-up in your company will be considered capital gains.

At the federal level this will be taxed at the lesser 15 percent, rather than at the higher straight income rate.[3] If you live in a state which levies taxes on your income, you'll pay roughly 6 percent.[4]

So, working backwards you'll need $4,370,000 to retire with enough cash to maintain your current lifestyle for the remainder of your life. After legal and accounting fees, sales commissions, and taxes you'll be left with that $3,125,000 figure we started with.

Of course, the figures we've been playing with are purely hypothetical. Let's take a look at your specific needs.

[2] Commissions are always negotiable, but typically, 6.0 percent for the first $3,000,000, with a reducing percentage for sums above that amount.

[3] There are tax advantages to structuring the payout over multiple years. Often this involves additional risk on the part of the seller. Discuss this, and all selling options with your financial adviser.

[4] If you live in Alaska, Florida, Nevada, South Dakota, Texas, Washington, or Wyoming, you'll get to keep 6 percent more of the total, reducing your necessary sale price to only **$4,107,800**.

Your Retirement Plan

Cash Needs Worksheet

Step 1: Enter the annual income you'll need to replace once you leave your company.

$__________ Annual Income

Step 2: Divide the sum in Step 1 by .04 - which is the sum you'll need to invest at 4 percent to produce the income in Step 1.

$__________ Sum Needed to Invest

Step 3: Multiply the sum in Step 2 by 1.15 to include the amount you'll lose to Federal Taxes.

$__________ Investment Sum before Federal Taxes

Step 4: Multiply the sum in Step 3 by 1.06 to include the amount you lose to State Taxes. Skip this step if you live in Alaska, Florida, Nevada, South Dakota, Texas, Washington, or Wyoming.

$__________ Investment Sum before State Taxes

Step 5: Multiply the sum in Step 4 by 1.02 to include legal and accounting expenses.

$__________ Investment sum before Federal and State taxes, and before legal and accounting fees.

Step 6: Multiply the sum in Step 5 by 1.055 to allow for sales commissions.

$__________ Investment sum before taxes, professional fees, and sales commissions.

Your Company

The Earnings Multiple

The single most important factor in determining a company's value to a prospective buyer is future profits. Your buyer will use those profits to repay his investment in the purchase of your property.

The formula is quite simple: $\textbf{Years to Recover Investment} = \dfrac{\textbf{Cash Invested}}{\textbf{Net Annual Earnings}}$

The shorter the payout, the greater the buyer's return on investment. If a buyer pays 5x earnings, he expects your company's profit to repay his original investment over five years. One fifth of that investment each year equals a 20 percent return.

If he can buy your company for only 3x earnings he can have his investment back in only 3 years. That equals a 33 percent return on investment.

There's Not a Thing You Can Do about the Multiple

Cash flow multiples are yardsticks created by buyers to compare your offer to what other companies similar to yours have sold for.

For most businesses the multiple is somewhere between 2.0x and 5.0x earnings. In general:

1x, or Less

Small personal services businesses in which the owner plays a critical role in "rainmaking," and makes the day-to-day decisions about the operation. Once that owner is no longer in the picture, the risk goes up. 1x the last year's net profit should be the high end of your expectations of cash at sale.

2x – 4x

Profitable companies with no competitive advantages, stiff competition, and few hard assets, but succeed due to the skills of the management team, will find buyers in the 2x – 4x earnings range. The majority of small businesses fall into this range.

5x – 7x

A good market position with competitive advantages and efficient operation will generally bring 5x to 7x earnings. The company's systems will produce revenue regardless of the skills of the management team.

8x – 10x

Investors paying 8x to 10x earnings will expect to purchase the market leader with rock solid earnings. There will likely be barriers to entry such as licensing or educational requirements.

A table of common cash flow multiples follows. As always, get advice from a professional.

Your Retirement Plan

Specific Earnings Multiple Examples

	Business Category	Multiple	Notes
1	Advertising Agency	0.75 - 1.0	May Require Earnout
2	Auto Repair / Auto Body	2.35 - 2.4	Add back real estate and equipment
3	Collection Agency	0.25 - 0.4	
4	Construction Company	4.0 - 6.0	
5	Child Care	1.0 - 3.0	Alternate: $1,000 - $2,000 per enrolled child
6	Dental Clinic	0.6 - 0.9	Multiple may be of accounts receivable
7	Dry Cleaners	2.0 - 2.3	Alternate: 0.7x - 1.0x accounts receivable
8	Employment Agency	1.0 - 2.0	Alternate: 0.5x accounts receivable
9	Engineering / Architectural	0.4 - 1.0	May add back value of furinishings and equipment
10	Funeral Home	1.5 - 2.0	Plus value of hard assets (furniture, fixtures, equipment)
11	Gas Station (full service)	0.2 - 0.4	Alternate: 2.0x - 3.0x earnings
12	Golf Course	3.5 - 4.0	Golf revenue only. No food or beverage sales in total.
13	Hair Salon	0.7 - 1.0	Alternate: 0.3x plus furniture, fixtures, and equipment
14	Internet Service Provider	0.8 - 1.5	Alternate: $200 per individual subscriber, $400 per business account
15	Janitorial Service	0.3 - 0.4	Alternate: 2.0x earnings
16	Landscaping	1.0 - 2.0	
17	Law Practice	0.4 - 1.0	
18	Medical Practice	0.2 - 0.6	
19	Motel	NOTE:	Current rule of thumb: $20,000 per room. Varies with region.
20	Pest Control	0.7 - 1.2	
21	Property Management	0.4 - 0.75	
22	Publishing	3.0 - 6.0	Alternate: 0.7x accounts receivable
23	Real Estate Brokerage	0.2 - 0.5	Alternate: $10,000 per agent
24	Restaurant (family)	0.3 - 0.5	Add back real estate and equipment
25	Restaurant (fast food)	0.3 - 0.4	Add back real estate and equipment
26	Travel Agency	0.03 - 0.08	

Now, armed with this rudimentary information on common multiples, let's tackle the Probable Selling Price worksheet and determine for how much you'll need to sell the company.

Your Company

Probable Selling Price Worksheet

Step 7: Enter your most recent 12 months trailing net sales

$_________ Annual Income

Step 8: Enter your estimated Cash Flow Multiple

X_________ Cash Flow Multiple (estimate)

Step 9: Multiply Annual Income from Step 7 by Cash Flow Multiple in Step 8

$_________ Preliminary Estimate

Step 10: Enter estimated value of hard assets, furnishings, and equipment

$_________ Asset Value

Step 11: Add Asset Value from Step 10 to Preliminary Estimate from Step 9

$_________ Estimate of Business Valuation

The Cold Hard Truth

Oh, my. This isn't good. You've determined that you need to sell for, say, $3.5 million. But the multiple for companies in your industry is 4.0x. And your company's earnings are $550,000.

At 4.0x earnings, $550,000 produces a quick valuation of $2.2 million.

Your $2.2 million, after Federal and State taxes, after commissions, after professional fees, will leave a net of $1.573 million. Invested at 4 percent, this sum will yield a perpetual $63,000 each year. Ouch.

Can you live on half your former income?[5]

A good broker can help you to build a case for your company being worth more. But to reach $3.5 million you'd have to find a buyer willing to pay 6.4x your earnings. That's just wishful thinking. Seriously, what kind of story would be so compelling that a buyer will pay so much more than a comparable company in the same industry?

[5] It's possible you have an additional $2,000,000 in savings and can make the disappointing $2.2 million sale price work for you. Most of us don't, and can't.

Your Retirement Plan

To fully fund your retirement with the sale of your business, you're coming up short $2.13 million dollars. That's $62,000 per year you won't have.

Perhaps you'll draw another $30,000 annually from Social Security. A step down from $125,000 to $93,000 isn't the worst possible outcome.

But it is so unnecessary. Because an influx of new, profitable customers solves the problem. Increase your revenue and earnings and you can still walk away with enough money to last the rest of your life.

The difference between the $4.375 million you need, and the $2.2 million you're likely to get is $2.175 million. At your industry's 4.0x multiple of earnings, that additional $2.175 million could be yours simply by increasing your company's profitability by $544,000 per year.
You're going to need to double your net sales.

How much time do you have before you plan to exit?

- In anything other than a start-up situation, doubling gross sales in one year is virtually impossible. Your business is not a startup. It simply can't happen in a single year.
- Doubling sales in three years is possible, provided you can become 26 percent more profitable in each of those years. A good advertising program coupled with efficient operation could make a three-year gold achievable.
- Over five years doubling sales quite do-able. Your company will need to increase net profit by 15 percent each of those years.

You'll Need Two Things to Reach Your Goal

You'll need time. You'll need ways to find and attract new, profitable clients.

Can your company grow 15 to 26 percent more profitable each year for the next 3 to 5 years? Regardless of your answer, you'll recognize this as a marketing issue.

And that's where a proven marketing consultant can help.

Let's plug in your numbers calculate your growth needs and timetable, and see how much help you'll need.

Your
Company

Cash Flow Shortfall Worksheet

Step 12: Enter cash needed at closing from Cash Needs Worksheet, Step 6

$_________ Cash Needed at Closing

Step 13: Enter Estimate of Business Valuation from Probable Selling Price Worksheet, Step 11

$_________ Estimate of Business Valuation

Step 14: Subtract Estimate of Business Valuation (Step 13) from Cash Needed at Closing (Step 12)

$_________ Value Shortfall

Step 15: Enter Cash Flow Multiple from Probable Selling Price Worksheet, Step 8

X_________ Cash Flow Multiple

Step 16: Divide Value Shortfall (Step 14) by Cash Flow Multiple (Step 15)

$_________ Annual Earnings Shortfall

Step 17, the Final Step: When do you wish to exit your company?

_________ Date you intend to exit.

_________ Years Until Exit.

To sell your company for enough cash to last the rest of your life, you need to increase your net sales by the Annual Earnings Shortfall in Step 16, and do so within the number of years in your final step.

Your
Retirement
Plan

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