

## **Cash Flow Forecasting: The Ultimate Reality Check**

In past issues of **The Exit Planning Review™**, we have looked at why cash flow is so important to third party buyers, and by extension, to sellers of closely-held companies. In short, a seller must demonstrate an increasing stream of cash flow from the business. Without a healthy cash flow, a buyer may pass over the opportunity to buy your business in favor of purchasing a "good" company with less risk.

In this issue, we will examine why cash flow is also crucial to those owners who wish to transfer their companies to insiders (employees, co-owners or children) and how to allocate cash flow.

Let me suggest the following 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.

As you prepare to transition out of your business (using any type of ownership transfer other than liquidation or, in some cases, a gift of the company to your children), it may be imperative that you secure an accurate future cash flow model. Why?

In a sale to insiders (employees, co-owners or children), cash flow may be the source of the buyer's payment to you. The future cash flow of the business after you have left it 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 suddenly acquire that cash or the ability to borrow any.

If you choose instead to sell to a third party, the valuation upon which any offer will be made may be based on a multiple of cash flow.

Should you plan to sell part or all of your business beginning in 2008, you, or better yet, your CPA, will need to make cash flow projections for 2008, 2009, 2010, 2011 and 2012. If you are preparing your own cash flow projection, you must resist the temptation to create an overly-optimistic forecast. Your projection must be grounded in the reality of past actual performance rather than in your rosy hopes for the future. For this reason, owners usually ask their CPAs to create these forecasts.

Once a realistic cash flow projection is prepared, you will use it 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 projected, you may not receive the payoff that you expected.

### **How to Use the Cash Flow Forecast**

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 (excluding payments to the business owner) less the cash the company must retain (for growth, working capital, etc.). The remaining cash flow is paid to you as compensation (salary, bonuses, and/or deferred compensation) or it is distributed to the shareholders (you, and to the extent you have sold part of your company, the new ownership). The distributions received by the new ownership, less taxes of 35 percent to 40 percent, is then paid to you.

The cash flow you receive is the sum of:

1. compensation, bonuses and deferred compensation;
2. payments for stock sold to new ownership; and
3. distributions of cash flow based on your remaining ownership.

The net after-tax annual cash you expect to receive combined with your non-business income sources (such as retirement plans, personal investments, etc.) must be sufficient to support you after you leave the business. If the combined amount (business and personal) falls short of meeting your lifetime income/financial needs, your departure date must be delayed or your financial expectations must be adjusted.

Your Exit Plan must integrate your exit desires (*when* you want to leave, *how much money you want* and need, and *who should own* the business after you) with the reality of the likely future cash flow from the business. Forecasting cash flow and the uses of that cash flow is, indeed, the ultimate reality check for your business exit.

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