

How Cash Flow Impacts the Sale of a Business



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Appraising a business can be approached from a number of different directions, including book value of assets, capitalized income and discounted future earnings.

One practical step to take, especially when selling a small business, is to look at cash flow in relationship to debt coverage. Unless the purchase is in cash, the buyer will most likely seek a bank loan. The seller might also provide some of the financing, especially when the intangible value is significant.

Bank loans are based on the values of land, buildings, equipment, inventory and other tangible items. Land and buildings can be mortgaged with a loan of up to 20 years, but everything else will require a shorter term because of quickly diminishing value.

The bank might do two loans – one for the building and another for all other business assets. Accounts receivable are considered an asset if they are transferred to the new ownership. These are not loaned against dollar for dollar, so only a portion can be financed. The age and quality of the receivables also affect their value.

As part of the loan process, the bank officer will evaluate the last three years of tax returns from the business. Discretionary items, current interest payments and noncash expenses such as depreciation and amortization are added back to net income.

This adjustment is applied to all three years, and an average is determined. The officer then sees whether this cash flow from operations is sufficient to cover the proposed debt payment.

This debt will include loans from the seller. To make a loan viable, the debt coverage ratio must meet a certain threshold, usually 1.25. To calculate the ratio, divide annual cash flow by the total annual sum of current debt. If the ratio is below the threshold, the loan will likely be denied.

In some cases, if the buyer can present a compelling case as to why their management will significantly improve operations, the bank might approve it.

The question of loan approval aside, buyers need to create a cash flow for their own purposes. Although they are purchasing an ongoing enterprise, they have the latitude to operate the business any way they choose.

This could mean additional investment or increased efficiency. When a business is in a mature or declining stage, it often has areas that can be improved. For example, perhaps the former owner has been absent while the new owner will be on site, thereby reducing some payroll costs.

As part of the due diligence process, each expense item needs to be examined to see if it can be improved. New quotes for insurance, inventory, advertising, professional services and other expense items can be obtained.

Sometimes rent can be negotiated for a break during the first few months of transition. Pricing can be checked to see if it is accurate, with a first indicator the ratio between sales and cost of goods sold. Sometimes businesses experience leakage of revenues that aren't booked.

The final cash projection will help the buyer determine whether this business is a good investment. Not only should it generate enough cash to pay expenses and loan payments, it needs to compensate the new owner. A healthy profit will also ensure there is money for reinvestment and growth.