Business Owners: Are you asking the right questions? (Part 1)

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If you're a business owner, you've likely spent years, possibly decades, building your business. No doubt you've poured your heart, soul and much of your finances into making your business successful. Unfortunately, if you're like most business owners, you probably haven't spent much time planning to capture the value you've created in your business. That is, you probably don't know how you're going to sell your business…

Over the next decade, approximately 6 million US business owners will attempt to sell their business. But most owners expect to simply be able to sell their business when they are ready, and don't spend adequate time planning their exit. As a result, data shows that less than one-third of these owners will be successful and these owners will leave millions of dollars on the table when they choose to sell. **So let me ask you, how much money are you willing to leave on the table when you leave?**

If your answer to that question is a resounding "None!" keep reading, because in this first part of three blogs, we're going to review the three key questions you must understand before you consider selling your business.

Question #1: How Much Do I Need from a Sale of My Business?

For me to work with owners on a plan to sell their business, I require them to consider three questions. The first is this: "How much do I need to sell my business for?" In other words, they must know how much money they will need in retirement to be financially independent. But your answer to this question will require both a thorough understanding of your annual expenses, and how much wealth you need to cover these expenses throughout your retirement.

A skilled financial planner is invaluable as you consider this question. They understand how to project the amount you need and how to adjust both your spending and savings needs for the future. If your retirement is expected to last the standard 30 years, a good rule of thumb is that for every $100,000 of annual cash flow you require, you'll need about $2.5 million of investment assets.

What are My Outside Investment Assets?

The next step is to understand the value of any investments you have outside of the business, such as a stock portfolio or real estate. This piece of information is vital since the greater your assets outside of the business, the less you'll need from the sale to be financially independent in retirement.

This information is also critical because, outside investment assets afford you leverage in negotiating the sale. For example, a business owner with $5 million invested in stocks, bonds and real estate has more leverage during negotiations than an owner whose only investment asset is their business. Inevitably, having this additional flexibility increases the value you will receive from the sale.

Here's a good example. Let's assume you have half your required assets in investments outside of the business, and you receive two offers from prospective buyers.

The first offer is on the lower end of our projected price range, but the buyer is willing to pay all cash. The second buyer, however, is willing to pay a significantly higher price. But this offer is a combination of cash, owner financing at above market rates and a small equity interest in the business.

Even though the price is lower, without your outside investment assets, you would almost certainly have to take the first offer. This is because the cash is guaranteed, while the second offer would unwisely put the financial health of your retirement in a company that you no longer control. But by having significant assets outside of the business, you now have the flexibility to consider the second offer, and the higher price, because it no longer generates unmanageable risk to your retirement.

What is My Business Worth?

You also need to know what your business is currently worth. Most owners believe they have a general idea of their business's value based on stories they've heard about the sale price of a "similar" business. However, they don't consider business specific factors such as the experience and independence of their management team or the diversification of their cash flows. These factors (and others) will significantly impact the value of your business.

Other owners base their ideas on a price multiple of their current earnings but don't realize how buyers would adjust their earnings during the due diligence process. If you're managing your financial statements primarily for income tax purposes, this will significantly impact on your earnings. For starters, consider removing all personal expenses from the books of the company and confirm your salary is what you would reasonably expect to pay someone else to do your job. This will increase the quality of your earnings, as well as the earnings multiple you can demand.

Finally, you need to understand the range of earnings multiples that will determine the value of your business. For example, if the range of multiples you should expect is between 3 and 6, and your current earnings are about $4 million, you should expect your sales price to be between $12 million and $24 million.

The next question is, how do you ensure your business is valued at the top end of that range? A business valuation consultant can be incredibly useful to help determine which characteristics will maximize the price you can achieve. As we've just shown, many of the factors that determine your earnings multiple will be within your control, and even small increases in this multiple can add millions in value to your ultimate sales price.

A thorough understanding of how much you need to sell your business for is the foundation for the sale of any business. In the next blog, we will examine the second critical question: Who do I want to sell my business to?

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