EVERGREEN™ EXITS

A DIVISION OF EVERGREEN WEALTH SOLUTIONS

THEORETICAL DOLLARS VS. ACTUAL DOLLARS IN YOUR EXIT

Millions of baby boomer owners are marching into retirement age with the majority of their net worth trapped in their illiquid businesses. These owners need to turn their illiquid business into cash or find another way for that asset to continue to provide income to them if they are to reach their financial goals. If you fit this description, then it is likely that one of the most important steps that you will take is to determine how and when you will be able to draw that cash out of the business. Therefore, knowing the value of your business is a likely place to begin your 'exit planning' process. And, while a professional appraiser has the ability to approximate the value of your business today, this newsletter is written to focus you on the critical

differences between a valuation that represents 'theoretical' dollars in your exit versus a buyer who represents 'actual' dollars in your exit.

Why the Valuation is Important

In short, an alarming number of owners do not know the value of their enterprise. Many owners overestimate what it is worth while a good number are also surprised on the upside to see that it holds a 'value' that exceeds their expectation. The valuation that you receive for your business is a very important factor in your overall planning. This number allows you to see the Value Gap, the amount between what you need to live on and what you have in business value (before fees and taxes) to see if you are 'in the ballpark' of affording to fund your exit.

Theoretic versus Actual Dollars

The value that you are presented with for your business is 'theoretical' – it is the approximate value that an experienced appraiser estimates your business to be worth. These are dollars that fit within a certain model to tell you how much value your company has generally

speaking. The value that is represented in your appraisal report does not represent 'actual dollars', i.e. dollars that a qualified buyer would be willing to pay to cash you out of your company.

Now, you may be thinking 'my business earns real dollars' so why are we referring to these as theoretical dollars? In fact, your company's cash flow represents actual dollars that are earned by your business today but the valuation is an estimate of what your company will produce in the future. Your cash flow is multiplied by a theoretical number that helps you understand the value of those future cash flows to another owner, which again is very helpful for planning purposes. However, it is important to remember that as experienced as your appraiser may be, he or she in all likelihood, is not representing the opinion of the riskiness of those future cash flows, as they are seen by a buyer who has cash to purchase your business. Further, unless your appraisal process includes an examination of the current marketplace for transactions similar to your own, it may not represent actual instances of where other companies have been purchased with actual dollars.

A good comparison of this difference and exercise can be seen in a typical budgeting and forecasting exercise. When business owners and their managers forecast into the future, they are looking to estimate what the business will look like in terms of revenues, expenses and profitability – these are theoretical dollars. However, once the sales happen and the products or services are delivered, those theoretical dollars turn into actual dollars – dollars that you can actually buy stuff with, and that is all the difference in the world. You see, forecasting and planning is important to organizing your business, however, it is the execution of those plans that is most important to actually achieving what has been put in writing.

How to Bridge the Gap Between Theoretical Dollars and Actual Dollars

In order to further know whether or not your theoretical dollars will turn into actual dollars, you can research similar sales of companies in your marketplace and try to determine the prices and 'multiples of earnings' that are being paid by buyers. This information, however, can be misleading and, if you're not careful, may lead you in a false direction. You see, privately-held companies do not disclose important factors regarding their business so it is very difficult in looking at other transactions in your industry to truly know whether your business should be valued higher or lower than the comparable that you are studying. In fact, a countless number of intangibles go into a buyer's calculation of value to simply draw a comparison to an approximate and likely purchase value for your business. That being said, a combination of the appraisers 'theoretical' dollars, supported by information that you can draw on

‘market transactions’ will help you gain some confidence and begin to bridge the gap between the theoretical and actual dollars.

While you are conducting this research you should remember that experienced professionals who sell businesses are often available to speak with you [often at no cost] to discuss what they are seeing in the marketplace and in your segment today. Further, these intermediaries sometimes have access to other intermediaries to gather additional ‘inside’ information regarding a comparable transaction so that you can know how close your deal would be to theirs.

This newsletter would also be remiss in not mentioning that owners who want to have an ‘internal’ transfer to managers, employees and/or family, can also begin to ‘convert’ their theoretical dollars into actual dollars through the budgeting and forecasting process and knowing how much of the future free cash flow they will take for their own. Remember, however, that these dollars will remain ‘theoretical’ until the company performs in future years whereas ‘buyer dollars’ can become actual dollars that you can buy stuff with once you consummate a transaction[ii].

Concluding Thoughts

The sale of a privately-held business is often the largest financial and emotional transaction of an owner’s life. Therefore, knowing the difference between theoretical and actual dollars and how this difference may impact the success of your exit is critically important.Again, as we are fond of saying, a pro-active approach to your exit is the optimal approach. Along these lines, we encourage you to further think through the implications of how and when you will receive the ‘value’ for your business.

Are you ready for next steps?

Click to complete our Business Readiness Survey and connect with our team.

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