EVERGREEN® EXITS

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MEASURING THE ROI OF A PRIVATE BUSINESS

While most business owners focus on the annual profit or cash flow of their business, it is less common to devote time and attention to an equally important measurement: your business' return on investment. An ROI measurement can help an owner determine whether their business is not only providing them with a solid lifestyle, but also whether or not they are keeping pace with the competition and making the most of their 'risk-adjusted' returns for all of their wealth. Do you know if the risk-adjusted return on your business is high or low? Do you know if you are getting the return that the market would require for the risks that you take in your business? These are important questions because if you want to exit your business someday, a prospective buyer will base his or her buying decision on their expected ROI from the purchase of your business.

Has Your Business Provided a Return to You?

The ROI of your business can be measured by the financial gain provided to you over the years that you own the company. A simple calculation, provided on the following chart, can assist with understanding an answer to your company's ROI to you.

The Return on Investment in Your Company

Your private business' return on investment can be measured.

The ROI Calculation:

Potential Sales Price:		$ 8,000,000
Less: Fees & Taxes:		$ 2,000,000
		$ 6,000,000
Excess Draw/yr. *net of tax	$ 100,000	
X 15 years	15	$ 1,500,000
		Total Return $ 7,500,000

Initial Investment	Investment Time	Annualized Return
$ 200,000	15 years	27 %

As demonstrated in the chart, the owner of a business that can sell for $8,000,000, which had an initial cost of $200,000, has an annualized return on investment of 27%, when also factoring in the 'excess salary' each year. In this case, the exiting owner grew the business over a 15 year time period while also generating 'excess compensation' (compensation as an owner, not as a manager) for each of the years of ownership.

Will the Same Business Provide a Suitable ROI for a Buyer?

The same ROI calculation can used to measure whether or not a business will generate a return for the next owner. As an exiting owner, it is helpful to look ahead to show a buyer/successor the type of return that they can expect to get by owning the business. Having this knowledge will help you argue for a higher value when the time comes to engage with a future owner.

Put simply, a buyer or successor for your business is interested in what future return the business can generate for them, not necessarily what the business has provided for you in the past. As an exiting owner, you can improve their positioning in the succession planning process by determining what the buyer or successors' future expected returns will be and then describe the risks involved with generating those returns.

Knowing Your Buyer's Motives

One of the most effective ways to get comfortable with engaging buyers is to understand their motivations and the math behind their calculations. Because buyers and successors have many options for investment opportunities, an exiting owner needs to understand how and where they can be a competitive investment for the buyer.

Minimum ROI requirements for prospective buyers can vary by buyer type or fluctuate depending on other business deals available to that specific buyer. If a buyer has, for example, a 25% return expectation for your business, then they will adjust their pricing to get to that level of return. In order to reduce the potential to have a buyer lower their valuation, an owner can look to demonstrate a higher ROI by projecting what will happen in the future and selling that future story to the buyer.

How to Get Paid for A Future ROI

Owners often make the mistake of overvaluing their businesses because of their emotions and the potential that they see in the company. These

owners need to change their thinking to accept that an investor will have his or her own expectations and goals for future growth. And just because your business has provided you with a nice lifestyle, this does not mean that your future buyer will see it the same way.

The ultimate question then for you, the exiting owner, is not 'has my business provided me with a great lifestyle over the years?", but rather 'can my business meet the return criteria of a potential buyer or successor in my industry so that I can both get a deal done and get paid the value that I would like to receive?"

Concluding Thoughts

Understanding your ROI and the ROI that a future buyer can expect from owning your business is a valuable tool in designing a plan for your eventual business exit. It is therefore crucial for an owner to objectively, accurately, and fairly portray the company's ROI, both for himself and for potential successors. This is an important way that an owner can determine the true value and health of his or her business, and that a potential successor can make an informed decision to buy your business.

We hope that this newsletter has helped you to see that the exit from your business is the beginning of someone else's investment. The better job that you can do in explaining a buyer's ROI, the higher the likelihood will be of having success in your exit process.

If you have questions or would like to explore these ideas further, we'd be happy to connect. Reach out to Ed at ed@egwealth.com

EVERGREEN™ EXITS
A DIVISION OF EVERGREEN WEALTH SOLUTIONS
www.egexits.com Ed@EGWealth.com
1000 Commerce Park Drive, Suite 416
Williamsport, PA 17701
Phone: 570.601.6960 | Fax: 570.651.9032