Zachary Scott
INVESTMENT BANKERS

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Seller Math: The Missing Variables

Seller Math is a flawed economic argument often used by owners when considering a sale of their company.

by Mark D. Working

In our years as bankers and financial advisors, we have learned that financial returns are but one of a number of reasons that people choose to own and run privately held businesses. Often it is not even the leading reason. There is a line of thinking that we repeatedly encounter and have come to refer to as "Seller Math." It goes something like this—when an owner sells his business, pays the taxes, and invests the remaining proceeds, the expected investment returns are invariably less than the "profits" earned from the business. The conclusion often drawn is that if the investment income doesn't equal or exceed business earnings, then it doesn't make sense to sell (at least at that price).

Given our preoccupation with the economics of private business investment, we wince when a flawed economic argument is used as the basis for critical ownership decisions. In our view, Seller Math leaves certain key variables out of the equation including the difference between profits and distributable cash, management time, liquidity, and relative risk.

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APPLES TO APPLES

When calculating Seller Math, business owners often compare profits earned by the business to the potential returns expected from the reinvestment of the sale proceeds. The fallacy is that profits can't be taken home, only cash can. Continued investment in working capital or fixed assets and repayment of debt consume cash. Therefore, the cash available to shareholders of a business is usually quite different from its reported earnings.

TIME IS MONEY

Most successful privately held businesses require close management of all aspects of their affairs. For many owners, running the business is an all-consuming activity—both vocation and avocation. Some of the "profit" generated by the business may actually be payment for the time spent and, once the business is sold, the owner will be free to spend that time elsewhere. Owners are often surprised at how much it costs to replace their particular talents and experience. Somehow, the fact that the business owner would no longer have to spend countless hours at the business must enter the equation.

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ILLIQUIDITY HAS A COST

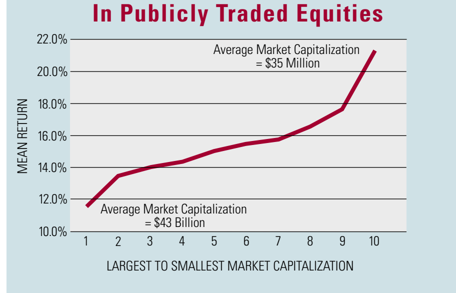
Selling a privately held business takes considerable time. Depending on the business' market position, its recent financial performance, and the continuity of the business in the hands of the next owner, it can take a minimum of six months to close a sale. If the business is under performing and/or has other issues or unique challenges, it may take longer or not be achievable at all. The value discount attributable to the illiquid stock of a privately held business may be quite large to account for the time and uncertainty of converting ownership to cash. Studies have demonstrated that liquidity discounts for control positions in privately held businesses are in the range of 15%-20%. If minority ownership positions are considered, the discount can exceed 40%.

The Seller Math dilemma is that it is impossible to trade an investment with an expected return in the range of 25% or higher into a less risky, more liquid investment and obtain a comparable earnings stream.

IT'S ALL ABOUT RISK

Financial markets reward investors for taking risks. Greater risk is expected to result in greater returns. For example, a treasury bond has an expected return in the 4%-5% range, whereas the return on a small-cap stock is expected to provide a double-digit return. This concept of relative risks is sometimes difficult for a business owner to acknowledge when applied to his/her own business. For the owner that lives and breathes the business (and its risks) every day, the risks are familiar and seemingly manageable. Most business owners don't have the opportunity to see a wide range of businesses because they are engrossed in their own. The fact is that small, privately held businesses are risky, and the numbers prove it.

Actual Returns Earned By Investors In Publicly Traded Equities



The above chart shows the actual returns earned by investors in publicly traded equities, segmented by size of business. The difference in returns is substantial and results from the higher perceived risk by investors in smaller, more fragile businesses. The smallest segment of the population in this study is businesses having an equity capitalization of

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$35 million. For that size of business, investors have earned (on average) annual returns of 21%. Equating this return to privately held businesses (using liquidity discounts), the return required by a control investor would be in the range of 25%-27%. Smaller companies would require even higher returns.

Ostensibly, this high rate of return reflects the fact that the risk inherent in small, privately held businesses is substantially higher than the risks associated with the investments that business owners are likely to undertake with proceeds from a sale. The Seller Math dilemma is that it is impossible to trade an investment with an expected return in the range of 25% or higher into less risky, more liquid investment and obtain a comparable earnings stream.

As business owners contemplate the economic trade-offs of selling their businesses, it is important to consider all of the variables that impact the relative risk and return of the investment in their business. ❖

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ABOUT ZACHARY SCOTT

Zachary Scott is an investment banking and financial advisory firm founded in 1991 to serve the needs of privately held, middle-market companies. The firm offers a unique combination of in-depth knowledge of the capital markets and industry competitive dynamics, sophisticated analytical capabilities, and proven expertise in structuring and negotiating complex transactions. For more information on Zachary Scott, please go to ZacharyScott.com.

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