

Balancing Business Owner Cash Flow and Business Value

Three key lessons when determining whether to reinvest or distribute cash



For business owners, trade-offs are often an inescapable, constant reality. A given day's choices might include approving a capital outlay, charting strategic direction, or setting corporate policies and procedures. Some choices won't have clear monetary costs, but the vast number could influence business value. That leads to the ultimate trade-off: reinvestment or distribution of the cash that the company has generated.

Many business owners can miss the subtleties of this trade-off. Some will generally reinvest in the business, while others will prioritize cash distributions. While there may be nothing wrong with the latter—it is perhaps the primary benefit of ownership—but it comes with a catch. All things being equal, the reinvestment-minded owner is likely to garner a higher exit valuation for their business because their consistent discipline has made the enterprise more transferable, more predictable, and more sustainable. Buyers generally pay up for those key attributes, so it's important to bear some key lessons in mind:

Key takeaways

- When owners pick their spots on the spectrum between distributing cash or reinvesting in their business, the truly wise ones take care that they are not diminishing future business value as they reward themselves today
- The reinvestment-minded owner is likely to garner a higher exit valuation for their business because their consistent discipline has made the enterprise more transferable, more predictable, and more sustainable

- **The transferability lesson:** Too many entrepreneurs try to do it all. They make all the decisions. They limit hiring (particularly at senior levels). They fail to emphasize robust systems and procedures. In the near term, those choices may yield more distributable cash, but there is usually a downside. Failure to invest in people and processes may make the owner indispensable—if the owner leaves, business value may suffer. That outcome could be avoided by building and engaging a multidisciplinary team, delegating authority, implementing good systems, and developing repeatable processes. These investments may slowly reduce the current owner's importance to the operation and make the business more easily transferable to a future owner. This sort of "turn-key" operation is generally far better positioned to maximize business value than an owner-dependent one.

- **The predictability lesson:** Predictable cash flow is often a cornerstone of value maximization. Think of software companies. They typically trade for higher price/earnings ratios than most other sectors because their license-based revenue models, and high switching costs “lock in” highly predictable future cash streams from a broad base of customers. Let’s look at the hypothetical example of a highly profitable contract manufacturing business. Significant distributions supported a great lifestyle for the shareholders, but purchase offers were disappointing when the owners decided to retire. The problem: over 60% of sales were to one customer who could easily switch to other providers. Consequently, the owners enjoyed current cash flow, but buyers couldn’t depend on future cash flows. Opting for lower distributions and directing cash toward new customer development could have diversified the company’s revenue stream, boosted cash flow predictability, and spurred investors to more appealing valuation levels.
- **The sustainability lesson:** Using a transportation company as another example, this business had a clearly articulated niche strategy and peer group-leading profitability that attracted many potential buyers, but passions cooled when they figured out that the company’s fleet was meaningfully older than the industry average. The reason: The seller valued cash distributions over fleet reinvestment. The result: The business didn’t fetch the top-of-the-market valuation the seller coveted. Buyers estimated the cash outlays to update the fleet and reduced their valuations accordingly. If they had lowered distributions to fund more regular fleet investment, the owners could have enhanced the sustainability of the company and perhaps achieved a higher valuation.

So, where do these lessons leave us? Simply put, growing business value is often an investing activity. When owners pick their spots on the spectrum between distributing cash or reinvesting in their business, the truly wise ones take care that they are not diminishing future business value as they reward themselves today.

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