The cost to get shares re-purchased in a Private Company is much greater than you think:

Rules of thumb to consider

Number One: whatever the share value is today, by the time they have been re-purchased (say over 10 years[1]), the total cash flow from total revenue will include:

- Tax on profits related to the principal purchase in any year; (Repurchase of shares is an after-tax allocation of profit.)
- Interest costs sustained over X years while the terms of the share purchase play out. While this is a deductible expense, the low(ish) tax rates for Canadian private firms translates into very little tax refunds for deductible expenses such as interest.
- The principal itself while not a deductible cost still represents a hazard because principal leaving a balance sheet means sustained weakness for many years.

All-in over 10 years, the total cash exit will be about 50% greater than the principal itself even after-tax credits for interest paid. ***Want to buy-back $1 million in shares?*** By the time you are done, the initial bill will be approximately $1.5 million[2]. However, because all this cash is leaving the balance sheet there is yet another cost: ***The opportunity of profit lost*** because of cash not staying on the balance sheet where it belongs.

Which brings us to rule ….

Number Two: Whatever the total cost in rule Number One, just double that to reflect the total cost of buying those shares for rule Number Two. This cost is the ***future profit lost on assets not on the balance sheet*** (where they belong) generating profits. Cash does not generate a profit all by itself. Assets that collectively earn profits are essential and mandatory.

If cash is exiting to buy shares, that cash cannot be used to buy assets which generate more cash and profits. This illustrates the ***Cardinal rule of all Private firms***: *generate cash on a sustainable basis and hang onto this cash as much as possible or die*.

For example, with an after-tax rate of say 8% on assets, not having cash to buy more assets from the exercise in rule Number One will translate into future profits lost (because cash was not available to generate more profit/cash producing assets). This represents an additional profit lost of about $1.5 million[3] approximately.

Still want to buy $1 million in shares? Go ahead, the total bill will be about $3 million!

The solution? Restructure your balance sheet so your firm is a prime candidate for no reportable debt and or banker's acceptance debt instruments and employ tax deductible hedging strategies that preserve and increase balance sheet strength.

Our firm specializes in this type of restructuring. Call to see our Case Study.

Article Courtesy: John Lindsay, ProfitExits.Ca, MacDonald Management

[1] Assume a 10-year re-payment schedule.
2 Assume a 25% corporate tax rate.
3 Consider Time value of money and opportunity lost on return on cash.