The Importance of Business Succession Planning

A number of years ago I watched as a good friend of mine went through an agonizing fight to keep the family business from going under. My friend's father had started a very specialized, niche construction business years before. He was a simple, hard-working man without any college education or formal business training. Even though he was not your stereotypical corner office CEO, he was a very talented expert in his field and was able to leverage that knowledge and expertise into a thriving business. When his daughter, my friend, joined him in the business, she immediately filled the gaps where he was weak, taking on a role that was part CFO and part office manager. She was not, however, involved much in the day-to-day construction operations. That was left to her father and their Vice President of Operations.

Unfortunately my friend's father became ill and unexpectedly passed away. In his absence "control" of the company plunged into a turf war between herself and the Vice President of Operations. Matters continued to sour and eventually the Vice President would leave the business taking many of their more valued customers with him.

Sadly, this story is not even remotely uncommon. Businesses routinely flounder when the leader or leaders decide to retire, unexpectedly become ill, or die. In fact, studies have revealed a sobering statistic that only about 30% of businesses survive to the second generation, 12% to the third generation, and an amazingly rare 3% into the fourth generation or beyond.

The lesson this should teach business owners is that they should be planning for business succession. How will they go about facilitating the next chapter in the business life in a manner that fits their goals and desires, maximizes their value in the business, and preserves the business for the benefit of its other employees and customers? Remarkably only about 25% of businesses actually have a Business Succession Plan. This article will take a brief look at this process and why it's important.

What is a Business Succession Plan?

A Business Succession Plan is a formal plan that helps guide the business through a change in ownership. This plan should be created by the owner or owners and perhaps a few key executive leaders. Although every plan is going to be uniquely fit to the business, they will generally include several universal parts:

A timeline – A timeline identifying what and when major milestones to allow for successful transfer of ownership must be achieved.

Potential successors- The plan should include all individuals or parties that are logical or desired successors. This might include co-owners, family members, key employees, outside entities, and even competitors.

Methods- The plan should identify critical documents and operating procedures which describe and control the essence of the way the business runs. The plan should include an evaluation of these items to determine areas that need work or improvement.

Valuation- It is essential that the plan include some form of accurate valuation. It is common for business owners to have either an inaccurate or unrealistic understanding of the business' valuation. When the business does change ownership, having an inaccurate understanding of the valuation can result in crushed expectations and unpleasant surprises. It is especially important to understand the value so that proper tax planning can be accomplished prior to the sale.

Succession funding- If the departing owner desires that the business go to a partner, family member, or trusted employee, the question of how the purchase will be funded is of vital importance.

Before a Succession Plan

Even before a Business Succession Plan is developed, it is wise to assemble a Strategic Plan. A Strategic Plan is used by businesses to identify actions that should occur somewhere in the following three to seven years to achieve the goals and mission of the business. Having a well thought out, documented, and implemented Strategic Plan will greatly assist the owners in thinking through and assembling a Business Succession Plan.

Why Create Such a Plan?

As my friend quickly discovered after her father's death, life would have been much simpler and less stressful if her father had prepared for the time that he would exit the business. He could have identified how the vacuum left by his absence should be filled. He could have prepared and equipped his daughter to take his place or made expectations clear about the transition of leadership roles that would best benefit the long-term health of the business. Therefore, a Business Succession Plan is all about having a design in-place to prepare for both the planned or unexpected exit of the business owner or owners.

A Business Succession Plan should be created well in advance, at least five years and more, if possible, before the owner anticipates exiting. Time is essential because some of the actions that the plan might have, such as developing a leader to take-over or getting the business "ready" for a sale may take years to accomplish.

Although all businesses should have some form of succession planning, **it is especially important under the following circumstances:**

• When the business is especially complex (How will the business continue to operate after the leader has exited?)

• When the business has multiple employees (Who will step into the void of the exiting owner?)

• When the business has repeat and on-going contracts and business activity (It is critically important that during a transition time, especially one that results from an unexpected exit of the owner, that customers are still properly serviced and supported.)

• When the owner has a successor in mind

Five Possible Succession Paths

Selling the Business to a Co-owner

When a business has multiple owners, it is often the desire for the remaining partner or partners to retain ownership and control of the business. This is usually accomplished with a Buy/Sell Agreement between the partners. Since it is rare for the co-owner or co-owners to have cash-on-hand to fund a buyout, these arrangements are often funded with life insurance taken out by each partner on the other.

Passing Onto an Heir

Many family businesses wish to keep the business in the family as a means of assuring financial longevity within the family. In this case the owner must decide whether a child, spouse, or other family member is best suited for the task. In cases where only a single family member is interested or equipped to take over, this decision may be easy. However, in cases where multiple family members are in the business, these decisions are much more delicate. It will involve the leader to be thoughtful about who is best suited to take-over. This decision will need to be clearly communicated to the entire family and those not chosen for the leadership role should clearly understand how they will be compensated. The owner should probably establish Buy/Sell Agreements so that there is an understanding who and how ownership of non-involved family members may be transferred to those desiring to stay in the business. It is also very helpful if the exiting leader can put together a vision for the future leadership structure.

Selling to a Key Employee

In businesses where there are no family successors available or interested in the business, the owner might have a trusted, key employee or employees to sell the business to. This sort of transition can be a positive one for the business since it is

highly likely that this key employee knows the business very well so that the ownership transition will be less disruptive than some of the other pathways. In this sort of transition, although the new owner may begin putting his or her mark on the company, it is much more likely that the culture and vision of the previous owner will remain intact for some time. For an owner that may still have some sort of interest or presence in the business, this is far more comfortable than when a third party with a completely different vision and culture takes over.

When selling a business to a key employee a Buy/Sell Agreement and Business Succession Plan need to be in-place. The plan should not only lay out the details of how ownership would transfer but also identify who the key employees might be and how they will be developed and mentored to prepare them for ownership. The most serious drawback of this transition option is that it is unlikely that the key employees have sufficient cash on-hand to purchase the business outright. This means that the buyer will either need to secure outside financing or the seller will need to be prepared to offer seller financing.

Selling to an Outside Party

Many businesses are sold to outside parties such as an investor, competitor, or business looking to expand its capabilities. This option is likely the most onerous for those left in the business, as many rapid changes in culture and business practice may ensue. However, for an owner or owner's estate that is looking for a quick exit and break from the business, this may be the best option.

For owners that are considering this route two things are very important to accomplish prior to the sale. First, the owner should regularly and properly assess and calculate the value of the business. It is important to know what the business is really worth, not what one "thinks" it is worth. It is probable that an owner who has invested many years of their lives building up the business to consider the value quite subjectively. Therefore, it is important that objective experts such as a CPA or valuation specialist be part of this process. A number of years ago I had the opportunity to assess a fastener business that was for sale. The two aging owners wanted to sell the business and retire. Their primary market was aerospace fasteners and over the years they had overrun many orders and placed the surplus into inventory to be sold another day. Unfortunately, that "other day" had not come for most of the parts and over a thirty or forty year period the business had amassed a large amount of slow moving inventory. When the owners went to value their business they included the entire inventory for what they "believed" it was worth. However, most of this inventory will never be sold, as it is simply too old, and has little or no value. Unfortunately the owners had built up expectations regarding the value of this inventory and were, thus, pricing their business at an unrealistic value. If they ever sell their business they are very likely to be disappointed in what they will really receive for the sale.

This then leads to the second important detail one must consider if selling to an outside party; "prepare for the sale". If one is considering selling to an outside party this route they should begin the process of preparing for a sale as much as five to ten years in advance of doing so. This may take significant resolve determination but is key to maximizing the value of the sale. Preparing for the sale might include getting key personnel in-place, getting the financials in order, and formalizing processes and procedures. A company that is stable and running well is far more attractive and likely to receive a premium price than one that appears to be in disorder. Once again, a number of years ago I had the opportunity to be part of an acquisition of a fastener manufacturer. When the patriarch of this company passed away, it was inherited by several aging family members who had no interest in running a fastener business. As such they quickly sought out a buyer and sold to a company I was working with. Unfortunately for them, although the business had some interesting proprietary knowledge that set them up as a notable niche player in the specialty fastener marketplace, they had used the business for years solely as a channel to distribute company earnings to certain family members. As a result, the financials and operations were a mess. The significantly depressed the sales price and the resulting sale was a bargain for the buyer.

Selling Shares Back to the Company

This option only exists for companies where there are multiple owners. In this case, usually at the formation of the company there is an Agreement made between the owners that when one of the partners dies or wishes to retire, the business will purchase their shares. In essence this increases the ownership position of the remaining partners. Much like several of these other options, however, the business may not have immediate, liquid resources to repurchase the exiting partners shares. For this reason, these agreements are often funded by the owners taking life insurance policies out on one another. In this way when the owner dies the business has sufficient funding to purchase the shares from the estate. These Agreements can be complicated and often have tax implications, so should be well thought out and prepared ahead of time.

Wrap-Up

No one is going to be around forever, which makes business succession an exceptionally important topic for business owners. To avoid problems when one wants to retire or unexpectedly dies, it is imperative to have a Business Succession Plan. In the same way that having an estate plan early in life is wise, it is never too early to begin to assemble a Business Succession Plan. The better one does this, the more likely that they will receive the most value for their share of the business when they exit. Therefore, don't put off until tomorrow what sensibly should be started today. ■

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