BY DAVID KING

YOUR BUSINESS THE NEXT GENERATION

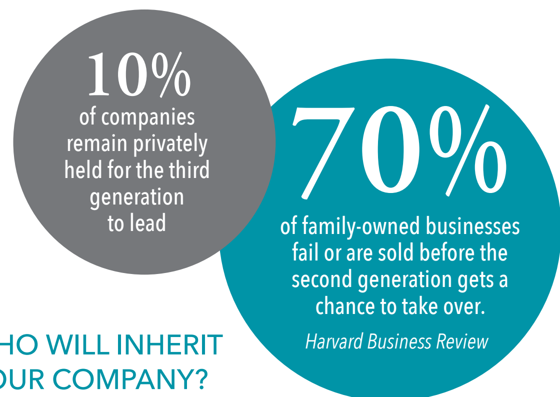
Why Effective Succession Planning is Hard and Why it's Essential

photo courtesy of Wilmington Trust

The ideal of the small business—built from the ground up by one or more entrepreneurs, whose success allows their families a better life and that they pass on to their children after years of hard work—holds a special place in the American consciousness. This ideal, of course, often butts up against a different, more complicated reality. One particular problem that does not usually attract a lot of attention though (presumably because in order to have this problem you first have to have managed to open and successfully run your own business, no easy task) is the issue of succession. Who will take over after the owner/chief operator retires, how will the business and the wealth it represents be passed along? It's easy to put off answering this question, but increasingly business experts are urging the heads of companies big and small to start thinking about it by putting together a succession plan—even if they plan to be on the job for years to come.

More and more data is emerging proving these experts are right. Numerous studies are showing the negative economic impact of ignoring the question and the botched successions at small and family run companies. In 2012 the Harvard Business Review reported that "some 70% of family-owned businesses fail or are sold before the second generation gets a chance to take over. Just 10% remain active, privately held companies for the third generation to lead." More recently, New York City Public Advocate Letitia James estimated that in New York City alone 3,700 businesses close every year as a result of the owner's retirement resulting in 13,260 jobs lost a year.

Early planning for the succession or sale of the family business significantly increases the likelihood that the transition of the business will achieve the exiting owner's objectives. Nicholas Preddice, CEO of The Affinity Group cautions that the planning should be an ongoing process, stating "from the time someone creates, inherits, or purchases a business, he or she should be thinking about the exit strategy. A business is like any other asset that can be effected by the economy, a natural disaster, or other unforeseen circumstances." With so many complexities involved planning well in advance of a transition event is critical, regardless of whether the intent is to sell the business or pass it along either to members of the next generation or to management or employees. Even if plans change, for whatever reason, it's easier to modify and existing plan to accommodate those changes than to start anew. "An owner's exit strategy should always be a work in progress, for ideally, his or her life's work, energy, talents and passion will be rewarded, in a very profitable way through a well-planned transition, or the sale of the business," adds Preddice.



WHO WILL INHERIT YOUR COMPANY?

Recognizing that business transitional planning needs to be done is a far cry different than knowing "how" to do it, and understanding what not to do is half the battle. So if the task is daunting, then you're probably on the right track. The best way to handle it is to take it one step at a time. Maurice P. Tessier, senior vice president of wealth management at UBS Financial Services

advises owners to start laying out a plan at least 3 to 5 years before the transition to ensure they give themselves sufficient time to lay out what he calls "the three legs to a successful plan: 1) A personal financial plan that includes: cash flow analysis, estate and well transfer planning, as well as contingency planning. 2) A business plan that focusses on growing the enterprise value of the business and the development of your management team with incentives. 3) A personal plan that focusses on the next chapter of the business owner's life when they are no longer running the business."

The financial plan should include wealth transfer strategies, estate planning, and cash flow analysis that compares the cash flow of the business to what ad after tax lump sum might generate and contingency planning. Tessier explains, "cash flow is particularly important because what we are trying to determine is can the after tax lump sum support the business owner and their family in the lifestyle they are accustom to. If we determine through that analysis they can support their family's lifestyle in the same fashion the owner did while running the business the business owner now knows what a good transaction looks like. Often times the top line number on an offer (to purchase) may look really good but after doing the cash flow and tax analysis the offer may not be as good as it appears."

The second part of the transition plan involves a business plan the covers the growth plan for the business, succession plan with specifics on who in the organization will run the business and incentives for them to run it. The third part is to have a well laid out plan for the next chapter of the business owner's life after running the business. "This is important because most business owners," Tessier says, "particularly those who sell to a third party regret selling the business. A well laid our written plan avoids seller's remorse. It is a lot of work but by preparing early the business owner will maximize the value of the transition to his family, the business and to the philanthropic causes that he or she support."

Identifying which members of the next generation should succeed the existing family business owner can be a difficult and emotional process and, if not handled deftly, could lead to significant family strife. In many cases, the children of business owners may not be interested in running the business or may lack the requisite skills or drive to carry the business forward. "We are seeing fewer and fewer of the next generation willing to take over the family business." Tessier acknowledges, "the other consideration which is even more challenging, which is can the next generation run the business?" It is critically important not only to consider family members in succession planning, but also to keep in mind the interests of business partners and key employees. It might be hard for some owners to accept, but selling the business to non-family employees or to a financial sponsor or strategic buyer may be the only appropriate alternatives.

If transitioning the business to the next generation is viable, the business owner should consider what roles and responsibilities are best suited for each participating family member-owner. Clearly set roles keep family members from stepping on others toes and foster cooperation over competition. It is not advisable for the exiting owner to simply divvy up the ownership among the next generation without also defining their respective roles and setting forth a governance road map for the business after the transition has occurred.

If no successor emerges then often the only option left is to sell the business to an outside buyer. "This is not an uncommon occurrence. There is no guarantee that someone in the family will have the passion and skill to run the business, even if they have experience working in the business." Says Christina Bark, business advisor with CMB Associates and a faculty member at the SUNY New Paltz School of Business. "I've seen family members shy away from operating a family business to avoid the pressure or politics of running a business that keeps food on the table of the sibling who is not involved in the day-to-day operations. Moreover, business environments change. The business' future may look less bright than it did when the business was started. There are a myriad of

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reasons a family member may not want to run the business, even if the business is otherwise successful." Fortunately, there are many alternatives to passing responsibility for running a business to a family member. "You can keep the business in the family, but hire someone to run the business and provide family oversight. You can groom employees to purchase the business. You can position the business for sale to a third party. And, don't forget, it may be possible to reposition the business so a family member would want to run it." Bark adds.

Another consideration is Estate Planning. Succession planning and estate planning are not the same thing, but they must be in sync with one another to ensure the objectives of both are achieved. "Succession planning first addresses the viability of the business in terms of going forward in the market place. Can the business support the goals of the next generation? If no, decisions must be made regarding what actions to take. If the vision is to move forward, a plan for that transition will focus on leadership development, employee concerns, possible family obstacles and the solutions needed." Preddice explains, "estate planning focuses on financial and legal protections and strategies. It is a wealth assessment process that provides guidance regarding insurance, investments, tax concerns, timing for distributions, and often health care options." Adds Tessier, "a good estate plan includes contingency plans with wealth transfer and estate planning strategies in the event of an untimely death. The transfer of his or her ownership interests should be synchronized with the succession plan. Failure to do so can result in the owner's vision of a successful transition not being realized."

The owner of a family business can use a number of estate planning and tax mitigation strategies to provide for a tax-efficient transition of ownership. Implementing these techniques early and not waiting until a transaction is imminent will expand the owner's options and the potential benefits for the owner and his or her family members. These planning techniques include gifts to family members (or trusts for their benefit) as well as more sophisticated wealth-appreciating shifting strategies.

Kevin DeHond of Wealth and Institutional Services Division Wilmington Trust offers some examples of a few such tools: "GRATs (Grantor Retained Annuity Trusts) is a popular method of transferring the growth on assets held in trust to future generations at a greatly reduced gift tax cost. When you establish a GRAT to transfer all or partial ownership of your business, you make a gift of company stock (or other business interest) to the trust, pay a tax on valuation that the IRS places on the estimated value of the remainder interest of the trust when the trust is established, and retain an annuity stream for life, or for a fixed term. Charitable lead annuity trusts (CLATs) work similarly to a GRAT, except that the annuity goes to a charity instead of to you." Additionally, you might try an Installment sale to an irrevocable grantor trust. "Rather than gifting your business to your heirs, it sometimes makes sense to sell it to them (or to a trust for their benefit), especially when you can charge a very low interest rate and still have the sale respected for tax purposes."

Succession planning is preparing for the continuation of your company. It's the process of identifying and grooming the next generation of leadership; of integrating practices that are sustainable through employee turnover; planning for the evolutionary success of a business and building a company on a platform that is flexible and adaptable. This process requires forethought, time,

energy and discipline. Yet, in the bigger picture beginning this process and making it an ongoing part of your leadership of the company is perhaps the most important thing you can for the betterment of the company, its employees and your family.

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