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Business succession planning Cultivating enduring value

Volume 1
The need for planning


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The need for planning

A plan for permanence

No one goes through the work, risk, and sacrifice of starting a business without hoping it will last. Building value that endures is the dream that motivates entrepreneurs. Yet in many businesses, too little of that work goes into determining who will take over when the founders leave the stage.

According to the National Association of Corporate Directors, fewer than one in four private company boards say they have a formal succession plan in place.[1] There isn't a good reason to justify the common oversight of not planning for business succession. Some business leaders are too caught up in the challenges of the present. Some have a subconscious aversion to the reality that they won't be around forever, or assume succession will work itself out naturally. Others are aware of the task's true complexity and find it overwhelming. Ultimately, however, the reasons people avoid succession planning aren't as important as the reasons they should embrace it.

For a business, working without a succession plan can invite disruption, uncertainty, and conflict, and endangers future competitiveness. For companies that are family-owned or controlled, the issue of succession also introduces deeply emotional personal issues and may widen the circle of stakeholders to include non-employee family members.

The next 10 to 15 years may bring substantial transfers of wealth through business ownership handoffs across generations and other new ownership structures. The long-term survival of those businesses, and the preservation of the wealth they have built, will depend upon a clear and early focus on strategic succession planning.

This paper outlining the need for business succession planning is the first in a series. Upcoming companion volumes will focus on business continuity and growth, personal wealth management, creating and maintaining a legacy, family dynamics and business governance, and the role of the advisor. Together, these studies form a library that can help business leaders identify and overcome the challenges that stand between them and an orderly transition of the management and ownership of their companies.

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[1] *http://www.nacdonline.org/AboutUs/PressRelease.cfm?ItemNumber=4699*

Not so simple

Succession planning is a complex process that draws upon many business disciplines. Many privately held businesses display solid professionalism and enviable profits in their daily operations, yet fail to properly plan for and complete the transition to the next generation of leaders. Even the most sophisticated and knowledgeable business professionals can get caught in a web of complicated issues. In fact, many business owners do not carry out a managed transition to a successor leadership team. In the case of family-owned businesses, only 30 percent survive into the second generation, 12 percent survive into the third, and only about 3 percent operate into the fourth generation and beyond.

An owner-manager usually has a personal vision to retire and sell the business "someday," but he or she may not have adequately considered what it will take to make that vision a reality. Even leaders who profess they'll never retire have to acknowledge that no one remains at the helm forever.

An unprepared new management group, or even a poorly managed transition to competent management, can trigger significant loss in value. If leaders want their businesses' intrinsic value to remain intact for the benefit of their successors, they should begin the planning process sooner rather than later. Many leaders choose to embark on a long-term program to identify and groom the company's future executives. In some cases, a careful planning process may reveal that selling the business instead of maintaining successor ownership really is the answer for their situation.

Not all succession plans are created equal. If your business has a succession plan in place, the questions on the facing page can help determine how effective that plan and your current practices actually are.

Even leaders who profess they'll never retire have to acknowledge that no one remains at the helm forever.

Succession planning — a starting point quiz

Compare your status quo to the questions below. If one or more "no" answers reveal deficiencies in your approach, know that you aren't alone — and that it's not too late.

1. Have you defined your personal goals and a vision for the transfer of ownership and management of the company?
2. Do you have an identified successor in place?
3. If applicable, have you resolved the family issues that often accompany leadership and ownership decisions?
4. Does your plan include a strategy to reduce estate taxes?
5. Will there be sufficient liquidity to avoid the forced sale of the business?
6. If succession will one day require the transfer of assets, have you executed a "buy-sell" agreement that details the process ahead of time?
7. Is there a detailed contingency plan in case the business owner dies or becomes unable to continue working sooner than anticipated?
8. Have you identified and considered alternative corporate structures or stock-transfer techniques that might help the company achieve its succession goals?
9. Have you determined whether you or anyone else will depend upon the business to meet retirement cash flow needs?
10. Have you recently had the business valued and analyzed in the same way potential buyers and competitors would?

A good plan takes time to develop and implement. This study is an introduction to the questions you'll have to ask as you start down that road. In subsequent editions, separate guides will look more closely at several of the important topics.

The need for planning

Succession planning is a multidisciplinary process. When you engage in succession planning, you're not just focusing on the future, because it's impossible to plan for the future without a deep understanding of the present. Leaders have to know the current reality of their businesses — how they operate, where the value lies, what their needs are, who their most vital customers are and why — in order to prepare for new leadership and new structures that can provide continuity in the ways that matter.

There are many benefits for companies and owners who plan properly and strategically for an orderly transition of management and ownership:

- Survival and growth of the business or its assets — under the current structure or after sale or restructuring
- Preservation of harmony when the business is family-owned
- Reduction or elimination of estate and income taxes
- Facilitation of retirement for the current leadership generation
- Ability to retain control of the process instead of having someone else make decisions

A multidisciplinary platform

If succession planning isn't as simple as some may believe, how can leaders make sure they're covering the necessary bases? An inclusive approach focuses on the crucial components outlined in Figure 1. Considering these components is a useful way for business owners to conceive and implement a broad-based plan that can address critical needs and win acceptance from multiple stakeholders. By following this approach, business owners can also draw on the experiences of select advisors who work together as a team, enriching the plan's scope and effectiveness.

The owners of privately held businesses face complex planning issues. For some, the first order of business is the long-term success of business operations, which encompasses a host of distinct issues. For others, the priority is the preservation of family wealth through estate, gift tax, retirement, insurance and investment planning — an equally complex challenge that may not always align perfectly with the aim of perpetuating the business.

These issues should be part of a long-term strategic plan that accounts for the needs of the business as well as the needs of the business owner:

- Creation of a formal development program for likely successors
- Evaluation of corporate finance and entity structure options, including debt and financing paths
- The competitive landscape of your industry and business value drivers
- Compensation planning for successors and other executives
- Creation and implementation of shareholder agreements
- Contingency planning in case something interferes with the performance or availability of leadership personnel
- The complexity of closely held stock valuation issues, and efforts to limit the impact of those complexities on long term value
- Use of tax-effective ownership-transfer techniques

Strategic succession planning becomes even more complicated when family issues such as legacy, birthright, communication, personalities, and interpersonal dynamics are added to the mix. Even an apparently simple succession scenario can become more complex when family interests mingle with business concerns. Even without any explicit disagreement among those involved, the goals of the business — to generate profits, exploit market opportunities, reward efficiency, develop organizational capacity, and build shareholder value — can come into direct conflict with the recognized goals of the family.

Figure 1: Components of an integrated succession plan for privately held businesses

Family
- Goal articulation
- Family information and communication
- Estate and gift planning
- Life insurance analysis
- Investment advisory services
- Family offices

Shareholder
- Shareholder agreement
- Disability planning
- Compensation planning
- Stock transfer technique

Business
- Business strategy assessment
- Management talent assessment
- Corporate structuring
- Current business valuation
- Retirement planning

Strategic succession planning becomes even more complicated when family issues are added to the mix.

Translating a need into an imperative

Even when everyone agrees succession planning is important and necessary, reasons to delay the process have a way of sprouting up.

- No one is sure exactly whom to call for help or how to start.
- Leaders worry about being fair to potential successors.
- Leaders struggle to acknowledge those personnel whom they want to retain on the management team but who aren't in line for ownership.
- Leaders have difficulty discussing financial matters and personal goals with others.
- The owner may not wish to retire.
- Leaders struggle to disconnect from the day-to-day urgencies to focus on long-term planning.
- Leaders are reluctant to commit to complicated strategies that may save taxes but don't address their own non-tax goals and concerns.
- They don't believe successors are ready to assume control, and so they feel nothing can be done.
- The entire process seems too daunting.
- Leaders perceive it is a cost that delivers no immediate benefit.

These anxieties help explain why so few private businesses have an actionable succession plan in place. Few business owners simply ignore the issue, but many may focus too narrowly on individual elements of a succession plan without taking on the full range of important issues. The result can be false security followed by a poor outcome for everyone involved.

These potential blind spots in long-term planning can cost business owners and families through lost future value as well as a hit to their legacy. An inclusive, multidisciplinary approach to succession planning can dramatically increase the chance for desirable results.

Aligning goals across time — and across roles

Taking the time to understand the factors that really drive a company's continuity and growth can help owners and stakeholders create strategic priorities and develop a detailed action plan.

It's common for leaders to think of succession planning in terms of the organizational chart — which people will replace which people. But it's just as important to think of an organization's operating structure and how it may change over time. What are the functional activities that must happen today? How will they be different tomorrow as the business grows? Will your customer base, suppliers, or product mix experience significant change? Only then can you turn to the question of which people will carry out those functions.

This exercise turns the organizational chart and operating structure from two-dimensional snapshots of "now" to three-dimensional representations that change along a time axis. An organization is constantly changing its alignment of people with operating requirements, and to do this, it should identify what competencies a role will require in the future and assess how individual team members progress toward acquiring them.

It's also common for business leaders to think of succession planning as a high-level exercise. In some businesses, the plan may encompass only the top job. In this top-down, three-dimensional approach, however, succession planning extends to all levels of the business. Leadership, management, and business units all have succession issues to address. You may put more detailed effort into determining who will be the next CEO, but the business stands to suffer if you don't also plan for who will succeed each department head, manager, supervisor, and significant team members.

An inclusive, multidisciplinary approach to succession planning can dramatically increase the chance for desirable results.

There is a cultural component to predicting and managing these changes. Studying and analyzing an organization's culture can help leaders see patterns and subcultures that have as great an influence on daily operation as any formal standards. The company's culture is derived in part from the vision of what it is to become. Does a small or medium-sized business aspire to be huge? Or to maintain its size? Are there plans to go global? Variances in these and similar paths ask different things of people.

In making these decisions, privately held businesses often hold the advantage over large corporate structures. Leaders in privately held businesses have the knowledge and authority to make people-based decisions effectively. They know which people exhibit long-term leadership potential, regardless of their present-day level of training. They have the contact to recognize character and decision-making ability, and they are able to move with agility in rewarding it. Where a large corporation sees a business unit member, a private company may be more likely to see a whole person.

A systematic approach that takes all these questions into consideration can help important stakeholders identify and understand the most critical issues pertaining to the continuity and growth of the business. With that understanding, they can create strategic priorities and develop an action plan that addresses their myriad needs.

This exercise is designed to reveal the critical issues. The plans that arise as a result should align with the goals and common vision the owners and stakeholders have identified. An important first step is to compile and understand stakeholders' goals and expectations, then to articulate a common vision for the future of the business.

Communication with stakeholders

Lack of clear communication is one of the biggest threats to a smooth transition of a business from one generation to the next.

Once you have identified critical issues, it's important for the company to articulate the owner's personal goals and vision for the future of the business, while also considering the needs and concerns of other stakeholders. That doesn't mean everyone will get what he or she wants. But by including the stakeholders in the goal-setting process, owners and other relevant decision makers can operate from a wider base of information. They can encourage all parties to feel a sense of ownership in the succession plan. And they can greatly improve the likelihood that it will play out as they intend.

The goal-setting process

To set an array of interlocking goals, start with a definition of the desired end result. If your communication process has produced a vision for the future state of the organization that stakeholders support, that's the end goal. Each intermediate step should be consistent with that vision and contribute demonstrably toward getting there.

A closely held business owner should consider not only developing goals for the business and establishing personal and family goals as well, including those related to an exit strategy, retirement, and personal lifestyle.

What are the characteristics of well-formed goals? The well-known mnemonic **SMART** makes it easier to remember them: Goals should be **S**pecific, **M**easureable, **A**ctionable, **R**ealistic, and **T**imely.

There are many questions that decision-makers should address early and often during the goal setting phase:

- Should the business owner keep the business or sell it?
- If the business is to remain within a family, who will lead it?
- Will the selection of a new leader create interpersonal acrimony?
- If the business will be sold, is the current operating strategy for preserving or increasing stakeholder value?
- For business owners who plan to sell their business in the future, what short-term actions could enhance the value of the business when a sale is executed later?

The goal-setting process allows owners and business leaders to identify and review the objectives for management and ownership transition, as well as to clarify the underlying business and continuity strategies. When drafting goals, consider the time frame and cost parameters for achieving each one. That is the first step in turning a wish into an operative plan.

Business strategy assessment

Business owners should account for the company's strategic direction when building a succession plan. In short: Where are you headed? What is the business planning to be or do that will make an effective succession worthwhile?

Many private business owners have already implemented a strategic planning process and developed written business plans. Others have either not undertaken this effort, or have not kept their business plans current and relevant. To better understand the importance of developing an overall strategy for the business, it helps to consider a number of general concepts.

What is strategic planning?

Strategic business planning provides an analysis of the business and its environment as it is today in order to create a formal program for guiding its development and operations tomorrow.

For closely held businesses experiencing growth, the strategic plan normally addresses a one- to three-year period, and often looks as many as five years into the future. Although the content of strategic plans varies considerably, the basic components include:

- **A mission statement**. A clear definition of what the business will be, the products or services it will provide, who will compose the customer base, and the primary purpose(s) for existence.
- **Goals**. Measurable statements of what the business will accomplish in areas such as growth, profitability, and research and development.
- **Strategies**. Broad initiatives that will be implemented to achieve specific goals.

Why undertake strategic planning?

Strategic planning provides the opportunity to create and position the business for competitive advantage in the future. In short, you can control the process or the process can control you. A sound strategic plan:

- Defines, in measurable and objective terms, what is important for the business to achieve.
- Anticipates problems and outlines positive steps to manage them.
- Builds commitment and orients senior management team members around a common purpose.
- Charts a clear direction and provides "marching orders" for the business and its employees to follow.
- Drives consistency in decision-making processes and effectively allocates resources, including people, equipment, and facilities.
- Establishes a firm basis for evaluating both corporate and individual performance.
- Provides a framework that management can use to speed responses to changed conditions, unplanned events, and deviations from the plan.

Who should lead strategic planning?

Select managers and owners of the business should assume responsibility for developing and executing the strategic plan. These individuals understand the business intimately. They recognize its potential and limitations. They can commit the resources required to implement plans, and they can initiate and monitor the steps that will drive implementation. They should oversee the formal analysis of the strategic planning data, reach the necessary conclusions, and commit the business to future courses of action.

This does not mean other internal resources or external consultants cannot or should not play a role in the strategic planning process. Indeed, both staff members and outsiders can offer invaluable perspectives in the development of a sustainable plan.

Conclusion

The quick take-away on business succession planning is that there is no quick take-away.

It should come as no surprise that preserving an organization's value for the future is just as challenging as building that value in the first place. Unfortunately, there are a number of reasons why some business leaders fail to recognize the magnitude of the challenge — and why others, consciously or otherwise, look past it altogether.

This paper has presented a high-level introduction to the myriad issues and concepts surrounding the business succession planning process — most of which are worthy of more in-depth discussion and exploration. Future papers in this series will provide a detailed look at these topics.

The next volume in this series will focus on ways to promote business continuity and growth. For those who may have envisioned succession planning as purely a matter of names and job titles, this exploration will be a worthwhile expansion of the real task at hand. After all, the choice of your next leader only matters if you leave that person something to lead.

Case studies

The following scenarios are based upon experience with actual family businesses. They are intended to illustrate the importance of goal setting, communication, and a holistic approach to succession planning.

Family feud

Robert is a closely held business owner in his early 60s. Two of his children, Nathan and Emily, are relatively inexperienced at working in the business, and a third child, John, does not work in the business at all. Robert wants to scale back involvement in the business so he and his wife can move away and enjoy their retirement years together. With outside help, Robert builds an estate plan that includes family partnerships and trusts that hold insurance and company stock. The family's perception is that the business succession plan is "complete."

A year later, Robert is ready to retire, but cannot because the siblings are floundering in their executive development. Robert relies more on non-family employees, who are not in line for ownership, to get things done. Nathan and Emily resent this. Meanwhile, John feels the salaries, company cars, and other benefits Nathan and Emily draw from the company are coming at the expense of his inheritance. When Robert finally does pull away, Nathan and Emily assert their leadership in the resulting vacuum despite their lack of preparedness. Several important executives and customers leave, sales fall off, and the top salespeople go to the competition. John wants Nathan and Emily demoted or fired to protect the value of the inheritance. Robert worries about the value of his stake as a source of retirement funding.

Months later, company operations continue to suffer. The children are no longer speaking with each other and holiday get-togethers are cancelled. John forces a sale of the business for cash, but the family receives only a fraction of the amount that financial advisors and attorneys projected years earlier in the estate plan. Taxes eat half of even that disappointing sum.

Nathan and Emily are not equipped to find similar high-level jobs elsewhere, and they struggle professionally. John blames Nathan and Emily for gutting his inheritance. Robert must revisit his post-retirement dreams. In the aftermath of the sale of the business, all the estate tax planning accomplished years before has been unraveled.

Analysis

Robert relied on specialists for sophisticated estate planning. Why did everything go wrong? In reality, estate planning is only one facet of succession planning. Robert made a plan for transferring enterprise value, but not one for continuing to generate or maintain that value. His approach to succession planning should have incorporated management talent assessment, compensation planning, stock transfer strategies, formal directorship roles for both family and non-family officers, corporate structuring, communication plans, and estate planning.

All goals are not created equal

Four unrelated partners — Anne, Carlos, Lawrence, and Brian — have worked together for decades to build a strong business. Three of them, Anne, Lawrence, and Brian, are in their mid-60s and intend to retire. Carlos is some 20 years younger than the others and feels strongly about keeping the business going.

The three retiring partners believe in the business. They genuinely want it to keep prospering with Carlos as CEO. However, they also want to monetize the value of their investments to fund retirement. An additional complication is that the group never envisioned three simultaneous retirements — everyone always assumed Anne would remain active for several additional years and spread the transition over time, but because of family medical needs she wants to sell and retire now.

Because of the company's current levels of capital, borrowing capacity, and risk tolerance, it is out of the question for Carlos to buy out all three of his partners and have anything left to operate with. Even if the retiring partners were to accept a reduced or deferred payout, the company would be left crippled.

Disappointed, but intent on preserving the value they've built, the four partners decide instead to sell the business rather than continuing it under Carlos's leadership. Everyone, including Carlos, receives the full present value of his or her stake in the company from the third party that buys and absorbs the company. But Carlos loses a different kind of investment — the 15 years of time and effort he'd put in. Rather than taking over as leader and sole owner, he's left with nothing to manage and the need to find a new job.

Analysis

The four partners shared a group objective, but they failed to map a path to that objective in a way that reflected the goals of each individual stakeholder. Had they examined the challenge more deeply and done more advance planning, the group could have chosen from among several options to bring about the succession outcome they desired: a stock transition plan, creation and revision of buy/sell agreements, or an earlier, phased transfer of partial ownership from the older partners to Carlos, with incremental payouts to match.

The group also failed to plan for the unexpected. Back-of-the-envelope calculations had told them the business could weather two retirement buyouts at the same time, but they didn't foresee the sudden need for three partners to leave simultaneously. Because that need arose without warning, the group could not be particular about the market window, and may have sold for a price that didn't return as much value as it should have.

Finally, the four partners focused on financial elements of succession planning — but even if the capital had been available to leave Carlos at the helm, what kind of team would he have been leading? Training and preparing a second-in-command for each of the four top leaders would have left the company with more operational flexibility when the big change came, and may have increased the partners' options at the critical moment.

Perspectives

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