Quist Insights™

Business Succession Planning for Private Companies

Creating Exit Options Comes from Early Planning and Creating Value

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Business Valuation Experts

For more than 30 years, Quist has provided valuation services to privately held companies, public corporations and private investment entities representing a wide variety of business models located throughout the U.S. and around the world.

Our valuation expertise is wide ranging. As companies grow and needs change, we can provide the valuation services they may require. Quist offers unequalled business valuation expertise and a quality of client care not found in other firms.

Over the years, our clients have invited us to become strategic advisers in their businesses and we have been rewarded with long-term client relationships as a result. Our client list is robust, and ranges from small emerging companies to large, multinational corporations.

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Fueled by the roughly eight million Baby Boomers moving toward retirement, the next 10 to 15 years is expected to bring substantial transfers of wealth through both the outright sale of businesses, as well as the transition of business ownership to the next generation and key members of management.

Recent conditions have created a favorable market for mergers and acquisitions, and private equity buyers have been a major force in this development.

However, the long-term survival of businesses and the preservation of the wealth created, will depend upon a clear and early focus on strategic business succession planning. Furthermore, while planning for a business succession, owners must also continue to increase the value of their companies. We recommend business owners begin thinking about and planning for a business transition five to ten years before they exit.

For many, the time is now to address business succession. This paper addresses the key areas where private business owners can focus:

- Creating options for ownership transfer, the most prevalent being third party sales or transitions to family members.
- Compelling reasons to plan and start early.
- Making the business more valuable for its owners and successors.

Choosing the Best Route

When business owners start to think about exiting their companies, there are a number of possible routes. About one-half of business owners anticipate a third-party sale and one-fifth anticipate a transfer to the next generation. Other routes include transferring to co-owners, selling to key employees, selling to employees using an ESOP, engaging in an IPO or liquidating.

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One of the keys to being able to select the best exit route is to create as many options as possible, which requires giving ample time before being ready to exit. With multiple options available to business owners, each should determine his or her timeframe, and financial needs and objectives after the transfer, which will help illuminate the best exit route. Because a business is usually a business owner's most valuable asset, accomplishing personal financial goals requires converting that asset to cash. Owners should retain a valuation specialist to determine a company's fair market value to help all owners get on the same page, evaluate the tax consequences of each exit path, and minimize IRS scrutiny after the sale.

Sale to a Third Party

Selling to a third party generally offers owners the best chance at receiving the maximum purchase price for their companies, as well as cash at closing. This route appeals to owners who want a definitive date when they will depart from the company and may want to see the business propel to the next level, but at the risk of the new owner.

The value of the business usually makes up 65 to 90 percent of a business owner's total assets.

The disadvantages of third party sales are that sellers may not receive all cash, depending on the specific transaction or the M&A market. Often employment contracts lasting one to three years where the owner agrees to work for the new company are utilized. Additionally, while desiring to reduce their role, owners may not want to lose altogether such a meaningful part of his or her life by exiting the business, nor do they want to risk the jobs of existing employees or subject loyal employees to a new culture.

Transfer to Family Members

Owners who consider transferring a business to family members do so for non-financial reasons, such as providing for the well-being of the owner's family, perpetuating a mission or culture, keeping the company in the community or allowing the owner to remain involved.

The major disadvantage to transferring a business to the next generation is heightened exposure to financial risk for the owner, given that in almost all cases, family members are not capable of paying an owner the amount of cash he/she wants or needs for the company. Owners often receive little or no cash at closing. Further, children may be unable or unwilling to assume the ownership role and issues of equitable treatment of children can surface.

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. Planning well in advance can minimize or eliminate many of these disadvantages.

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Why Plan Ahead for Transitions

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.

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. 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.

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Ultimately, however, the reasons people avoid succession planning aren't as important as the reasons they should embrace it.

Start Planning Early for a Smooth Transition

It's tricky for an owner to work out when and how to leave a business. Ideally, the planning process should start five to ten years before he/she wants to leave or sell to allow time to:

- Identify and prepare a successor.
- Put tax and insurance strategies in place.
- Calculate the financial needs of all parties.
- Assess the value and marketability of the business.
- Grow the value of the company as needed for all parties to achieve their goals after the sale.
- Plan the role he/she intends to have in the company after the next generation of owners and managers take over.

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.

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 emotional personal issues and may widen the circle of stakeholders to include non-employee family members.

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.

A thoughtfully governed family business can be an asset for everyone involved – not only in terms of wealth creation, but also in promoting harmony, personal fulfillment and shared purpose. Business leaders should learn how to balance business needs and family concerns in order to create a long-term governance plan that can help the business and family prosper together.

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

- Disability planning
- Compensation planning
- Stock transfer techniques

The decision to move on from the company can be difficult for a business owner, but ensuring the company and all those involved emerge from the transition as smoothly as possible is critical. Beginning the process well in advance and establishing open lines of communication with all stakeholders will better position the company to have a smooth transition. Whether current owners choose to sell the business, or pass on leadership to another individual or individuals, adequately grooming the company and successors is key.

According to research conducted by McKinsey & Company, companies that invest in marketing and sales capabilities see 30% higher revenue growth.

Making the Business More Valuable for Its Owners and Successors

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. The characteristics buyers who will pay top dollar seek must exist before the sale process even begins. Plus, it's the job of the business owner to create value within the business prior to a sale.

The factors that drive up value regardless of industry include having a realistic growth strategy, a stable, motivated management team, strong operating systems, effective financial controls and consistent and improving cash flows. Creating a long-term strategic plan for the business, its owners and its successors is one of the most important activities leadership can undertake and can position the company for optimal exit.

Business Strategic Plan

100% of academic studies agree that companies with high ratings for ESG factors have a lower cost of capital.

Before a current owner can successfully transition the business to new ownership or management, or even adopt a new business direction, the company will need a long-term strategic plan. The plan outlines where the business is heading, what it will take to get there and who will be responsible for keeping business operations on track.

A long-term strategic plan should account for the needs of the business as well as the needs of the business owners, and be a documented and evolving tool:

- Business strategy assessment, including business value drivers such as market evolutions, competitive position in an industry, innovation, marketing and sales, operations and planning, and environmental, social and governance (ESG) factors.

- Management talent assessment and formal development programs for likely successors.
- Compensation planning for successors and other executives.
- Evaluation of corporate finance and entity structure options, including debt and financing paths.
- Creation and implementation of shareholder agreements.
- Contingency planning in case something interferes with the performance or availability of leadership personnel.
- Current business valuation with the assistance of professionals given 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.

Understanding your company's value is crucial in accomplishing personal financial goals.

Tax Costs and Private Wealth Considerations

Plans a business owner makes for a company can have significant and often surprising effects on the plans he or she makes in retirement. Planning ahead for estate and gift taxes, life insurance and a comprehensive investment portfolio can help business owners address family and company needs and meet individual retirement goals.

In addition to utilizing the business planning techniques for business owners to maximize company value discussed in this paper, sellers should consult with their trusted advisors including a qualified wealth management advisor, a tax attorney and CPA to ensure maximum value capture from a business sale by reducing the tax cost of the transaction.

Planning early, as much as five to ten years in advance of an anticipated transfer of ownership, will give business owners the widest range of exit options.

For example, the lower the price paid for the ownership interest, the fewer dollars are subject to double-tax—paid by both the buyer and seller for ownership interest and the seller's capital gains. Business owners should consider:

- Taxes and overall planning considerations.
- Specific techniques for gift and estate tax planning before a transaction.
- The importance of structure and timing with income tax planning.
- The potential problems associated with reducing and deferring federal tax on a sale.
- Post-transaction wealth management issues.

In many cases, the valuation of a business prior to a sale may be significantly less than the eventual sale price. Because gift and estate taxes are based on the value of assets transferred, taking advantage of lower valuations could allow the owner to transfer assets at a lower tax cost. Consequently, understanding your company's value is crucial in accomplishing personal goals. As with business exit planning in advance for optimal valuation at sale, the importance of planning for private wealth considerations early is also relevant to reducing the tax cost of the transaction.

Conclusion

Planning early, as much as five to ten years in advance of an anticipated transfer of ownership, will give business owners the widest range of exit options for the business when the owners are ready to entrust the company to the next generation or sell to a third party. There are numerous actions an owner can take to maximize value creation.

About

At Quist, we work with business owners across the full lifecycle of their businesses, from start-up stage through growth to eventual exit.

- Quist Insights™ gives business owners and trusted advisers visibility into company, strategic and market insights to improve management decision-making and business valuation. Our Management Insights™ tool is designed to engage your leadership team, board members and investors in a more robust value creation and risk management process.
- Quist's core valuation services advises management teams on the front end of a transaction by identifying key financial metrics and value drivers of a business, and in understanding market valuations.
- Quist also advises on the back end of transactions by assisting eventual acquirers with financial reporting requirements.

More Insights

"Innovation, Marketing, Sales and Company Valuation,"
Quist Insights™, 2015

"Governance, Strategy, KPIs and Valuation,"
Quist Insights™, 2015

Sources:

The material in this whitepaper relies on the experience of Quist advisers and other research.

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2. "Succession Planning," Price Waterhouse Coopers, 2015.
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4. "Exit Routes for Business Owners," and "Value Drivers Whitepaper," Business Enterprise Institute, 2012

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Learn more at QuistValuation.com

Quist's Management Insights™ tool poses questions for management teams to assess direct and indirect valuation drivers to help organizations determine where they can improve and create financial value.

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