

Succeeding at succession: structuring your transition plan

January 2012

Matching your objectives with your exit strategy

In the early years of a privately held business, it's not uncommon for owners to follow Bob Dylan's risk mitigation strategy: when you got nothing, you got nothing to lose. Over time, those who successfully employ that strategy, as well as more conventional ones, frequently find themselves with something—a profitable business—and much to lose: wealth, family harmony and more.

Despite these achievements, many business owners unwittingly risk losing everything by failing to adopt the optimal transition structure. Very frequently, family-owned businesses fail following the death of the founder. Unexpected events aren't the only source of business failure. Just 30% of family-owned businesses survive the second generation, 15% the third generation and 5% the fourth, according to the Canadian Association of Family Enterprise (CAFÉ). 78% of family businesses face a transition of ownership within the next 15 years, yet 70% have done no succession planning.

These numbers paint a bleak picture for the future of privately held business, at least at first sight. Yet many businesses thrive and prosper after succession. Why? Because the owners took time to align their personal objectives with an

appropriate succession structure, one that not only pays financial and emotional dividends, but also reduces the risk of business failure and minimizes taxes.

Have you reached a turning point in your business?

While the need for an effective succession plan is ongoing and best started early, it is often precipitated by a shift in the owner's outlook toward business and life. In some cases, owners who were willing to bet the house on a new or rapidly-growing business become more reluctant to gamble with both personal and company assets as time goes on. In other cases, the need for a new generation of managers or a transition to the next generation is the impetus for the succession.

External change, such as market dynamics, can also bring an owner to a turning point. The business may need new strategic direction to maintain competitive advantage and maximize shareholder value. Or the new realities may put the owner at odds with younger managers or family members seeking faster change or more aggressive tactics.

No matter what the precipitating factor, the shift in attitude can have unintended consequences. Without adequate succession planning, growth can stagnate, management may become disillusioned and value erosion could follow at alarming speed. Recognizing that shift is one thing. Taking the steps to consider the consequences and structure an appropriate succession plan is another matter altogether.

The first step is to reflect on what you want for yourself and for your business. Few business owners allow themselves this luxury, but it's critical to establishing a personal agenda and identifying catalysts for change. This self-evaluation requires the owner to honestly answer questions such as:

- What are your personal ambitions? How long, for example, would you like to stay active in your business?
- Are your personal aspirations aligned with the objectives of your business?
- What is your appetite for risk and is it aligned with your company's strategic direction?





“When we meet with owners, we ask a series of open-ended questions. Questions about the capability of the management team, the owner’s need for liquidity or whether the owner cares what happens to the employees when they’re gone. We can’t answer these questions, but when the owner starts answering them the right strategy and structure soon become clear.”

Stephen McGee
Grant Thornton, United States

- What underlying challenges does your business face?
- Do they require capital?
- Is your management team capable of operating and growing the company?
- Do you need any personal liquidity?

It’s important to keep an open mind when undertaking this self-evaluation. Your answers may surprise you. Quite often, an owner is thinking more about aspirations for their business and less about outcomes from a personal perspective. In other cases, the owner may harbour nagging self-doubts about their own abilities, believing their company will be substantially better off in the hands of someone else. Then, through this introspective discovery process, they realize that isn’t the case after all.

Of course, any number of conclusions is possible, including maintaining the status quo, at least for the time being. The goal is to reaffirm what you’re seeking for yourself and to determine the implications of those choices from a business ownership and management perspective.

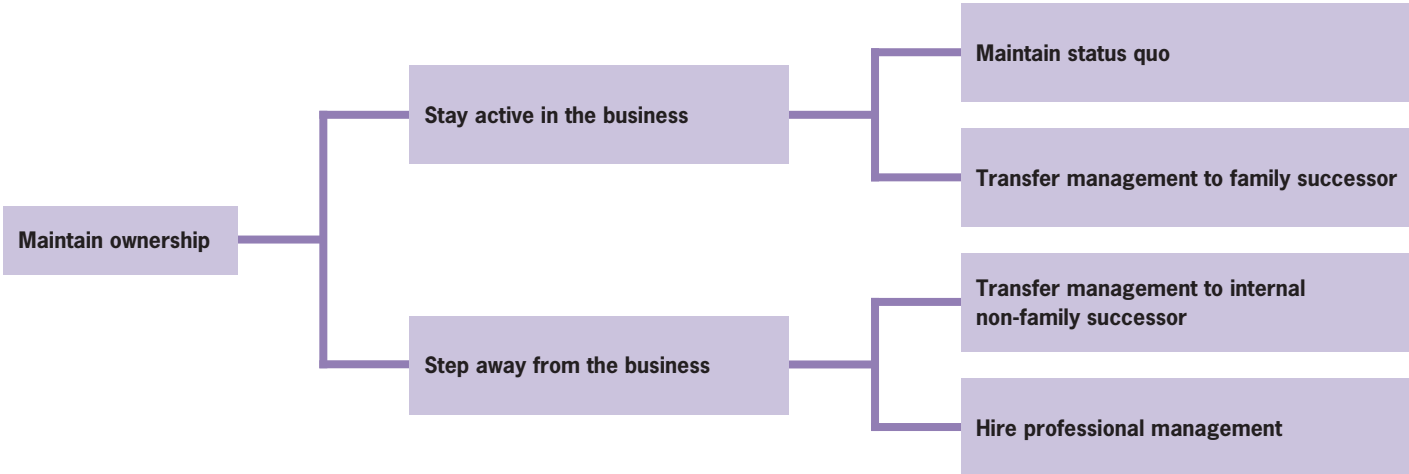
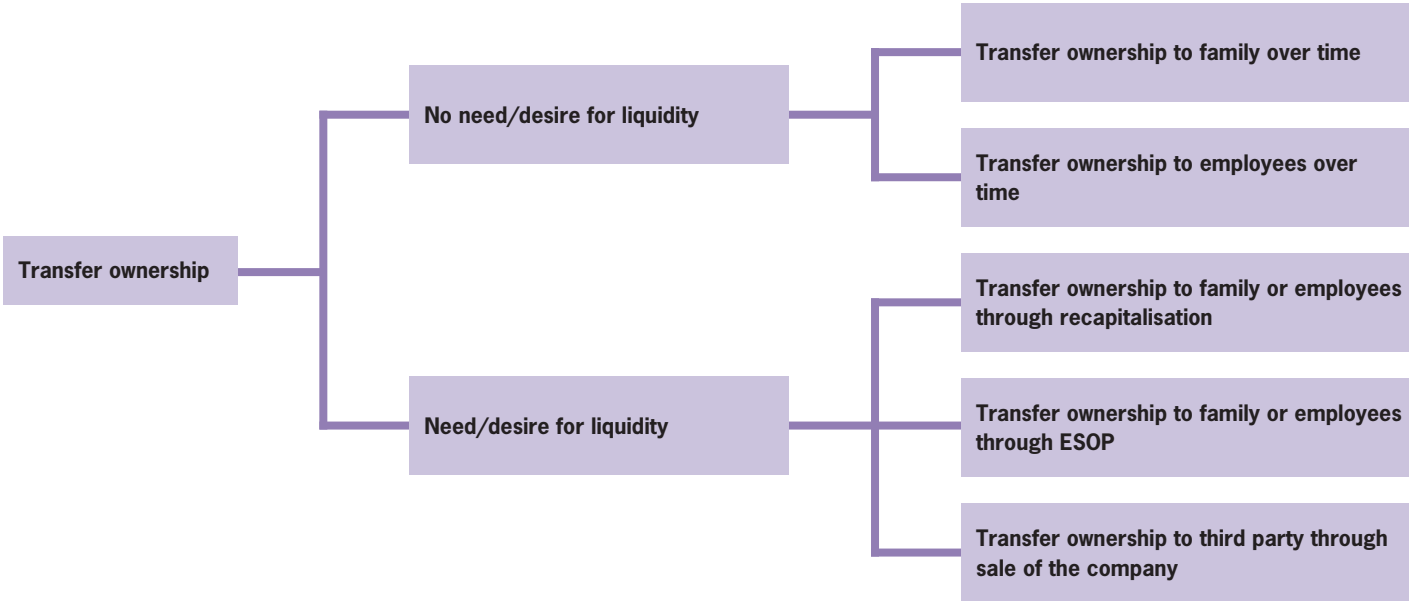
Selecting the best structure

With a clear understanding of your objectives, you have the elements you need to structure your succession plan. Whether you intend to transfer or maintain ownership, the following decision trees can assist you in evaluating your options. This process is especially useful in helping you decide whether to look internally or externally for the human and financial resources you’ll need to reach your objectives.

Internal succession is the structure typically followed by family-owned businesses. Ownership and management are usually transferred to family members or to management through a management buyout or an Employee Share Ownership Plan (ESOP).

In either case, a governance committee, such as a board of directors or family council, can smooth the transition from an organization with a single owner to one with either a professional or family management team. You do not necessarily require a legal structure when adopting a governance framework. In many cases, it is equally effective to simply interact with new management on an informal basis and provide oversight during the transition or for longer periods if needed.

Transferring ownership options



Source: Grant Thornton US



“The transition strategy you adopt is largely governed by your answers to an introspective discovery process. You can’t structure the transition effectively until you articulate your core objectives.”

Scott Griffin
Grant Thornton, Australia

On the flip side, external succession may be a better option if your family members aren’t interested in the business or there’s a lack of confidence in the ability of family members or the management team. Financing and liquidity requirements are also a determining factor. The most viable route for these situations is a triple-track process that simultaneously explores structures for a strategic sale, financial sponsor-led recapitalization or Initial Public Offering (IPO).

For those seeking to maximize short-term liquidity, sale to a strategic acquirer may be the best option. If you’ve decided to retain ownership but step away from day-to-day management, then an IPO could be considered. While many owners still view IPOs as a time-consuming, expensive proposition, access to equity markets has eased, making IPOs an attractive option in many cases.

Private equity-led recapitalizations are usually best for owners seeking employee continuity or capital to finance a transition. Although many business owners worry about their ability to attract financing from private equity investors like strategic purchasers, these firms are also interested in a company’s fundamentals, even though they may approach valuation differently. Private equity firms generally invest in businesses that are unable to maximize market opportunities because of lack of capital, limited management depth or an aversion to risk.

There are a plethora of techniques and structures that can work independently or together. The key is to match these to your company’s cash flow, growth plans and your need to take money off the table.

Keeping your options open

Establishing a structure for your succession plan is essential, but it’s only a good first step. Because in business, as in life, things rarely go according to plan. So the structure must be flexible enough to adjust to changing circumstances. Determining the degree of flexibility requires consideration of two groups of factors: controllable factors, such as company policies, family creed and business values; and uncontrollable factors, including economic trends, ownership continuity and growth plans.

All of these internal and external factors, controllable and uncontrollable, form the basis for testing various succession structures. This testing, also known as scenario planning, provides answers to key questions, including:

- How does the transition match growth and expansion plans?
- How does the owner get liquidity—either immediately or over time?
- What is the role of existing management?
- Will external managers be required?

Scenario planning can also highlight pitfalls. For instance, in the transition of a small- to mid-sized privately held business, many owners unwittingly negotiate against themselves by agreeing to a financially supported transition that requires them to maintain a management role. If the deal is linked to future performance, the owner remains largely responsible for that performance and committed to years of extra work, which may not have been part of the bargain at the outset.

For their part, large private businesses can use scenario planning to ensure the smoothest transition possible. By considering different scenarios, these companies can develop response plans in advance to deal with the potential lack of appropriate management skills or the challenges that may arise if different family groups conflict.

Many owners fail to perform realistic scenario planning because they lack a clear vision for themselves and for their business. Others conduct rudimentary scenario planning that leads to the adoption of a single or inflexible succession structure. The objective is to establish a primary succession plan and a plan B that match the expected long-term performance of your business while allowing for the unexpected.

Getting real about value and risk

Structuring and negotiating a succession plan can be an emotionally charged process for all parties. For the owner, it's a once in a lifetime event involving a significant hurdle—letting go.

After years of blood, sweat and tears, there's an understandably strong personal attachment to the business and to the ownership, which is nearly always jealously protected in a family business. Even if the owner sells an ownership interest and stays involved, tension can develop between the owner and a bunch of "know-it-all" management experts. Willingness to sell is another issue that leads to difficulties in reaching an agreement. Despite seeking a purchaser, the owner may not be fully committed to selling unless there's a real need or desire for liquidity.

When it comes to valuation, private equity and venture capital buyers are unequivocally attached to the financial side of a purchase. Owners, on the other hand, often focus on the factors which they consider make their business "special" or the possibility for strong growth. These differences can lead to a valuation gap or even the realization that the business is worth more to the owner than the purchaser.



“The structure must be flexible enough to deal with future changes and unexpected occurrences. However, there is a limit to scenario planning because you can't envision every possibility. So you must be prepared to deal with changes in a practical way.”

Frank Walsh
Grant Thornton, Ireland



“Owners need to determine the long-term forecast of the business. Any structure you put in place, especially if a buyout will occur over time and be paid out of the cash flow of the business, must match the expected future performance of the business.”

Kevin Fraser
Grant Thornton LLP, Canada

The responsibility is on owners to protect themselves and be realistic about value and risk. Understanding the true value of your business also lessens the likelihood that you’ll leave money on the table or allow the purchaser to extract all of the upside. An independent advisory group can be particularly helpful in removing emotion from the transaction and ensuring that valuation is both realistic and fair.

Dealing with tax issues

Scenario planning is also an effective means of dealing with the tax implications arising from the sale or transfer of shares, which can be substantial. Where the owner is able to claim the capital gains exemption on the sale of qualified small business corporation shares, this will have a significant impact on the tax that has to be paid. Other provisions are available that may allow the owner to defer paying tax on any gain. Regardless of the personal or corporate tax reduction or deferral methods that are available, you can’t leave the tax planning until late in the game. It’s important to seek tax advice early and to structure your company appropriately before a change in management or ownership. This can help ensure that your succession plan provides every opportunity to maximize your wealth.

All tax aspects of the transfer must be considered, especially the timing. Even if a transaction is eligible for favourable treatment from a transfer tax or estate

planning perspective, it may not be appropriate from a personal or corporate tax perspective. Care must also be taken to avoid double taxation when a company operates in more than one tax jurisdiction.

Yet despite the importance of tax planning, owners must understand that the most critical number associated with any transition is the net amount they take away. While tax planning can help owners arrive at that net amount, tax considerations alone should not drive the transition’s structure. Instead, financial considerations must remain paramount, while conducting tax planning to avoid any unanticipated outcomes.

Ask the right questions

Experience tells us that the best approach to succession planning is to start early. That helps to avoid surprises and gives you time to gain confidence in and comfort with your decisions. You can prepare for structuring your succession plans by answering the following questions.

Retirement and estate planning:

- Is there a shareholders’ agreement regarding the disposal and valuation of shares?
- Is your will up-to-date?
- Do you know how much income tax will be payable on your death?
- Have you made arrangements to reduce the potential liability of this tax?

- Do you have adequate health and life insurance?
- Will your spouse be financially independent if you were to become disabled or die?

Wealth preservation:

- Do you know how much the business is worth?
- What proportion of your wealth is tied up in the business?
- Is there scope for extracting non-essential assets from the business?
- Do you hold business assets personally?
- Do you have a diversified portfolio of investments that are not dependent on the fortunes of the business?
- Do you actively manage your personal wealth?

Owners of small private businesses may also want to ask themselves these additional questions:

- Do you have a set retirement age?
- Do you have adequate pension arrangements?
- Could you afford to retire without selling your shares in the business?
- Do you have adequate wealth outside the business to facilitate retirement?

Making the most informed choice

Succession planning is a highly personal process. With many options or combinations of options available, it can be daunting for even the most experienced entrepreneur. Being a once in a lifetime experience doesn't make the task any easier. That's why outside advisers with succession planning expertise can be valuable.

Following time-tested methodologies that are adapted to each client engagement, the practitioners at Grant Thornton LLP will collaborate with you—the owner of a privately held business—to help you make the most informed decisions. From estate and tax planning to transaction advisory and wealth management, we can help you build an effective transition strategy. With our global reach, proven track record, integrated suite of services and in-depth knowledge of privately held businesses, our practitioners truly act as your trusted guides to help you navigate the succession planning process.

To find out how our professional advisers can help you effectively structure your succession plan, contact your Grant Thornton succession and estate planning specialist.



“Some vendors are unsophisticated and may leave it to a strategic buyer to resolve the valuation issues. Those vendors are likely to leave an enormous amount of value on the table by allowing the buyer to extract all of the upside.”

Alysoun Stewart
Grant Thornton, United Kingdom

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