

The art of business succession.

Part one: The art is in the planning

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Part one: The art is in the planning

Succession planning is a complex process involving many business disciplines. This document is designed to help business owners manage an orderly transition of the management and ownership of their companies, through a comprehensive and strategic approach to the process. With substantial wealth transfers anticipated over the next 10 to 15 years, the key to long-term survival for companies affected by these transfers will be a clear and early focus on the importance of strategic succession planning.

For those companies that are family owned, the ramifications may be even more sweeping. The personal issues they face, compounding other day-to-day business concerns, range from planning for income taxes to maintaining interpersonal relationships with family members.

Despite solid professionalism and enviable profits, many closely held businesses fail to complete the transition to the next generation. While some boast sophisticated and knowledgeable professionals at the top, they nonetheless get caught in a web of complication.

Many owner-managers have an ultimate vision to retire and sell their businesses, but have not adequately considered the steps needed to make that vision a reality. Even those who never plan to retire will need to plan to ensure that the intrinsic value of their business is retained to benefit their heirs. Unless the owner is prepared to let the business expire, a long-term program to identify and groom future company executives must be undertaken.

Does your business have a succession plan in place? If so, you can identify the effectiveness of your current practices by answering the following questions. If not, these questions and the following parts of this series will help you establish a framework for approaching the process.

A negative response to one or more of these questions is a good indication that there are opportunities and benefits to be gained from undertaking a more disciplined strategic planning process:

1. Have you defined your personal goals and vision for the transfer of ownership and management?
2. Is your successor identified and in place?
3. Have you considered the importance of family involvement in leadership and ownership of the company?
4. Are you currently using techniques to minimise your taxes?
5. Do you have enough liquidity to avoid the forced sale of your business?
6. Do you have a 'buy-sell' agreement?
7. Do you have a contingency plan should you become disabled?
8. Have you considered alternative corporate structures or share-transfer techniques to help you achieve your succession goals?
9. Are you dependent upon your business to meet your retirement cash-flow needs?
10. Have you had your business valued recently?

A multidisciplinary platform

Succession planning requires a multidisciplinary process that presents business owners with a comprehensive and strategic approach to the orderly transition of the management and ownership of their business, and the opportunity to incorporate meaningful personal goals. Some of the benefits to business owners who plan properly are:

- Survival and growth of the business
- Preservation of family harmony
- Minimisation of taxes
- Facilitation of 'creative' retirement.

A comprehensive approach focuses on the key components as outlined in Figure 1-1. A multidisciplinary approach is a very powerful methodology for business owners to achieve and implement a broad-based and widely accepted succession plan. The business owner seriously considering how to formulate (never mind implement) such a plan will no doubt be daunted by the task. The business owner will not have the depth of relevant experience to draw on as this is likely to be the first time that this has been attempted. The multidisciplinary approach allows the business owner to draw on the experiences and expertise of several advisors who will work together as a team, to assist the business owners and the interested parties in defining and meeting their strategic goals.

The complexity of the planning issues facing closely held business owners is disproportionately large when compared with those of individuals of similar net worth who do not own their own businesses. Closely-held business owners must not only account for the preservation of family wealth – through estate, retirement, insurance and investment planning – but must also deal with the host of additional issues directly related to the enduring success of their business operations.

Some of these issues include:

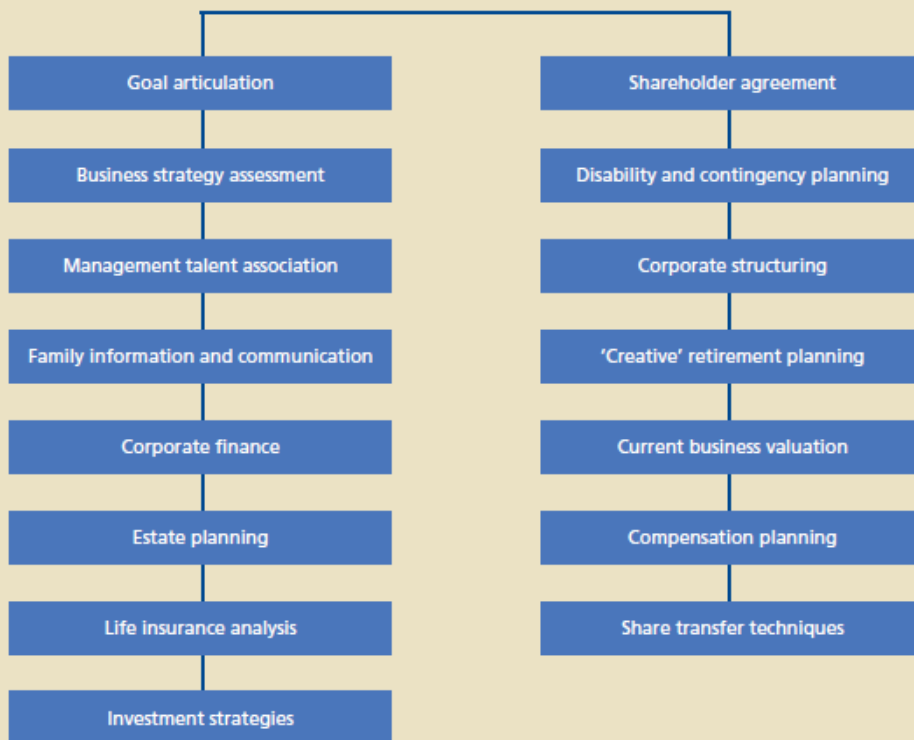
- Development of a formalised 'grooming' program for successors
- Building a long-term business strategy
- Evaluation of corporate finance and entity structure options
- Addressing compensation planning for successors and key executives
- Implementing shareholder agreements
- Establishing a contingency plan for the business (in the event of something happening to interfere with the performance of key personnel)
- Considering complexity relating to closely held share valuation issues
- Utilisation of tax-effective ownership-transfer techniques.

As if the financial, business, and tax issues are not challenging enough, strategic succession planning becomes even more complicated when family issues – relating to legacy, birth right, communication, personalities, and interpersonal dynamics – are added to the mix. What may appear to be the simplest of tasks can become more complex due to the interweaving of family interests with business concerns: explicable because the goals of the business, (e.g. to generate profits, exploit market opportunity, reward efficiency, develop organisational capacity and build shareholder value) are, on occasion, in direct conflict with the recognised goals of the family, (e.g. to nurture, develop self-esteem, grow healthy adults, provide love and safety).

Additionally, we are seeing a growing trend of business owners, rather than retiring fully from the business, taking the opportunity to redefine their role as part of the succession planning process. This trend reflects the reality that not all business owners want to retire from all aspects of the business they have helped to create. They simply want to retire from those aspects that they no longer wish to spend time dealing with, but at the same time benefit from the mental and physical challenges of continuing to work in the business – a creative retirement. Even though an owner may choose to stay in the business, it should not impede the transfer of ownership or the broader succession issues being dealt with.

Figure 1-1: Key components of effective succession planning

Business succession planning



The following are frequently offered as reasons to delay the succession planning process:

- No one is sure exactly who to call for help or how to start the process
- The owners worry about being 'fair' to all potential successors
- They fear the possibility of straining their interpersonal relationships
- They are concerned about how to acknowledge key personnel who are on the management team and valuable contributors to the business who should be retained, but are not in line for ownership
- They have difficulty discussing financial matters and personal goals with others (or outsiders) because it is too private, somehow unpleasant, or considered taboo
- The owners may not wish to retire
- They struggle to disconnect from the day-to-day urgencies to focus on long-term planning
- They assert that because successors are 'not yet ready' to assume control, nothing can be done
- The entire process seems too daunting
- Owners perceive that it's a cost to be incurred with no immediate benefit.

With all of these anxieties, it is not surprising that studies show that fewer than 30% of private businesses have an achievable succession plan in place. Most business owners do nothing or they choose to focus on one element of a succession planning process and ignore other equally important issues, often leading to a poor outcome for all.

A comprehensive, multidisciplinary approach to succession planning can dramatically increase the chance of a desirable result (see Figure 1.1). But with so many considerations, how do we begin the process?

The answer is through the implementation of a systematic, strategic and comprehensive approach to succession planning, which should include the following:

- Articulation of owners' goals
- Identification of key stakeholders (those individuals who are significantly affected by the plan, or may have the capability to have a significant impact upon the plan)
- Articulation of key stakeholder goals and communication
- Compilation of owner/stakeholder goals; development of a shared vision
- Application of a succession planning platform (figure 1.1)
- Identification and prioritisation of most critical issues
- Implementation of coordinated solutions that best address critical issues identified, and are in alignment with the owners' and stakeholders' shared vision. These solutions, in conjunction with each other, constitute the overall succession plan
- Monitor and review for obsolescence

Goal articulation and communication with stakeholders

The biggest threat to the successful transition of a business from one generation to the next lies under unturned stones. The first step in succession planning should involve the articulation of the owners' personal goals and vision for the future of the business. The goals of all of the other key stakeholders (individuals significantly affected by the succession plan) should also be communicated and understood. By including the stakeholders in the goal-setting process, owners and other relevant decision makers can compile important information about their individual goals and expectations. *(Note: It is important to understand that none of the decision-making authority of the senior owners is diluted by the involvement of stakeholders. They are not being granted voting rights; those rights still belong with the owners of the company. The purpose is to provide the stakeholders with a formalised mechanism to express their goals, expectations, and desires, while supplying the ultimate decision makers with a complete frame of reference for making good decisions.)* As a result, all parties feel a sense of ownership in the succession planning process, greatly improving the likelihood of its ultimate success.

Succession plans that are unilaterally implemented without communicating or fully understanding the issues of the people affected by them typically waste time and money and, not surprisingly, fall apart. Even the most innovative and elegant succession-planning techniques can fail when assumptions are made regarding the desires of others.

The goal setting process

Every business, whether it is family owned or comprised of non-related business associates, needs to define and establish a commitment to a shared future. This 'blueprint' for success is commonly referred to as a *vision*; an image of the future state of your organisation and a description of 'where you see the company' years from now.

More than a dream or a set of hopes, it must include management's commitment to making the vision a reality. If well-articulated, and appropriate for the organisation, it will help to build consensus among key people. It should be ambitious and set clear standards of excellence for which all must reach.

Yet the establishment of a vision does not in itself constitute a sound succession plan. Goals must also be set. Time consuming but necessary, the goal-setting process should start with a definition of the desired end result. If you don't know where you're going, how will you be able to get there? All goals should be consistent with, and support, the vision. It is important to note that if you are a closely held business owner, you must not only develop goals for the business but establish personal and family goals as well, including those related to exit strategy, retirement and personal lifestyle.

Goals can be formed by sitting down with your family (and/or applicable decision makers in the business) and brainstorming. This will give you a sense of everyone's true interests in the company and where they may see themselves fitting into the future.

The following questions, in addition to many others, must be addressed early and often during the goal-setting phase:

- Should the business owner keep the business or sell it?
- If kept within a family, who will lead it?
- Will the selection of a new leader create family animosity or bitterness?
- Perhaps the business will be sold. If sold now, is the current business operating strategy maximising value for the shareholders?
- Are there steps a business owner can take to enhance the value of the business in the short term while planning a later sale?

There are many characteristics to well-formed goals, easily recalled through the use of the acronym SMACC:

Goals should be

- Specific
- Measurable
- Achievable
- Challenging
- Consistent (with each other, as well as with the company vision).

Only the goal-setting process will allow owners and leaders of a business to identify and review the many meaningful objectives for management and ownership transition, and to clarify the underlying business and continuity strategies. When drafting goals, consider what is to be accomplished and how, (i.e. develop the time-frame and cost parameters within which the goals are to be achieved).

Understanding the critical issues

After compiling and understanding the goals and expectations of the stakeholders, the owners should spend time examining the application of each of the succession planning disciplines (shown in Figure 1.1) to their particular situation. For example, an overall succession plan may include elements pertaining to management grooming, incentive compensation, retirement planning, tax planning, share transfer techniques and business governance. The most critical issues will emerge from this exercise, and the solutions implemented will align with the goals and the common vision as identified by the owners and stakeholders earlier in the process.

Case study

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

Scenario A

Robert is a closely-held business owner in his early 60s. Robert has four children (Nathan, John, Emily and Amilia) who are experienced at working in the business, plus two younger children (Cindy and Gail) who do not currently work in the family business. Robert's wife (Sally) also owns shares but does not participate actively in company management. Sally wants Robert to scale back involvement in the business so that the two of them can enjoy their retirement years together. Sally would like to move closer to the beach and be able to travel unburdened by the demands of the business.

Robert decides to take action and meets with financial business advisors and lawyers to build an estate plan – one that includes family partnerships and trusts that hold insurance and company shares. Robert does not completely understand what has been done, but rests easy thinking that he has implemented a plan that will save large amounts of tax when he dies. The family's perception is that the business succession plan is 'complete'.

A year later: Robert is ready to scale back involvement in the business, but cannot because Nathan has decided to resign from the business for family reasons. As a result, Robert relies more on unrelated key employees (who are not in line for ownership of the company) to get things done. The children recognise this and mutual unspoken resentment begins to develop with management. Meanwhile, Gail and Cindy feel short changed of a 'birthright,' as the other siblings are drawing salaries and driving company cars. In addition, the plan developed last year involves the transfer of non-voting shares to Gail and Cindy that do not pay dividends. Gail and Cindy are beginning to think the current arrangement is unfair and are becoming increasingly resentful of other family members.

Robert is now feeling pressure at work and at home – and is, not unexpectedly, developing health complications. Sally and the family doctor recommend that Robert reduce time spent in the office, leaving a vacuum that the children exploit to assert their leadership – a role for which they have not yet been

adequately groomed. As a result, several key executives and customers leave. Sales fall off and the top salespeople go to the competition. Gail and Cindy see the value of the inheritance falling and demand the other children be demoted or fired. Robert and Sally worry that the poor results from the company will affect retirement cashflow needs and long-awaited travel plans.

Months later: Robert's health improves, but company operations continue to suffer. The children are no longer speaking with each other and holiday get-togethers are cancelled. Cindy and Gail want to sell ownership for cash to outsiders, catapulting the family into consideration of a sale of the entire business.

The value received in the sale is a fraction of the amount projected by the professional financial advisors and lawyers years earlier in the estate plan. There is a real concern that the previous estate plan has turned certain pre-Capital Gains Tax (CGT) shareholdings (and therefore not subject to tax) into post-CGT shareholdings. The company's corporate structure and the terms of the sales transaction leave the family with the prospect of receiving only 35 cents after-tax on every dollar of sales proceeds received. The legacy of the family business is no more.

Aftermath: The children obtain employment elsewhere but not with the same benefits they previously enjoyed. Gail and Cindy blame the other children for the reduction in inheritance. Robert and Sally's post-retirement plans must be revisited. In the aftermath of the sale of the business, all the tax planning accomplished years before has been unravelled.

Q. Robert used sophisticated estate planning techniques devised by the best specialists. So, why did the plan fail?

A. Effective succession planning considers many disciplines and interlocks those disciplines to create a cohesive and anticipatory framework. Robert focused on just one component – estate planning – to guide the business succession planning process.

Scenario B

This time, Robert begins succession planning by instituting a formal strategic process, called a *Critical Issues Assessment*, based on the application of a multidisciplinary succession planning platform and designed to encourage input and participation of all the key stakeholders affected by the plan (in this case Robert, Sally, the six children and the key executive, Peter). Facilitated by experienced professional consultants using proven methodologies and assessment tools, an understanding of goals, expectations and feelings about legacy and birthright of the individuals affected by the plan, is achieved. The adequacy of the existing plans is evaluated against a succession planning comprehensive platform. Strategic meetings with stakeholders are conducted and a multidisciplinary blueprint for success is developed.

Everyone becomes focused *as a team* on the important strategic decisions ahead. Information collected during the Critical Issues Assessment helps Robert organise and prioritise issues from every discipline – right from the start – that might have an impact on the ultimate succession plan. Lines of communication between stakeholders are opened, and broadened levels of understanding help everyone coordinate their respective individual goals with the goals of the entire family and business 'system'. After going through this strategic process, Robert has the proxy of the other stakeholders to act in their mutual best interests.

Robert discovers both Gail and Cindy are very concerned they are not being adequately groomed to succeed in future executive roles. They want to participate in a structured program to develop the needed skills to succeed and are willing to 'do whatever it takes'. Further, Robert uncovers that Gail and Cindy are concerned about being deprived of a rightful share of any profits that may exist in the future because of their less-than-active participation in the business.

Robert also discovers that several valuable unrelated employees are being recruited by competitors. These individuals have been tempted by offers of options and incentive compensation packages from other companies but prefer their current work environment for now. Furthermore, they do not have ownership expectations, nor are they threatened by the children's participation in the business. They have indicated they are willing to participate in a grooming plan for the children but express a desire for a greater share of the expected success the company will enjoy over the coming few years in recognition of their contribution to that success. Robert is also made aware of significant tax exposure. The company and the real estate owned by the company are structured inefficiently for income tax purposes. The projected tax liability on the transfer of wealth might total millions of dollars, causing the family and the business serious liquidity problems.

Additionally, company management feels that the board of directors should play a greater strategic role, especially with regard to the management development plan of the successors. No retirement planning has been accomplished by Robert and Sally to quantify their ability to pay for the retirement lifestyle they desire. Robert's individual investment planning seems somewhat haphazard with the result that his portfolio has significantly underperformed in comparison to the market over the past 36 months.

Robert and the stakeholder group discussed all of the critical issues laid before them, and collectively decided to prioritise them as follows:

Attention needed: immediate

- Design a specific management grooming process to enhance the development of the children. Determine the characteristics, experience, and education required to effectively fill the anticipated future role. Assess the qualifications that the children currently possess, and begin to implement specific programs (under the direction of current executive management) to match qualifications with job requirements
- Build an incentive-based compensation program that is tied to company performance measures to reward unrelated upper management for their contribution to the management development process and the overall success of the business. The goal is to retain and motivate these key management personnel during the critical management grooming process
- Build an incentive-based share bonus program for the children, which is tax effective, will transfer 'time released' ownership to the children and will motivate/reward the children for striving to exceed the objectives of the program

- Develop an active board of directors, including independent representatives from outside ownership and management, to provide strategic insight and constant feedback during this critical period of transition. Certain board members will be assigned the task of monitoring and reporting the progress of the management development plan to the shareholders
- Devise a tax strategy plan, which dovetails with the plans above, to legitimately eliminate or reduce exposure that now exists. The plan could include a program to gift and bequeath non-business assets to Gail and Cindy, who are not active in company management, and transfer ownership in the company to the other children, while leaving control of the voting shares with Robert until the children's management grooming program is complete. Several recommendations can be presented by the advisors, and the best approach will be recommended by the advisors and approved by the owner and the stakeholders
- Review Robert's wealth-creation strategy to identify strengths and weaknesses. This will include an assessment of his appetite for risk and whether he is 'at risk' as a result of his business activities, and the use of appropriate structures and strategies to mitigate this risk as far as possible. Given Robert's age, a comprehensive review of his investment strategy will be required. This will include the consideration of both Robert and Sally's use of superannuation as a savings vehicle and for providing tax-efficient income streams in 'retirement'. This will also consider utilising tax deductible contributions for Robert and Sally and/or uneducated contribution strategies to boost the effectiveness of this strategy. The appropriateness of the investments and the strategy should be actively monitored in future.

Attention needed: three to five years

- Restructure the corporation and related entities to be more tax efficient and meet estate planning objectives
- Robert should consider scaling back his current active role in management in accordance with the recommendation of the board and his perceptions on the development progress of the children. Alternatively, Robert might 'retire' to a new role that could see him with a market facing position in the business requiring him to meet with valued customers at company events, acting as a sounding board for the new Chief Executive Officer (CEO) on major contracts and presenting the financial accounts at the AGM
- Reassess adequacy of insurance coverage for company, (e.g. key person life, buyout insurance).
- Finesse Robert's wealth-creation strategy to provide the cash flow and capital sums for Robert's 'dream' retirement, including the purchase of a new home in Point Piper, Sydney, world travel, a fishing boat and educational trusts for the grandchildren

All the stakeholders agree to this blueprint for succession. Robert begins to take steps to implement the strategies with the full support of the other stakeholders. Responsibility for monitoring and periodic review during the succession planning process is assigned to key executives and board members. All stakeholders are kept apprised of progress and adherence to the plan.

When Robert unexpectedly takes ill, the management team and children pull together during the crisis, rather than struggle for power. Gail and Cindy appreciate the rigorous management development program undertaken by the children. They also understand their family birthright is not directly affected by business operations because assets outside of business operations have been set apart for their inheritance. Key executives have been offered incentives to remain with the company for ten years by use of tax-deferred compensation. These individuals even take on a paternal role in developing the executive skills of the next generation.

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