THE ART OF BUSINESS SUCCESSION

Part two: business continuity and growth

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INTRODUCTION

Effective succession planning enables a company to examine and integrate diverse business planning elements into one coordinated plan. All of the elements must be working in concert in order to achieve the goals of the company's stakeholders. Any oversight may result in the plan becoming derailed. Elements to consider include business strategic direction, development and/or recruitment of management talent, share transfer techniques, entity structure, compensation planning, disability planning, valuation and financing alternatives.

BUSINESS STRATEGY ASSESSMENT

All business owners should account for the company's strategic direction when building the succession plan. While many private business owners have already implemented a strategic planning process and developed a written business plan, others have either not undertaken this effort, or have not kept their business plan current and relevant. While a detailed discussion of writing a business plan is beyond the scope of this document, Appendix 1 contains an outline of a sample Strategic Business Plan. General concepts that would help closely-held business owners to better understand the importance of developing an overall strategy for the business are also included in Appendix 1.

MANAGEMENT SUCCESSION

The management-succession process becomes more and more complicated as businesses grow. In order to ensure the successful transfer of knowledge, skills, abilities, values, talents and behaviours required to maintain the business culture and management effectiveness, a formal plan must be developed, implemented and monitored. The development of such a plan may also serve as the basis for future strategic placement, development and use of human resources.

Remember that management succession is also an important aspect of a business operation and should support a number of desirable operating disciplines including:

- The creation of an environment within which individuals can successfully carve a career
- Ensuring the replacement of important knowledge, skills and abilities
- The competitive positioning of an organisation as an 'Employer of Choice", interested in attracting, retaining and developing talent. (Note: the management-development plan should also be coordinated with the overall corporate strategic plans, marketing initiatives, compensation/incentive programming and owner exit strategies).

MANAGEMENT TALENT & ASSESSMENT

Professional competency evolves from a combination of factors, including education, experience, motivation, personality, intelligence and innate ability. Business owners must also recognise that management competency and its perpetuation will not only have a direct bearing on internal business processes, but will have a direct impact on the preservation of share value as well.

The process of developing competencies in next generation leaders is strongly influenced by the following:

- Understanding of the business goals and time frames
- Preparation of an overall management-succession strategy, coordinated with other elements of the owner's succession plan
- Identification and definition of the leadership positions of the company and the competencies required for each position
- Assessment of available candidates
- Comparison of identified leadership positions with the skill sets of available candidates
- Preparation and implementation of individual development programs for chosen successors
- Monitoring and tracking progress

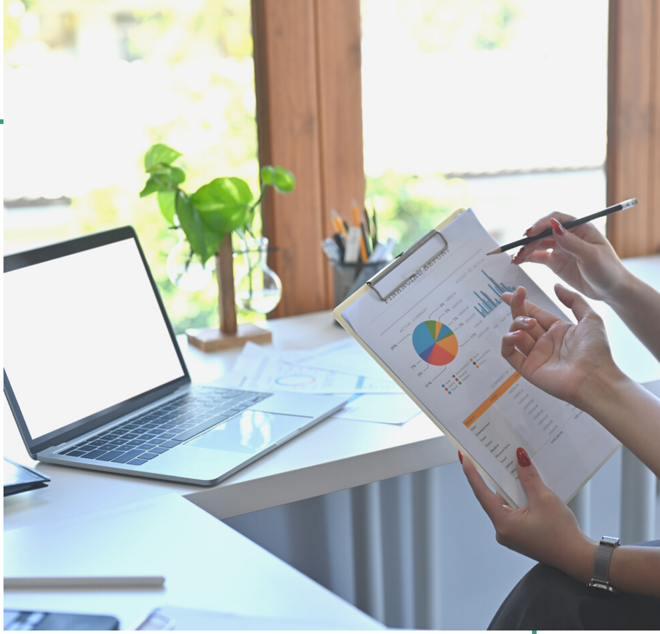
A formal process should be implemented by the company that will define the needed competencies, identify the chosen successors and develop a grooming regime. This process is often referred to as a management talent assessment and development program.

ASSESSMENT AND DEVELOPMENT

First, the company must review the current state of the business regarding areas such as vision, mission, strategic plan, market position and company culture. If appropriate, comparisons with industry standards or other similar businesses may be helpful. The company should also ascertain the current state of the relevant job market and try to identify the company's respective standing in that market. The result will offer an up-to-date understanding of the company's current position, direction and strategy.
After the future key leadership positions of the company have been defined, the related core competencies must be identified for each position. Core competencies are the skills and behaviours needed by a candidate to perform the job. These are determined by the incumbent leadership team, the board of directors, and sometimes outside management consultants. The company leadership should have determined exactly what executive positions are needed, and what sort of individuals must be found to fill them.
The next step is to identify candidates. A pool of potential successors should be created and each candidate reviewed using factors including current responsibilities, work history, personality traits, special talents, abilities, education, history, professionalism, years of experience and other relevant job-related criteria. The professional and personal expectations of each candidate should also be explored in order to develop a better understanding of the capacity of each of the candidates to perform within the context of the company.

With the future leadership needs of the business now clearly documented, and the population of potential leaders (including their current competency levels) identified, senior management and board members must analyse – and match – those criteria for each candidate based on current competencies and future potential.
Matching the proper candidate with the proper position, the process is scientific. Management consultants may help to accomplish this process through the use of interviews and other tools that serve to assess behavioural traits, talents and other skills defined as 'core competencies'.
In the case of a family business, the selection of the successor is often determined by blood and, on occasion, the 'successor pool' may contain only one individual. When this is the case, the process relating to the development of the CEO will not focus on selecting the best candidate from the pool but on the immediate next step in the process, matching the successor's current skills and experience against the core competencies (as defined earlier in the process) and the construction of a grooming program.
Sometimes the process reveals that an adequate successor is not currently employed in the business. This is important information to absorb, as company owners must then consider alternatives, such as recruitment of a suitable successor, the cultivation of a business combination or a strategic alliance with another company, and the exit strategy for the current owners and managers.

ASSESSMENT AND DEVELOPMENT



Once a successor (or group of successors identified as high potentials) has been identified and the individual's readiness quantified, the next task is to match the successor's readiness and skills with the required job core competencies. Areas of skill and experience 'gaps' must be identified (as well as processes to close the gaps) and developed. It bears repeating that it is in the best interests of your company to make sure that the process accounts for and acknowledges the personal career goals and expectations of the successor.
In those cases where a long-term management development program is to be implemented, adequate consideration should be given to providing for interim management while the successor is still developing. As plans don't always work according to the desired timetable, interim leaders may need to lead the company in times of crisis. If the current CEO becomes ill or disabled, an undeveloped successor candidate should not be thrust to the fore. A more experienced albeit short-term leader should 'assume command', until the CEO is able to return to duties, or until the successor development program is complete.

In order to gain business experience, as previously mentioned, some grooming plans require that the successor spend a period of years working for another company or even, under certain circumstances, a competitor. Other plans may address the need to improve the successor's understanding of company operations by cycling the successor through a rotation of responsibilities in different divisions within the company, or by participating in large proposal efforts and special strategic projects, (e.g. plant expansion, corporate financing deals or acquisition plans). Typically, these types of development plans include the following elements:

- On-site activities/projects
- Community projects or participation
- Off-site activities
- Self-development
- Formal training
- Shadowing

In addition, compensation strategies for successors should be designed to reward achievements within the management development plan. Motivational short-term incentives can be provided for the successor related to training, educational and developmental goals, while longer-term incentive packages can be arranged to help retain the successor throughout the life of the development plan and beyond.

AFTER THE PLAN IS DESIGNED AND IMPLEMENTED

It is important to monitor the development of the candidate and the validity of the grooming program. The candidate's progress should be compared to the plan, and areas of significant progress or difficulty should be identified and examined. New areas of focus may become evident through this 'checks and balances' procedure, and the development plan itself should be periodically checked for obsolescence in light of changes in the business strategies and environment. It is also important to consider how 'chemistry' plays into succession in terms of palatability with customers or with others on a team. These additional elements that relate to behavioural reception are important in the transition of competence to new generations.

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In summary, it is valuable to remember succession planning is defined as the transition of both ownership and management. While many business owners spend significant effort developing a formal ownership transfer plan (using accountants and lawyers to develop an ownership transfer strategy and manage the tax implications of the strategy), they fail to develop similar formal programs to groom the next generation's management team. Too often, the next generation is expected to gain the necessary executive skills 'by osmosis'. In many cases, management succession may require even more formal planning than ownership succession. Selecting, evaluating and developing candidates for leadership positions within the company is an ongoing process. If you wait until there is an immediate need to find a successor, in most cases, you will have waited too long!

ENTITY STRUCTURE

Closely-held business owners are typically presented with challenges regarding the selection of a proper legal structure, whereas larger, publicly-held companies generally are not. The large public companies offer the greatest access to the public capital markets. Without this consideration, there are more options for closely-held business owners, and deciding on the best corporate structure is often influenced by the succession plan.
Closely-held businesses operate in many different forms, including private companies, trusts (discretionary, hybrids and unit trusts), partnerships, sole proprietorships and various combinations thereof. There are a myriad of considerations, both tax and non-tax related, that closely-held business owners must consider when structuring (or restructuring) to achieve their goals.

For the leadership of a closely-held company, the right choice of entity is crucial as, unlike in the case of an employee or shareholder of a large public company, the financial transactions of a closely-held business may have a large, immediate and direct impact on the closely-held business owner's personal finances, cash flow and income tax bill. Because of this, the impact of corporate plans must be considered in conjunction with the needs and goals of the individual stakeholders who are directly affected by the strategic decisions of the company.

For example, a closely-held company may be owned partially by an older shareholder who is thinking about exit strategies, estate planning, and retirement. That individual's personal financial situation may be comfortable. Personal objectives may include the distribution of wealth (in accordance with an estate plan) and the sale of ownership at a premium as soon as possible. There may be another younger shareholder who has only recently obtained ownership. That individual may have borrowed money or given up cash compensation in exchange for shares in the company. There may be employment restrictions tied to the ownership of those shares. They may have a new family to support, relatively high mortgage payments and current cash flow pressures. Likely objectives are going to be to grow the company for the long-term and maintain sufficient personal cash flow.

In such a case, it is undesirable to devise a restructuring plan that will accomplish the goals of one owner at the expense of the other, especially where there are personal relationships involved. In planning for corporate structuring, just as in the other disciplines of succession planning, it is important to work with the entire 'system' when possible, taking into account the goals, needs and expectations of all of the stakeholders affected by the plan. A suitable compromise can almost always be reached when everyone is afforded the opportunity to voice concerns and participate in the decision-making process.

PRIVATE COMPANY

The primary reasons many business owners operate through companies are not tax-related. Corporations provide a corporate 'veil' of liability protection for the owners that partnerships and sole proprietorships do not. Because a private company is a separate legal and taxable entity, some shareholders value the separation (tax and otherwise) from their personal affairs afforded by this structure. And although limited liability companies (discussed below) allow a corporate veil of protection for their owners, the courts have sought to lift the corporate 'veil' to attack the directors of the company. Private companies have been around for a long time and many individuals consider them a safer bet regarding personal liability.

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The Corporations Act, the Income Tax Assessment Act (ITAA) and other statutes may affect a business owner's decision to operate through a private company. For example, under the ITAA, certain restrictions are placed on companies lending funds to shareholders and their associates, certain restrictions are in place on private companies paying dividends or returning capital to shareholders, etc. These restrictions do not apply to other structures such as partnerships and trusts.

Advantages

There are some advantages afforded to private companies including limited liability and the corporate tax rate of 30% (or in some cases 25% if the Small Business Company tax rate applies). This is compared with the top marginal rate of 47%. Dividends paid by companies can have franking credits attached to them reflecting tax paid by the company. Companies are also suitable vehicles for equity-raising and are able to take advantage of any R&D concessions that may be available.

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PRIVATE COMPANY

Disadvantages

A number of onerous tax provisions apply to private companies, including the private company loan provisions which, if invoked, will result in the loan to the shareholder (or the shareholder's associate) being taxed as an unfranked dividend with a debit to the company's franking account. Furthermore, private companies are subject to complicated ownership rules in order to utilise tax losses. Should the ownership rules be breached, the company will be subject to, and required to satisfy, the more complicated same business test before it can utilise its tax losses. Additionally, if a company tries to pay excessive remuneration to associates of the company, the Australian Taxation Office (ATO) may re-characterise the excessive portion of the salary as a dividend and deny the excessive salary deduction for the company under the rules for payments to associates.

Companies do not obtain the benefit of the 50% CGT discount on the sale of CGT assets. This is in contrast with individuals and trusts which (subject to satisfying certain tests) can obtain the benefit of the CGT discount.

The decision to convert from private company status or convert to private company status is complicated, but it may be part of the answer in building a succession plan. This is because of the advantages pass-through entities (like trusts) allow in many tax-effective ownership transfer plans.

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Another advantage of pass-through entities (like trusts) over regular private companies is that pass-through items (such as capital gains) retain their character as they pass from a trust to a beneficiary. This can result in significant tax savings. For example, a company sells an asset and incurs a capital gain upon which tax is paid at the corporate tax rate of 30%. The proceeds from the sale are paid to the shareholder in salary or as dividends, thus the income is re-characterised as ordinary income, subject to the various salary on costs (if paid as salary) and higher individual ordinary income tax rates. However, if the entity is a pass-through entity, the proceeds from the sale may be distributed without additional tax to the recipient, (i.e. beneficiary of the trust), and the preferred capital gain treatment is passed through to the recipient. In addition, tax legislation is in place that places restrictions on companies returning capital to shareholders.
It is a good idea for private company shareholders to institute formal shareholder agreements and written dividend policies that address important issues like ownership transfer arrangements.

PARTNERSHIPS

Like the other entity choices for closely-held business owners, there are both tax and non tax reasons to conduct business as a partnership. The biggest disadvantage to partnerships is unlimited personal liability for the general partners. A traditional partnership provides no veil of liability protection for the personal assets of the general partners (a limited partner is typically only at risk to the extent of their investment in the partnership). This reason alone is enough for most owners to find it unacceptable to operate a business in the form of a general partnership.

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Advantages

In their favour, partnerships are easier to set up than corporations, allow for more flexibility in apportioning and distributing profits, and generally are less costly to administer. For example, partnerships can allocate items of income and expense amongst the individual partners in any manner the partners agree on, and as documented in the partnership agreement.
Another often-touted advantage of a partnership is the ability of the owners to deduct losses against the partners' other income if the partnership incurs a tax loss (rather than the tax loss being trapped in the partnership).

PARTNERSHIPS

Disadvantages

The disadvantages of partnerships compared to companies are mostly non-tax (such as joint and several liability). Other perceived disadvantages include the difficulties associated with admitting new partners and the day-to-day control and decision-making as each partner has the ability to bind the entire partnership. However, there are several tax advantages corporations have over partnerships. The proper choice of entity will differ, depending on the objectives of the owners, the composition of the owners and management team, and the overall strategic plan. Often, estate-planning techniques will dictate the best structure, such as when family business structures are formed to facilitate tax-effective transfer of wealth from one generation to another. Often, share transfer techniques overlap with structuring strategies, like in the case of an Employee Share Ownership Plan (ESOP). The tax benefit of certain compensation plans may be enhanced by the choice of structure. The possibility of a public offering will certainly be a consideration when choosing an entity structure.

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Furthermore, the choice of the proper entity will be affected by the relationship of the owners and managers. For example, owners who are not active in the company management may be concerned with tax-effective dividends and not as concerned with compensation plans. Individuals who are active in management but do not currently own shares may be more interested in structures that are compensation-friendly. Older individuals may have retirement savings in mind and may want to restructure the company as part of an estate or retirement plan. Younger individuals who stand to benefit from a share-transfer plan may want a structure that helps facilitate such a plan. Older managers may be thinking about exit strategies, while younger managers may be thinking about reinvesting and diversification and acquisition strategies – all of which are affected by the entity structure.

The recurring theme when discussing all the components of succession planning is the interlocking nature of the parts – it is like fitting together the pieces of a jigsaw puzzle. The correct corporate structure must be combined with the other relevant elements of the comprehensive succession planning platform to build a tax-effective program that meets the needs and goals of all the stakeholders involved in the succession plan.

TRUSTS

Trusts are used for a variety of purposes. The flexibility of trusts is perhaps the major reason that they are so widely used in tax planning. Trusts can be created and funded during a lifetime (inter vivos trusts) or they can be created by the terms of the will (testamentary trusts). The terms of a trust may allow it to be changed or even revoked, or the terms of the trust may be fixed or irrevocable at the date of creation.

Discretionary Trusts

Advantages

The discretionary trust is the most common type of trust, and is commonly used in family tax planning arrangements. Compared to a fixed or unit trust, a discretionary trust offers greater flexibility and scope for the trustee to distribute the trust income in order to minimise tax liability on the total net trust income. Under a discretionary trust, some or all of the entitlements of the beneficiaries in any particular income year are determined by the exercise of the trustee's discretionary powers. Other advantages typically include the distribution of tax-free amounts to beneficiaries with no income tax or CGT consequences; limited liability by appointing a corporate trustee; eligibility for 50% CGT discount and CGT small business concessions; and not having to maintain a franking account.

Disadvantages

A discretionary trust is generally more costly to establish and maintain than other entities. Other disadvantages include the fact that a trust must vest within 80 years; losses cannot be distributed and must remain in the trust until recouped; and the potential limitations in making distributions of income or capital to family members only where the trust has made a family trust election.

Fixed Trusts

Advantages

A fixed trust is one in which the beneficiaries are said to have a vested and indefeasible interest in a share of the income and capital of the trust. The trust deed tells the trustee precisely how to deal with the property and income under the terms of the trust. A unit trust is a form of fixed trust under which the entitlement of each beneficiary to trust income and trust property is determined by the number of units owned by the beneficiary. Essentially, under a fixed/unit trust, the trustee can decide how much to distribute, but the beneficiaries and their share of the net income to be distributed, is predetermined. One of the main advantages of a fixed/unit trust over other entities is the ease of introducing and retiring equity members and the fact that there are fewer formalities than there are with companies.

Disadvantages

The disadvantages are much the same as in the discretionary trust scenario, with the added disadvantage that some non-assessable distributions cannot be distributed to beneficiaries without a reduction to the cost base of the units or interest for CGT purposes.

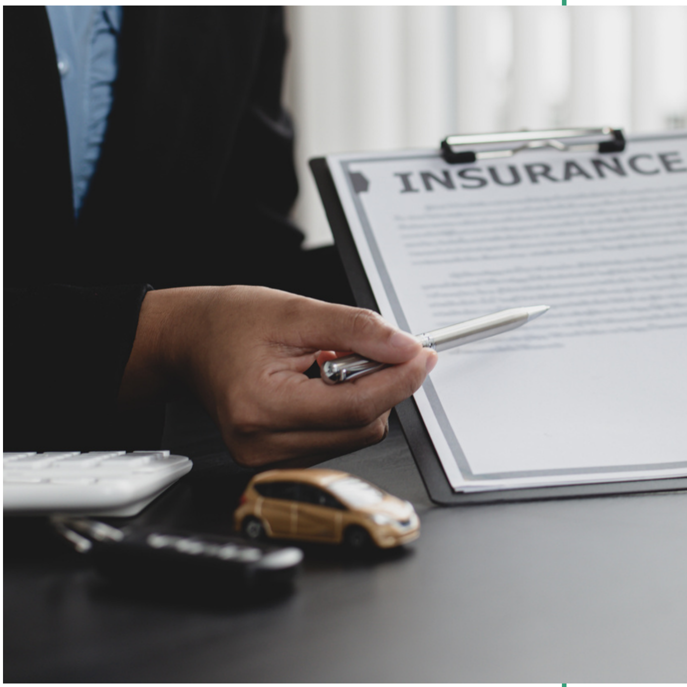
DISABILITY AND CONTINGENCY PLANNING

When it comes to disability planning, business owners have more responsibility than regular employees. If a regular employee who owns disability insurance is injured or becomes ill and is unable to work, the employee will receive payments from the insurance company to replace the pay cheques until the disabled earner can return to work.
It is not as simple for business owners. They need disability insurance to provide income for their families in the event of disabling injury or sickness, just like everyone else, but business owners must also plan for the survival of the business in the event of diminished capacity. No succession plan is complete without the development of a contingency plan – survival of the business and family wealth may depend on it.

Disability buy-out insurance and the shareholders buy-sell agreement

Shareholder agreements, or buy-sell agreements are legal and binding between the individual shareholders of a corporation in order to provide restrictions on the transferability of closely-held shares and other business interests, for the overall protection and benefit of all the shareholders. Certain agreed-upon events will cause the corporation and/or other shareholders to redeem or cross-purchase the ownership from the shareholder who has 'triggered' the specified event. It is common that most buy-sell agreements define the death of a shareholder as a triggering event, and buy life insurance as a means to fund the redemption or cross-purchase of the deceased shareholder's shares.
Unfortunately, many buy-sell agreements overlook long-term disability as a triggering event. The result can be the paralysis of the corporate board and senior management and an inability to take those strategic actions that would be in the best interest of the business, because the responsibilities and voting power of the disabled shareholder have been relegated to relatives or others who may not be prepared to make informed business decisions

DISABILITY AND CONTINGENCY PLANNING



Benefits of implementing a buy-sell agreement

- Preservation of control among existing owners
- Avoidance of a disruption in managing the closely-held business
- Establishment of a market for an otherwise illiquid asset
- Establishment of a predetermined method for determining a fair price and terms for the buy-out
- Reduction of financial risk for deceased's family.

For this reason, it may make sense to include a provision in the buy-sell agreement that defines long-term disability as a triggering event for redemption or cross-purchase of the disabled shareholder's shares. The company, or other shareholders, can acquire a long-term disability insurance policy on each of the owners in order to fund the buy-out. The buy-sell agreement should define long-term disability in the exact manner as the insurance policy.
Debilitating accidents happen even to young, healthy people. It may seem unlikely, or even morbid to plan for such unpleasant possibilities, but addressing the issue of disability is sound business practice. In addition, buy-sell agreements can be used to accomplish many other strategic tasks as part of an overall succession planning process.

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Keyman Insurance

In order to help manage the risk of cash flow problems associated with the extended disability of a business employee/owner, many companies buy keyman insurance. Keyman insurance is for the benefit of the company, not for the benefit of the disabled individual's family members. It is intended to keep the business viable until the disabled employee/owner is able to return to work. The insurance benefits are used by the company to replace cash flow lost due to the absence of the key employee/owner. For example, the insurance proceeds may be used to employ a temporary replacement, pay debt, rent, utilities and help make payroll until the disabled employee/owner can return to their duties.

DISABILITY AND CONTINGENCY PLANNING

Disability contingency/emergency action plans

The balance of power, particularly in a closely-held business, can be very fragile. The loss of the company leader can leave a void that results in power struggles, employee turnover, managerial mistakes, lost customers and lost profits. Even a vital and profitable company can unravel quickly when its leader is unexpectedly removed from the mix.

The loss of a mentor and business leader may be especially damaging to the crucial management succession grooming process. Not only are the company's profits threatened, but the plan for the long-term development of the successor managers may become derailed. Successors who are not ready to lead may be prematurely thrust into leadership positions where their chances of success are drastically reduced. Other employees may sense trouble and begin to seek employment elsewhere. Important customers and suppliers may react in the same way.

In order to minimise the chance of this type of panic or power struggle, emergency plans should be developed to account for the sudden absence of leadership. Responsible individuals (such as corporate officers and board members) should be made aware of and empowered to implement the plans, should such an occasion arise. Furthermore, the plans should be reviewed periodically and updated as appropriate.

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BUSINESS VALUATION

An accurate valuation of a business is often the necessary first step in making significant succession planning decisions. The value of a business has a profound impact on many succession planning issues including:

- **Retirement** – how much will the sale of the business provide for retirement?
- **CGT** – what is the tax cost and benefit of transferring shares in the business?
- **Life insurance** – is life insurance adequate, given the value of the business?
- **Shareholder agreements** – what value should be included in a shareholder agreement for transfers and buy-outs? Will a valuation formula work? Does the agreement call for a formal independent valuation?
- **Corporate finance** – how much loan collateral is available? How much are the company shares worth in a sale? In an Initial Public Offering?

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The valuation process for closely-held businesses relies on professional standards and methodologies but, in reality, is more of an art than a science. Some assets, like a car or a parcel of real estate, readily lend themselves to valuation because there is an active market and an abundance of comparable sales to help determine fair value. There is usually no widespread market for closely-held business interests, and usually very few comparable sales for an appraiser to use in a valuation. When this is the case, appraisers must turn to other methodologies to approximate the value. For this reason, the valuations of closely-held businesses can be more complex and more subjective than those of many other kinds of assets.

CORPORATE FINANCE

Most ownership succession plans require cash. Depending on the circumstances, a closely held company may be able to fund its succession plan using internal sources of cash.
At other times, the need for cash outstrips the amount available within the company, creating a need to turn to external sources of cash.
Fortunately, the variety of financing sources is greater today than ever before. As a result of deregulation, financial institutions have broadly expanded their services and differing types of organisations (commercial banks, leasing companies, mezzanine and private equity funds, even venture capitalists) are now finding themselves on increasingly competitive ground.
Increasing access to alternative 'outside' resources, such as foreign investors, and corporations seeking strategic alliances, is also available.
There are two basic financing alternatives available to any business: debt and equity. Debt is simply a loan, with a promise to repay the funds borrowed, plus interest, over a designated period of time. Equity financing involves the sale of an ownership share in the company to another party.
There are advantages to using either form of financing and the right answer for any company depends on the specific circumstances at hand and the interplay with other elements of the succession plan.

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Some advantages of debt financing include:

- Senior debt financing is finite: the company's obligation to the lender ends when the debt and interest are repaid and the owner retains control of the business
- Flexibility: for example mezzanine, or subordinated debt, represents an alternative class of debt subordinate to the senior lender. Though more expensive than senior debt, it fills the funding gap when senior debt cannot meet the funding requirements of a transaction
- Generally, the interest payments on corporate debt are tax deductible, making the effective cost of borrowing funds significantly lower than the stated interest rate
- Recent relatively low interest rates make senior debt financing even more attractive.

Some advantages of equity financing include:

- Money received by the company stays in the company. There is no commitment to the shareholders that requires future payments of cash
- Multiple classes of shares (voting and non-voting) may allow companies to receive an injection of cash from outside investors without giving up management control of the company
- Some companies simply do not have the capacity to incur additional debt, leaving equity financing as the most viable alternative.

CORPORATE FINANCE

Modern financing has generated numerous variations on simple debt and equity. Some forms of debt have provisions allowing conversion into shares. Some forms of equity, such as preference shares, have rights to repayment before ordinary shares, in the case of liquidation or windup. Another type of equity security, the warrant, allows the holder to purchase shares in the future at today's price without putting up equity capital today. Warrants are sometimes required in connection with subordinated debt financing as an 'equity kicker'.

It is important to remember that the basic strategy for all capital sources, whether they are senior or mezzanine lenders or equity investors, is the same. By advancing you money, they expect to be repaid in the future with a reasonable profit or rate of return. This rate of return translates into the cost of the money for the company in succession. The cost of money (expressed as an interest rate) increases with the level of risk assumed by the funding source. The amount of risk perceived in your business, that is, the perception of limits on your company's ability to succeed, is one of the main factors that determines the cost of borrowing. Lenders and investors consider many things in assessing the risks involved in a business (such as past history of profitability, credit reports, prospects of the business, and the quality and integrity of management).

Another important factor in determining the cost of money is the interest rate charged by commercial banks. Most banks publish their prime rate, which can change at any time. Originally, this was the interest rate charged by banks to their lowest-risk customers. In recent times, larger customers have been able to negotiate financing agreements with banks at rates below the general lending rate.

The level of risk accepted by various capital sources varies dramatically with the nature of the financing they offer. Debt financing is generally viewed as lower risk because it is usually secured against the assets of the company. If the borrower defaults and is unable to repay the loan, the lender has first claim on the assets of the company and may sell them in an attempt to recover what is owed. In order to reduce its risk further, a lender will generally not lend beyond certain safety margins below the value of the assets of the company or may require other forms of security or collateral including inventory, fixed assets or other property. If the company experiences a sales slowdown and the safety margins are exceeded, a bank may be able to 'call the loan' and demand immediate repayment, forcing the company's sale of assets.

As risks become greater, the required rate of return expected by the lender increases. At some point, risks reach a level where the company may be unable or unwilling to pay the interest rate required to obtain third-party debt financing. In this case, it may be necessary to obtain outside investors by selling part ownership of the company. By using the money from the sale of equity, the investors expect the company will be successful and the appreciation in its value will be greater than the interest that would have been paid on debt.

CORPORATE FINANCE

Equity investors vary considerably in the amount of risk they are willing to assume. Investors in publicly-held companies seek entities with proven track records to minimise the risk of their investments. Venture capitalists, on the other hand, are willing to take greater risks and often purchase equity in small or early-stage companies. A primary 'asset' that often attracts venture capitalists is technology in development which, unless successful, has limited resale value. Other intangibles which venture capitalists consider include the uniqueness of the product, the quality of the management team, the risk presented by competitors and the potential of the market.

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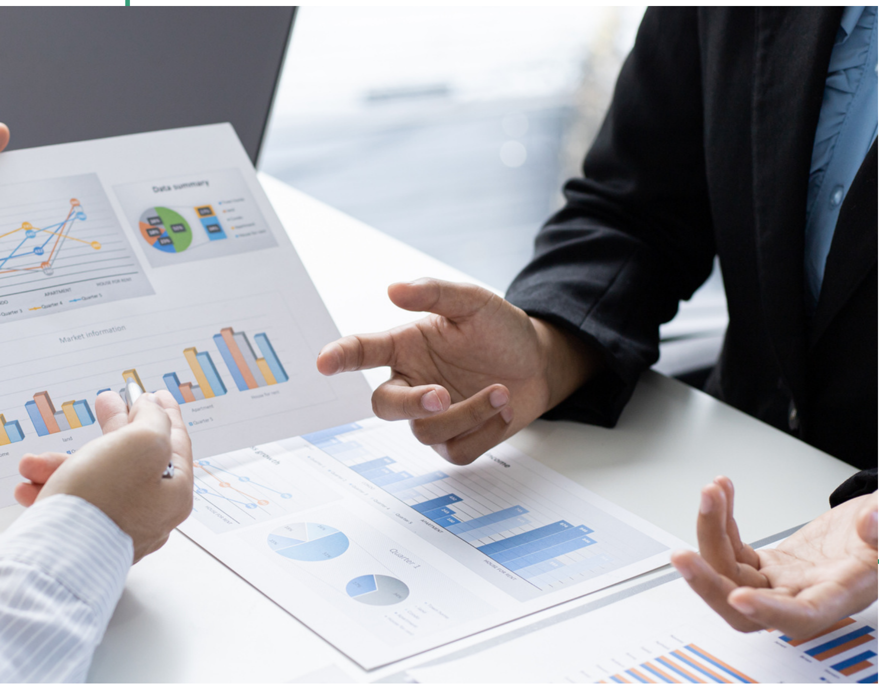

Because of such uncertainties, the possibility for a complete loss of the investment is much greater in these circumstances. As a result of such high risks, the rate of return sought by a venture capitalist is much higher than would be acceptable to a lender or to an investor buying shares in a public offering. The fact that a company is doing well does not necessarily mean it should not sell equity to finance its growth or ownership transition. Bankers may be unwilling to lend to a company that is already highly leveraged (that is the amount of outstanding debt is already high compared to the amount of the owners' money invested in the business). A company may also wish to sell equity in a public offering of shares in order to return cash to the owners for their original investment. For some companies, there are disadvantages associated with going public. But for many, there are significant benefits. Therefore a company will often sell equity even though its business risks are not high.

APPENDIX 1

Strategic business plan

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 success tomorrow.
For closely-held businesses experiencing growth, the strategic plan normally addresses a one to three-year, and often five-year, period. Although the content of strategic plans varies considerably, the basic ingredients should include:

Mission statement

A clear definition of what the business will be, the products or services it will provide, who will comprise 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 to be implemented to achieve the specified goals.

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Why undertake strategic planning?

An overriding reason to engage in strategic planning is the opportunity creation and positioning of the business for competitive advantage. Specific reasons for doing strategic planning include:

- To define, in measurable and objective terms, what is most important and what needs to be achieved by the business
- To anticipate problems and to take positive steps to eliminate them
- To build commitment and orientation to a common purpose among the members of the senior management team
- To chart a clear direction and furnish 'marching orders' for the business and its employees to follow
- To ensure consistency in all decision-making processes and to allocate resources most effectively in areas such as people, equipment, facilities, product/service changes, etc.
- To establish a firm basis for evaluating performance, both corporate and individual
- To provide a management framework that can be used to facilitate quick responses to changed conditions, unplanned events and deviations from plan.

APPENDIX 1

Who should undertake strategic planning?

For strategic planning to be effective, it must be done by the key managers and owners of the business. These individuals understand the business best, recognise its potential and limitations, can commit the resources required to implement plans, and can initiate and monitor plans to ensure successful implementation. They should do 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 that other internal resources or external consultants cannot or should not play a role in providing information for use in the planning process. Indeed, both staff and outsiders can offer invaluable perspectives in the development of a sustainable plan.

How is strategic planning done?

As varied as the strategic plans themselves, there are many methods or techniques to be considered. Basic steps for an entrepreneurial management team to implement should include the following:

- Diagnosis of the business situation
- Development of a mission statement
- Development of goals
- Definition of strategies
- Impact assessment on the business.

Diagnosis of the business situation

A company should begin its strategic-planning activities by taking a critical look at itself and the environment in which it operates. The strategic or situational diagnosis can be quite detailed. In general, the situational diagnosis entails an examination of the organisation internally and externally through the use of a 'SWOT' analysis (see below) to identify the strategic issues confronting the business and the subsequent decisions that will be required. At the conclusion of the strategic diagnosis, the executive management team should agree upon the most critical issues and the means to address them in the strategic plan.

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SWOT (strengths, weaknesses, opportunities and threats) analysis

The internal examination involves defining the organisation's:

Strengths

Positive features of the organisation and factors which differentiate it from the competition

Weaknesses

Deficiencies of the organisation or areas of competitive disadvantage The external examination is done to identify organisational:

Opportunities

Positive conditions such as new market openings and population shifts that present new potential to the business

Threats

Negative conditions such as government regulations, market segment decline and a changing economic climate that can pose challenges to the business.

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Development of a mission statement

As part of the company's self-examination, management should develop a concise statement of what the mission for the business will be for the next one to three years and, ideally, five years. The importance of this statement cannot be overemphasised as it expresses and communicates the basic intent of the business. It is best written either at the end of the strategic diagnosis or after the business has set its new strategic goals. The mission statement should answer the following questions:

- Why are we in business? (to make a profit or to provide security and employment to others?)
- What business are we in? What businesses will we be in—in the future?
- Who are/will be our customers?
- How do we want to be known by them, (e.g. For quality, for service, etc.)?

Development of goals

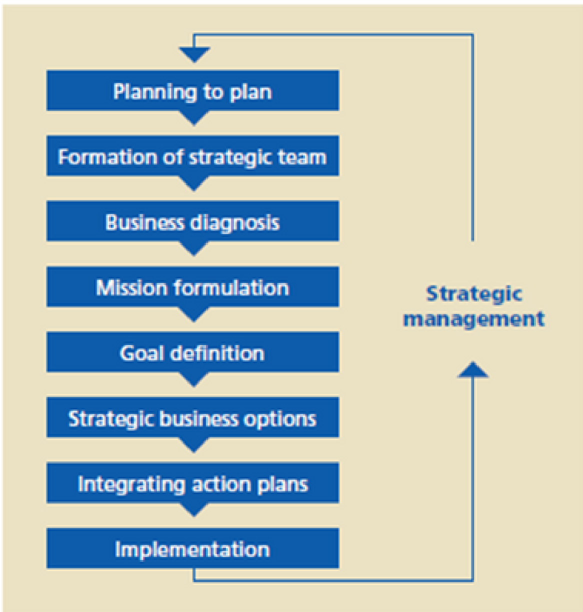
The executive management team should use the strategic diagnosis findings to set the strategic goals for the business. These goals spell out what the business wants to accomplish over the next one to three (and perhaps five) years. The team should set a goal for each critical issue area pinpointed as a result of the 'SWOT' diagnosis. Generally, this means that a business will have somewhere between four and eight goals. Each goal should be written as a measurable and precise statement in order to explain the specific execution and time frames required. A well-written goal should include a clear presentation of how it is to be accomplished and the specifics of successful performance, (e.g. how well? Within what time frame? What quantity is to be achieved? What quality is to be realised? At what cost?).

Definition of strategies

After the firm's strategic goals have been developed, the executive management team should develop a set of strategies that outline the methods for successfully accomplishing each goal. These should include:

- Action steps to be taken
- Persons responsible for completing the steps
- Time frame for performance
- Resources/assistance required to take the steps.

Strategic planning model



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Determine impact on the business

The last step in the strategic analysis process consists of the newly defined mission, goals and strategies to assess the demands they will place, or the effect they will have, on the business. Areas to be considered include:
Resource requirements – what will total plan implementation cost?
People – are human resources adequate? Will additions to staff be necessary? Will there be additional needs to develop, retrain or replace employees?
Facilities/equipment – is the production capability sufficient? What changes will be necessary?
Organisation structure – is the business appropriately organised?

What form should the strategic plan take?

A strategic plan does not always have to be presented as a written document. This is especially true when businesses are smaller and a shared vision of the future can be easily communicated and maintained. However, as businesses grow and more people have to 'buy-in' to the concept and implementation of the strategic plan, a written document becomes essential.
In many cases, putting a plan to paper will offer demonstrable 'proof' of the seriousness of the planning effort as well as a tangible reference point from which to evaluate progress and future efforts. It is important to emphasise that, even once the 'real' plan is in place, it should not be viewed merely as a written document but rather as a framework for management decisions in order to achieve the vision.
If the executive management team has completed the five steps described earlier, the plan will almost write itself.

Sample outline for a Strategic Business Plan

Executive summary (highlights mission, major goals and strategies)

Company description and strategy

A. Strategic diagnosis findings (SWOT analysis)

1. Strengths
2. Weaknesses
3. Opportunities
4. Threats

B. Strategic direction

1. Mission
2. Goals
3. Strategies
4. Action Programs

Management and organisation

C. Organisational structure
D. Policies and procedures
E. Human resources
F. Resource allocation

The market and competitors

Marketing and sales

Financial information

G. Financial plan
Sales/revenue/expanse forecast
exhibits
reference materials

Timetables and benchmarks

H. Contingency plan

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How should the plan be implemented?

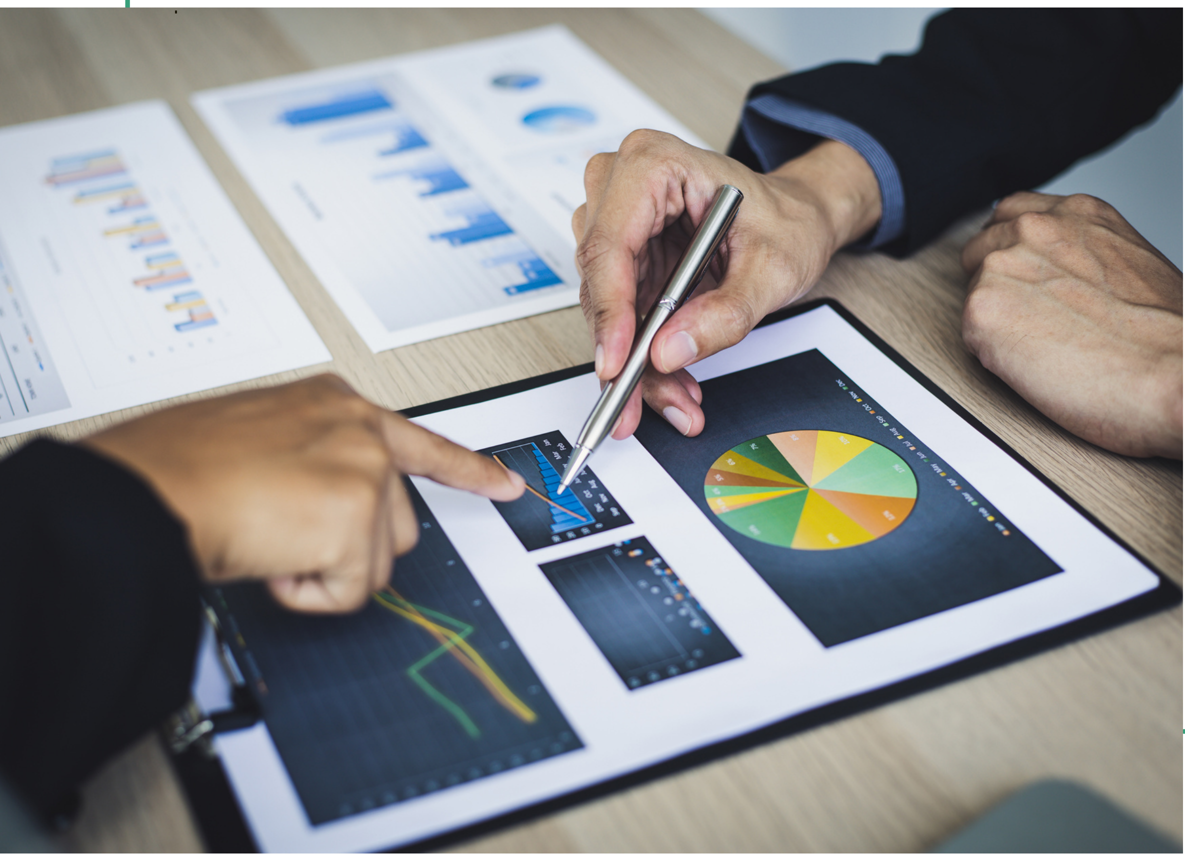
The process of implementing the plan is a complex one to which entire books have been devoted. Major steps that should be taken to ensure effective implementation include:

- Communication of the plan to all those who will be involved in putting it to work
- Holding people accountable in the areas of the plan for which they are responsible
- Evaluation of progress toward the plan
- Use of the plan as a decision-making tool, along with continual modification as required
- The reward of successful performance against the plan
- The review and annual updating of the plan. [note: include the development of a new plan on a regular basis (i.e. Three to five years).

The 'right way' to plan strategically

The essence of successful strategic planning is:

- Getting the right people involved
- Asking the right questions
- Addressing the right issues
- Committing the right resources to implementation (human as well as financial)
- Making course corrections quickly when things don't work out as planned or conditions change
- Evaluating whether decisions were on target
- Beginning the process all over again right from the top



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