FOCUS ON SUCCESSION PLANNING

Three sources for buyers of your business – but start early

By BRUCE A. PALMER
Special for Lehigh Valley Business

Several business platitudes come to mind for owners of closely held businesses that do not consider succession planning a priority, including "begin with the end in mind" and "failure to plan is a plan to fail."

Palmer

Waiting until the owners are ready to sell or retire to plan an exit transition is not an optimal strategy and usually results in receiving a lower realized value for the business. In a worst-case scenario, no value is received and the business closes.

Most closely held business transitions involve the sale of assets, including tangible assets such as real estate, equipment and fixtures, etc., plus intangible assets such as goodwill, customer lists, business name, etc.

A business valuation will normally be prepared to document the value of these assets. The intangible assets represent much of the value for a closely held business and are a reflection of the ability to generate positive cash flow, plus the relationships with customers and employees that help generate these results.

Rightly so, most business owners focus on the financial and tax issues related to succession planning. Periodic review of the plan with key advisers is critical to achieving success.

POTENTIAL BUYERS

Typical succession planning for a closely held business looks at several buyer options to consider, including family members, key employees and competitors. Each of these options has benefits and pitfalls.

PHOTO/RA2STUDIO
If done properly, a key employee will have been groomed in all aspects of running the business.

For many business owners, the business is their legacy, plus their employees and customers are treated as part of the owner's extended family.

How best to transition this relationship is dictated in many cases by timing and who is available to successfully run the business going forward.

FAMILY

Family members many times will be employed in a closely held business.

Will some of these family members have the desire and the skills to take over running the business?

Assuming they do, will they be able to afford the buyout payments to the current owners?

Setting out goals and objectives for family members who hope to eventually own the business is key to a successful transition.

KEY EMPLOYEES

Key employees are another option to take over ownership. If done properly, they have been groomed over time in all aspects of running the business.

The willingness of owners to delegate responsibility is a key factor for this scenario. This allows the transition to occur gradually over time.

A noncompete covenant is put in place for the key employee, along with ownership transition via direct payments to the owner, or taxable compensation that is deductible by the business.

THIRD PARTIES

Competitors or third parties are another succession option. If no likely buyers are known, sometimes a business broker is used to find potential buyers.

A nondisclosure agreement usually is used so potential buyers cannot use the information obtained to their advantage without consequences.

This method typically is the default option if family members or key employees are not viable options.

FILLING THE TIME

One area many owners fail to consider is what to do with their free time once they have retired.

Most are "Type A" personalities who thrived on being decision makers and making an impact by their presence.

Playing golf or going fishing seven days a week soon loses its appeal to them. So it is important to also consider how the owner will fill the void once he or she transitions their business.

Not too bad a problem to have.

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Retaining key management, creating transferable value

By BRENT SABA
Special for Lehigh Valley Business

Simply put, transferable value is what your business is worth to someone else without you.

It is the value that you have created that can sustain itself long after you depart.

Saba

If you are a business owner hoping to receive top dollar (or even fair market value), you must change your relationship with your business if you want to position yourself in the best place to successfully exit.

This does not mean you should stop being involved in day-to-day operations, but it does mean you must identify, properly train, motivate and retain competent management to run your business without you.

Unfortunately, many owners of successful businesses "do the heavy lifting" until they want out, only to find there is no one sufficiently trained or qualified to run the company.

Or, they have identified and trained the right candidates but they assumed (wrongly) that their key people would stay on with the new owner after the sale.

INTACT MANAGEMENT

Sophisticated buyers and their advisers understand the significance of having competent management intact that will continue to grow the business after they depart.

Think about it, why would a buyer want to buy the business from you if they even have a hunch that the business will decline after you leave?

Management teams are valuable because they are not easy to assemble and even more difficult to keep together.

If a good management team is in place and motivated to stay on and continue to grow the company, prospects will look good for continued success.

CORRELATION

For buyers, there is a direct correlation between the existing management team and future cash-flow projection.

When buyers evaluate this risk, they will want to see that future cash flows will at least match, and preferably exceed, historical results.

A central element to this will be whether management is able and willing to grow the business.

Simply put, the stronger the management team, the higher the price. In other words, transferable value is the difference between what your business is worth on paper and what it is worth to someone else.

EIGHT STEPS

As you work with your business adviser, Certified Public Accountant and attorney to design and implement a successful exit plan, consider the following ways you can begin to create transferable value in your business:

(1) Identify your key people, their skill sets and level of competency. (Hint: Key people tend to think and act like owners.)

(2) Analyze your level of involvement in the business and areas that management are/are not involved.

(3) Create an honest assessment of the strong and weak sides of your business and create a plan for delegation to your management team.

(4) Implement a timeline for delegation of tasks – who will do what and by when, including by you, the owner.

(5) Consider performance-based incentives (short-term and long-term) that will motivate management to not only improve business value but remain with the business after you sell. Retention is often accomplished through meaningful incentives tied to a vesting schedule and strong forfeiture provisions.

(6) Communicate. Make sure you and management are on the same page with not only the timeline for delegation of tasks, but the creation of a realistic growth strategy.

(7) Document. Make sure progress is being documented and your growth strategy is reviewed regularly.

(8) Seek counsel. Meet with your team of advisers regularly to review and update your plan, as necessary.

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