

Successful Legacies:

7 Steps for Creating a Succession Plan



FORTUNE Business Transfers & Acquisitions
400 Blankenbaker Pkwy., Ste. 301, Louisville, KY 40243
502-244-0480 / 888-367-8861 www.fortunebta.com

By requesting this report, you are already a step ahead of the vast majority of your peers. Investing time now to create your Succession Plan will preserve the future success of your business, reap financial reward and give you peace of mind.

Ultimately, a Succession Plan should provide a roadmap to an owner's exit from his or her business. We believe the Plan should also identify key drivers to the success of the business, include detailed action items to increase the value and profitability of the business over a set timeline, address personal wealth objectives and contain contingency plans to handle any unforeseen events. It is much more than just a checklist; it's a workable plan to ensure an owner will reap the rewards of their business success and meet the personal goals they've set for themselves and their families.

There are many things to consider when putting together a business succession plan including your age, health, state of the industry, competition, the health of the economy, and the interests of your family. The sooner you put together your plan, the more control and options you will have personally as well as for your business. The longer you wait, the greater the risks that either personal or business changes will occur that will decrease your options and may force you down a less favorable path.

A Business Succession Plan should be treated in the same manner of importance as estate planning and the creation of your will. Given that the exit from your company is likely to be the most significant financial event of your life, why leave it to chance? The 7 steps shown below will help you create a successful succession plan.

7 steps for creating a Successful Succession Plan:

1. Determine short, mid and long-term objectives
2. Identify business value drivers and benchmark the value of your business
3. Perform business and profitability analysis
4. Create an action plan to maximize business value and profitability
5. Match your succession strategy and personal wealth objectives
6. Develop contingencies for unforeseen events
7. Monitor the plan and exit the business

“The toughest thing for the entrepreneur to realize is that time is constantly running out. Most owners don’t plan because they don’t think they are ever going to retire or die.”

Leon Danco

Director of the Center for Family Business

- *70% of businesses fail to make it to the next generation*
- *80% fail to make it to two generations*
- *70% of businesses transferred are sold to a third party*

Step One: Determine short, mid and long-term objectives

If you are like most business owners, you spend a considerable amount of energy on the daily operations of your business and you worry over its financial performance. You assume the future will take care of itself, if the business is successful. Sadly, that is a misconception that we see applied very often by the majority of owners. Let's look at an example:

Two owners of a thriving engineering firm had been college roommates and started a small consulting business right out of school. The economy was healthy and within five years, their sales grew to \$500,000. Both owners married, had children and were well respected in their community. They worked very hard and within thirty years they had grown the business to \$25 million in sales. They had 75 employees on the payroll, had just moved into a brand new office and had been awarded a 5-year government contract worth \$15 million.

The owners, now both in their early 50's, were celebrating their good fortune one evening after work and began discussing the possibility of early retirement. One partner admitted that he no longer had the stamina to travel and he was considering bringing his son, who had recently graduated from college, into the business as his future successor. His partner, who had always assumed they would sell the business to a third party upon retirement, was shocked.

The two partners exchanged heated words and within a week their years of friendship began to erode. They both decided they wanted out of the partnership and they called an outside advisor for help. After reviewing the situation, the advisor had more bad news for them: since the two owners had retained control of all the key functions, the business was unlikely to remain successful unless they continued in those roles, nothing had been done to create funding for the owner's buy out and there was no formal partnership agreement that identified the terms for a conflict resolution.

This story illustrates an important point: these partners never took the time to discuss and document their business and personal objectives. For years, they devoted themselves to the daily management of the firm, handling hundreds of details, and putting out fires. The intensity the owners generated and the energy they expended made their company a success,

but because they did not have an agreed upon exit strategy or a buy-out agreement, the future of their business, their personal financial security and the jobs of 75 employees were put at risk.

In Step One of your Succession Plan, there are three main questions you need to ask yourself:

1. How long do you want to work in the business before retiring or moving on?
2. How much do you require or desire in annual after-tax income once you exit your business?
3. Who do you want to transfer the business to: family member, key employee, or third party?

By exploring and analyzing your options you will begin to structure your short, mid and long-term objectives.

Ideally, a succession plan should be developed as soon as you start, inherit or acquire a business. However, no matter where you are in the lifecycle of your business, you should set short, mid and long term objectives that are measurable and can build upon each other. A disciplined, systematic approach to accomplishing your objectives will ultimately result in an orderly and successful exit from your business on the previously projected date from question one above.

Your lifestyle expectations and anticipated exit date along with estate planning will all need to be considered when answering question two above. A qualified, trusted advisor can be of great assistance in this area.

The answer to question three should be carefully considered. If you choose a family member, start grooming them several years in advance for the position. Make sure they have all the necessary attributes, the passion to run your business, and the ability to contribute to its growth. If you choose an employee, start mentoring them and including them on strategic decisions so the transition becomes more seamless. If you choose to transfer your business to a third party, plan well in advance.

Your answer to questions one and two may influence your choice in question three. We advise you to consider all your options, but keep in mind that although 50% of owners want to transfer their business to a family member, 70% of businesses fail to make it to the next generation.

Step Two: *Identify business value drivers and benchmark the value of your business*



Value drivers are the characteristics that reduce the risk of owning the business or increase the probability the business will grow in the future. If these characteristics are present in your business, a buyer will pay a premium price. The most common value drivers include: Management Team, Systems & Procedures, Customers & Suppliers, Facilities & Equipment, Financial Discipline and Growth Strategy.

Management Team – too many business owners make the mistake of retaining complete control which makes it hard to separate them from the business. Start now to designate a manager or assemble a management team that is capable of running the business now and after your departure.

Systems & Procedures – like the management team, reliable systems and well documented procedures will help sustain the growth of a business and ensure a smooth transition to a new owner. Write a formal business plan; create written job descriptions; develop a systems manual; organize customer and supplier files; consider investing in technology and software tools that will help streamline current procedures.

Customers & Suppliers – a diversified customer and supplier base helps to insulate a company from the loss of a single customer or dominant supplier. No one customer should

account for more than 10-20% of your total sales. This may require you to invest in additional capacity that will allow you to broaden your customer base. Taking the time to investigate your current suppliers is a prudent strategy and may result in reducing your cost of goods as well as your reliance on a major supplier.

Facilities & Equipment – make sure your facilities are up to code and convey the image you want to project. Invest in new equipment and maintain service records.

Financial Discipline – all businesses are valued based on the health of their historical income statements as well as 5-year projections that are substantiated. The existence of financial controls supports an owner's profitability claims. It is extremely important that your company's financial records are accurate and verifiable. A potential buyer or lender will want to carefully review them.

Growth Strategy – being able to demonstrate a realistic growth strategy is vital to the perceived value of your business. Creating a pro forma statement with projected discretionary earnings is the best way to communicate future opportunities. Make sure you document your assumptions and clearly outline new products, marketing efforts, increased demand, industry dynamics and other factors that impact growth.

A business valuation serves as a great tool to benchmark the current market value of your business. Due to the historical use of unreliable valuation approaches, we recommend you use an unbiased and honorable certified business valuation firm. If the valuation proves insufficient to support your long-term financial objectives, you should devote a significant effort toward focusing on the key value drivers and the necessary action steps to build value. If the valuation is right in line with your expectations, you should take steps to preserve its value and occasionally have the business re-valued. Industry dynamics and the health of the economy are external factors that can greatly alter the market value of your business.

Step Three: *Perform business and profitability analysis*

To perform a business analysis, start with conducting a SWOT analysis. Identify the company's true strengths, known weaknesses, growth opportunities and any threats to the future of the firm. Strengths and weaknesses are internal factors. Opportunities and threats are external factors.

For example, strengths could be a new, innovative product or service, the location of your business, or your marketing expertise. A weakness could be undifferentiated products or services or a damaged reputation. Opportunities could be a developing market such as the Internet or a strategic alliance. A threat could be a new competitor in your home market, price wars, or legislative action that negatively impacts your industry. Make sure you are realistic and very specific when performing your analysis. SWOT analysis should distinguish between where your organization is today, and where it could be in the future.

Next, you will want to determine your company's profitability drivers. This starts with understanding where you make and lose money. It is easy to equate growing revenues with making money, but unless your operating margin is keeping pace with your revenue growth, you are actually facing a decline in profitability.

To understand the profitability picture, you need to analyze the cost structure and contribution margin of each business component separately. A component may be a brand, product, channel or customer.

One common mistake companies make is to allocate a large percentage of their cost structure to "shared costs". If all costs are not directly attributed to individual components, profitability is likely to be overstated in some areas and understated in others. This could cause a company to make poor business decisions such as increasing their sales with a high volume customer that is actually far less profitable than is apparent when they should be growing their business with lower volume, higher profit customers.

Consider the following initiatives once you have determined profitability drivers:

1. **Re-evaluate all products and services:** Consider dropping low volume products or services. Only keep them if their customer reach is strategic in terms of loyalty, satisfaction and relevance. Compare their contribution margin to all other products and services. Evaluate their system wide operational impact on manufacturing and distribution productivity.
2. **Realign customers:** Renegotiate pricing or completely eliminate unprofitable customers to improve the low-cost and high-cost mix. This may allow for consolidation of facilities, reduction of manufacturing lines and more efficient distribution. Focus resources on profitable accounts with high growth potential.
3. **Set long-term strategy:** Share your findings with your leadership team so that all future decisions will be based on true costs, system wide impact, and the most favorable profitability strategies.

Step Four: *Create an action plan to maximize business value and profitability*

After completing steps two and three, create a list of action items, with projected completion dates, that will maximize your business value and increase your profitability. Careful planning will allow you to transition your company without jeopardizing either near-term performance or future growth. Your goal should be to move from a revenue culture to a profit culture and to

strengthen the business in the areas of the six value drivers identified in step two.

Set aside time to review your action plan twice a year and compare your progress against your short, mid and long-term objectives. Make adjustments and work with external advisors to stay on course.

Step Five: *Match your succession strategy and personal wealth objectives*

When setting your objectives in step one, you made a decision on who you want to succeed you in the ownership of your business. If you chose a child or employee(s) and want to be able to finance your retirement solely from your business, make sure they have the financial fortitude to invest in your business at the level you desire. In this scenario, be sure to collect a significant down payment, 40%-75% of the sale price, because you may not receive the balance if there are performance issues with the new owner. If you plan to put your business on the market, transition to a profit maximizing accounting approach at least two years before your anticipated transfer date. Most privately owned businesses are run with the objective to

minimize taxable income, however this approach can also minimize the value of the business. Select an outside CPA to prepare all of your financial statements. Buyers will be interested in reviewing three years of clean financial records.

Keep in mind that the sale of a business can suddenly create significant liquid assets for the owner and without a plan, there can be unwanted consequences. One consequence is a higher tax load than necessary. Other consequences could be hurried or poor investment decisions, family disagreements and a future estate tax that is higher than necessary. Tax and estate planning should be an essential element to this section of the succession plan.

Step Six: *Develop contingencies for unforeseen events*

Once you've completed steps one through five, you may be feeling satisfied that your future and your business is in good hands. However, there is one additional step that we recommend to complete your succession planning.

It may be unpleasant to consider what would happen to your business or your family if something tragic were to happen to you, but it is absolutely critical to develop contingency plans to address unforeseen events. Without these plans, a tragic event could be compounded by placing a financial burden on your family, leaving valued employees without jobs or the dissolving of your successful business. Therefore, it is imperative that a business owner communicate in writing their wishes as to what should be done with the business if they are no longer able to operate it.

These unforeseen events can occur in the form of:

- Death
- Illness
- Disability
- Divorce
- Ownership disputes
- Critical cash flow issues
- Declining markets
- Excessive debt burden

Make sure you have sufficient insurance to cover your family's needs in the event of your death or disability. Consider investing in key man insurance to protect the business against the loss of yourself or a critical employee. Although insurance is very helpful, it will not cover all the consequences due to insufficient planning.

If you have a business partner, create or update a buy-out agreement as well as an ownership agreement that identifies what happens to an owner's investment if he or she is no longer able to work in the business or needs to "cash out" of the business. Make sure any payouts are based on a current certified business valuation.

Diversifying and reducing your dependency on one customer, one supplier or one product will help cushion the impact of a declining market and minimize cash flow issues. Keep adequate cash reserves in the business and avoid transferring them to fund an excessive lifestyle. Minimize your dependency on third party financing. A business with minimal debt can weather a bad economy. One with excessive debt may result in having the bank note called in which may force the owner to shut down their business.

Step Seven: *Monitor the plan and exit the business*



With a Succession Plan in place, you now have a roadmap to direct you toward a planned and successful exit from your business. Continue to

monitor the plan, making adjustments as necessary, to stay on track.

Ideally, the best time to sell a business is when the business is performing well (at the top of the bell curve), future projections look even better, the economy is strong and the industry is healthy. Although your business has been valued in the past, it is imperative that you have an updated business valuation performed before placing your company on the market. This will help you set a realistic, defensible asking price. Keep in mind that many businesses can take up to two years to sell to a third party.

There are several types of buyers that may be interested in your business – strategic, industry, private equity groups (PEGS), or individual buyers. Your marketing efforts should be targeted to buyers that will see the most value in your business. A business transfer advisory firm is highly specialized to assist you in targeting the right buyer and facilitate the transfer process.

Summary

***80% of results come from 20% of efforts
- Pareto's Law***

A good succession plan ensures the following:

- Viability of the business is maintained
- Profitability is increased
- Retiring owner's needs are met
- Other stakeholder's (i.e. family, employees, creditors, customers and vendors) needs are met
- Chosen successor is qualified
- Contingency plans are in place for unforeseen events
- Third party selling strategy is developed
- Taxes are minimized
- Overlaps with estate planning

The plan takes an integrated approach to help private business owners address, in advance, potential issues in the areas of business, personal, legal, financial and tax. The benefits to the owner are:

- Lowers business risks
- Avoids asset concentration
- Maximizes value of the company at the time of exit
- Avoids over or under valuing the company
- Preserves family wealth
- Lowers or eliminates capital gains taxes
- Creates peace of mind

We hope you find this report to be both enlightening and helpful. If you need assistance in the areas of succession planning, business transfers or business valuations, we would welcome the opportunity to serve you.