Guide: Succession planning

The realities of succession planning and the future sale of your business

In New Zealand it is estimated 24% of small business owners are now over 60 years of age. A further 25% are between 50 and 60.

A great question to ask yourself is 'What if I were hit by a bus tomorrow?' In other words, in the event of death or disablement how would the operation, management and value of my business be affected?

Successful succession planning assists in the transition of a business from its current owner to new ownership.

Why is advance succession planning so important? Why is advance succession planning so important?

An ageing population combined with the dynamic of younger generations who seem less motivated to acquire a business, tests long held assumptions that our businesses will be our future superannuation.

SMEs need to focus on extracting the capital value of their business and with an increasing number of those businesses expected to come onto the market in the next few years we can expect the polarisation between the good and the bad to grow.

Good businesses will continue to sell and command a high price, whereas poor performing businesses will at best come under greater price pressure and at worst be unsaleable.

Grooming the business

The ideal timetable for an effective succession plan is three to five years from initial plan through to final succession. In a perfect world we'd recommend a minimum of two years to prepare and in a sense groom the business for sale.

Grooming the business is essential in maximising business value and the capital you eventually extract from your business.

Your succession options

You essentially have four options:

1. Sale of the business
2. Generational succession — i.e. sell to a family member
3. A management or employee buyout
4. A structured liquidation of the business assets

Who are your potential buyers?

Considering your potential buyers and identifying the most likely ones can be increasingly useful in determining your likely succession plan.

Possible buyers include:

- Family members
- A competitor
- A supplier
- A business in a similar market
- An employee

- Somebody going into business for the first time

The value of a clear process

A clear succession process provides a structured plan, enhances efficiency, assists in delegation of key elements, and provides for greater certainty of a successful outcome.

Key steps include:

1. Meeting with essential advisors
2. Choosing the most appropriate succession option
3. Diagnosing the business by considering an internal due diligence of both financial and non-financial matters
4. Completing a valuation
5. Agreeing on a succession timetable
6. Developing and documenting the structured succession plan
7. Taking the business to market
8. Filtering enquiries
9. Completing the sale agreement
10. Completing settlement
11. Dealing with post settlement matters

Your essential advisors

Your accounting team is a key part of the succession planning process. The skills they can bring to the due diligence, valuation, business preparation and in fact the entire succession planning process cannot be underestimated. Their expert advice and assistance can add significant value to the eventual business realisation.

Your legal counsel can also provide significant value at key stages of the planning, sale agreement, settlement and post settlement phases.

Developing the succession plan

Two key questions

Two key questions need to be considered early on in the planning stages.

1. What needs to be done to prepare the business for succession?
2. What can be done based on the timetable agreed?

It may well be that the succession plan needs to be ‘fast tracked’ for whatever reason, be it health of the owner, the owner’s procrastination or sudden desire to ‘quit’ the business, or even an unanticipated approach from a competitor who expresses a keen desire to acquire the business.

Given that we don’t always have the luxury of the ideal succession time frame on our side, it’s useful to establish the ‘early yardage’ factors that we should prioritise.

Four key areas

There are four key areas to consider when grooming a business:

1. Structuring
2. Housekeeping
3. Risk management
4. Value enhancement

What you can achieve in the preparation stage primarily depends on the time frame chosen.

If less than a year is available to complete succession, it is likely that only housekeeping matters will be able to be addressed. To achieve a sustainable value difference probably requires a minimum of three years in most businesses.

So, in a short time frame, where should we focus?

1. Complete the diagnostic analysis of financial and non-financial matters
2. Complete an internal due diligence of business risks through self-examination
3. Implement actions to remove any obstacles to succession planning success
4. Identify any surface enhancements that can be made to the business to improve its saleability and value

Valuing the business

Valuing the business is a fundamental element in the succession process.

Not only does an early valuation provide an opinion to the business owner, it also reality tests the owner’s view on business value. It is very common for there to be a gap, sometimes significant, between the owner’s expectations as to value, and the commercial realities of what the market is prepared to and therefore likely to pay. This valuation expectation gap is best flushed out very early in the succession planning process as it often sets a ’stake in the ground’ for the beginning of a business improvement programme.

Preparing the business for sale

Assess the current position

Firstly, it is important to assess the current position of the business by performing a diagnostic and internal due diligence of a wide range of matters.

Having diagnosed the business, we move to a value enhancement phase, growing and improving the business in anticipation of a sale.

The purpose of the diagnostic analysis is to:

- Undertake a financial analysis of the business
- Undertake a non-financial analysis of the business
- To show trends
- To identify operating changes that will impact performance

Enhance the value

Enhancing the value of a business involves making meaningful changes to the business that increases its value and ensuring that these changes result in sustainable increases.

Whilst value enhancement can sometimes be delivered within short timeframes, it probably requires three years to illustrate significant progress made.

Our message to you is very clear. Start with the end in mind. In other words, the best time to start succession planning is at the very beginning of the life of the business.

The four key drivers of business value

Four key drivers

These are:

1. Growth
2. Profitability

3. Efficiency and capacity
4. Risk management

Growth and profitability

Growth and profitability within a business are underpinned by a range of key business drivers that combined and improved contribute significantly to improved profit, cash flow and ultimately business value.

A comprehensive growth and profit improvement plan combines an exhaustive list of strategies to improve everything from pricing and margins to market share and everything in between.

Conducting an entire planning day process with your accountant can be beneficial to setting clear priorities for growth and profit improvement.

Such a planning day involves:

1. Completion of a comprehensive business improvement questionnaire by the owners
2. Review of that questionnaire by your accountant, identifying areas for improvement
3. Full planning day meeting to establish business improvement activities required and priorities
4. Planning day report setting out agreed activities, establishing responsibilities and a timetable

Efficiency and capacity

Improving efficiency will usually add to profitability. It also reduces business risk in that it reduces or eliminates write-backs, write-offs, wastage, and spoilt work. Efficiency is largely driven by a combination of systems and training. Efficiency gaps and issues will be identified by the diagnostic analysis and internal due diligence process.

Risk management

Risk management improvement is an often underestimated component of business value improvement.

We are all guilty of being reactive as opposed to proactive at some point in time or other in our business lives. We usually become critically aware of the risk management threats of our business in response to an event, whether it be fire, flood, earthquake, writing off a large bad debt because of our own inadequate debtor collection and enforcement systems, or even inadequate health and safety processes.

Any rigorous due diligence undertaken by a potential buyer of your business will expose risks in your business, potentially disturbing or even scaring away the buyer, and certainly reducing business value.

Why take unnecessary risks that can be avoided by some planning? Having no contingency plan is unfair on yourself, your family and your business.

The risks

Just some of these risks include:

- Premature death
- Serious accident
- Major illness or trauma
- Being sued by someone
- Being unable to pay your debts
- Loss of business records and systems
- Marriage or partnership breakdown
- Loss of key clients
- Loss of key staff

Creating a safety net includes:

- Wills for all the family
- Enduring powers of attorney
- Appropriate insurance
    - Business package
    - Life insurance
    - Key man insurance
    - Medical assistance
    - Trauma cover
    - Sickness and accident, including ACC
- Personal and business records access and security
- Having the right ownership structure
- Having a succession plan
- Maintaining a checklist of important documents
- Robust tax planning
- Clear communication programme with potential successors
- Regular (and constructive) meetings with your advisors as a team

Full risk management review

A full risk management review covers four legs:

1. Operations
    - Workplace health and safety
    - Organisational structure
    - Staff handling procedures
    - Debtor management and control
    - Systems and processes
    - Systems Manual
2. Structural
    - How well organised is the business?
    - Trading structures
    - Asset ownership
    - Relationships between different legal entities
3. Documentation
    - Wills
    - Enduring powers of attorney
    - Trust deeds
    - Minutes and resolutions
    - Shareholder agreements
    - Business agreements
    - Customer documentation and agreements

- Employment agreements
- Workplace health and safety agreements

4. Liquidity
    - Profit and cash flow forecasts
    - Performance monitoring
    - Cost control
    - Liquidity controls
    - Assessment of liquid assets, cash reserves, debtor finance and factoring, financial instruments, and funding schemes

Generated succession

Objectives of each family member must be canvassed

Any family succession plan must recognise and accommodate the various needs, goals and objectives of each family member.

It is imperative that any attempt to complete a family-based succession plan does not create ill feeling or bitterness between family members. The family succession plan should be developed first, ensuring that the objectives of every family member are canvassed, some compromise achieved where necessary, and that a reality check on achievement of individual objectives is performed before you proceed to the succession plan itself.

There can be significant attitudinal differences between generations.

The founder may have worked 40 to 80 hours per week, worked weekends, missed the kids' sports days, had little time for community involvement and essentially placed business ahead of family.

On the other hand, the next generation may want more involvement with family, want to play golf in the weekends, coach the kids' sports team, leave work at 5pm (or even 4pm!) and establish very much a 'family first' business.

Four key considerations

1. Is the proposed successor capable? Consider:
    - Willingness to commit and engage
    - Ability and business vision
    - Leadership and respect capability. How are they viewed by employees, customers, suppliers, and other business partners?
    - Can they genuinely add value to the business?
2. Can the transaction be financed? Consider:
    - The capital requirements of the vendor
    - Funding capacity
    - Taxation considerations
    - Identifying the exit position. When is the vendor financially transitioned out of the business?
3. Control transfer issues
    - Can the vendor 'let go'?
    - What will the management transition process be?
    - What approach will be taken to ensuring management compatibility?

- How do we maintain both business and family relationships?

4. Transfer process issues
   - Maintain formality in the process
   - Use independent advisors
   - Don’t take short cuts on contracts. Complete these in the same way you would if the buyer were unrelated to you
   - Complete shareholder agreements to cover ‘what if’ scenarios
   - Create clear distinction between shareholder, management and director status and roles

Employee buyouts

An employee buyout should be managed in the same way as a normal sale. These types of buyout may increase in future.

Some do’s and don’ts of employee buyouts to remember:

Do’s

- Ensure everyone uses independent advisors
- Encourage proper due diligence
- Complete contracts just in the same way you would in any other sale
- Be prepared for the deal falling over

Don’ts

- Don’t provide special terms or arrangements
- Don’t offer vendor finance
- Don’t try to trade off between employees

And finally…

Succession planning is a journey not a destination. Selling your business is not the end point. Developing, improving, and grooming your business is the start point.

It’s the business you need to sell, not you. The tricks are to sell the future using the past, get a plan and start now!

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