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Leaving your Legacy: Business Succession Planning

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For decades, vast wealth has been created for millions of Americans through growing private businesses. However as business owners, especially Baby Boomers, reach the later stages of their careers, a new study by US Trust shows that the majority do not have a formal succession plan or exit strategy.

U.S. Trust recently released its 2016 US Wealth and Worth Survey, which sampled a group of millionaire business owners with at least $3 million in investable assets. In this study, nearly two-thirds of business owners do not have a succession plan (which could include either a sale or transfer of the company). Since most of the business owners rely on their businesses for income, the lack of such planning means that their main source of income could be in jeopardy.

Additionally, the results showed many owners have failed to think about the future of their businesses beyond their own lives. Only 16 percent plan to pass the business on to their families, and 63 percent of older business owners (those over 50) have no formal succession plan. In addition, the majority of business owners have not formulated a strategy for ensuring the highest possible valuation of the business or its continuity beyond the life of the current owner. Many business owners, whose finances and identity are so closely tied to their companies, simply don't want to think about giving them up. According to the report, three-quarters of the millionaire business owners founded their companies and only 8 percent inherited them. Thus, most are first generation businesses. Without a plan, many may intend to simply work well past retirement age.

Many entrepreneurs never plan to stop working or they wait until they are ready to retire (not a good plan – what if the unthinkable happens). Others have a plan in mind that they may or may not have even communicated to key stakeholders, but leave its execution to chance by not formalizing it. In my experience, not having a formal plan leaves a very low likelihood of an optimal transfer or sale of the business.

In my 20 years of experience, I find that succession planning is a crucial part of long-term business planning that helps prepare for a smooth, strategic exit by the owner or for an unexpected change in circumstance, such as illness, disability or divorce.

Five Key Elements of a Succession Plan or Exit Strategy

The benefits of a thoughtful succession plan or exit strategy are vital to all stakeholders, whether they be the founder, the employees or the clients who have placed their trust with the firm. When they're ready to transition, the business owners are uniquely positioned to capitalize on the value of the firms they've built.

The majority of business owners I work with are focused on ensuring that the businesses they've built will endure—they want to create a lasting legacy. But they are not always sure how to pursue that goal – especially when there is just one owner (with multiple partners, I find that it can be a little easier…but not easy).

It's for that reason, that I believe that business owners need to think through five key considerations necessary to create a successful plan and exit strategy. These elements will benefit the company's owner(s), whether their goal is internal succession, external succession or a combination of both.

1. Create a Clear Vision

The initial challenge business owners face when developing a plan is to actually understand where to start. There must be a willingness to look closely at personal and professional goals, and an ability to look impartially at the value of their company. Rather than asking what a successful succession plan looks like, a better question for the founding principals would be to ask themselves "What does a successful transition look like—for me?". Getting to that answer requires personal reflection and careful consideration. Please note that if there are multiple owners, that each owner's goals need to be accounted for. Setting personal, professional and firm-related goals will help create a clear vision for the owners and the firm, as well as an improved peace of mind for employees, clients and other stakeholders.

2. Determine The Business Valuation

There are many approaches to determining a firm's value. But operating cash flow (typically viewed as earnings before interest, taxes, depreciation, and amortization or EBITDA) is the common denominator used to establish fair value. Unlike book value, revenue or net income, cash flow is the best indicator of company profitability and overall operating efficiency. Prospective buyers want to see dependable, growing and predictable flows. Quality of cash flow matters, too. Buyers typically pay a multiple (or measure of equity or firm value relative to revenue or earnings that it generates) based on the quality of cash flow and its growth rate.

Companies will fetch top dollar for such things as a stable client base; revenues that are overwhelmingly from a recurring business; a track record of growth and strong margins; and a core group of professionals who are committed and incentivized to operate the firm as the founders reduce their responsibilities and ownership stake (a.k.a. key employees).

Many firm owners may either want a quick exit or may want to retain a degree of control in a transition - either can also impact valuations. It's worth considering bringing in a valuation specialist or transaction intermediary to review the mix of goals, revenue streams, expense structure, legal structure, finances, clients and other available information. A specialist can help ensure that a fair and realistic firm valuation is achieved. While there are many approaches to valuation, attributes that are always considered include risk, scalability, growth and cash flow quality. It is also time to clean up the books. As any valuation is dependent on EBITDA, it is important to make sure that the books and records are in good shape. For that, I suggest a review and/ or audit.

3. Maximizing Value

Buyers place a high value on business continuity—assurances that clients and key employees will remain in place once the firm begins its transition. Clients who can easily follow disengaged staff out the door are an obvious risk to a successful transition. This risk can be mitigated by hiring key employees and professionals who are a good long-term fit and by creating a compensation strategy with incentives that help employees share in the firm's success. Creating a structure that allows key employees to participate in ownership is a powerful value driver in successful business succession planning.

Firm value is also enhanced by institutionalizing client relationships—which means ensuring that clients are connected to the firm rather than to any individual employee (or even the owner).

Additionally, firms can reduce risk and maximize value by documenting all processes, including compliance procedures and contingency plans. Firms that demonstrate systematized business practices will yield higher valuations than those without this level of transparency.

4. Maximize Scale

Efficiency is another key value driver. It's worth exploring ways to facilitate growth without adding fixed overhead. Not only do strong margins benefit owners in the short term but they can also serve as a platform for future firm growth—always appealing to prospective buyers. But there's an important distinction to be made here: While efficient operation is desirable, being lean to the detriment of staff workload and compromised client service is not. Buyers aren't necessarily seeking a bargain, but they do want lower transaction costs per unit of revenue. Efficiencies can be created, for example, by automating work-flows to streamline operations and by creating a segmented service offering that fits the revenue profile of each client segment. Creating proportionally lower costs will equate to higher margins and drive EBITDA and possibly the multiple you receive even higher.

5. Demonstrate Consistent Growth

Buyers will pay a premium for firms that are rigorous about new business development and that have an effective customer growth strategy. The most sought-after companies have multi-tiered growth strategies that utilize customer referral, cross-selling (where possible), marketing, and public relations programs to capture customer revenue opportunities from a number of different channels. Successful firms tend to have well-documented business development compensation and incentive plans in place for the entire staff, to ensure that everyone has a vested interest in the firm's growth.

Today's business owners have spent their careers building firms on a foundation of successful relationships, the entrepreneurial spirit and the desire to grow and expand. Establishing a succession plan that secures their firm's legacy beyond the founder's working life is critical not just to their firm and their clients but also to the long-term success of the next generation of leadership. The succession planning process can take as many as five to 10 years to establish and implement—and there's just one chance to get it right…having a plan that works for you, your family, your employees and all stakeholders. Understanding the many factors that influence a succession plan is the first step. Business owners who take the long view by starting to address their risks, scalability, growth and cash flow, will see their efforts pay dividends when it is time to implement their exit strategy (whether solicited or unsolicited).

If you want to hear more on these ideas, check out two of my interviews from my radio show, The STA Money Hour (on 950AM KPRC Radio, daily from 1pm to 2pm Central Time):

Interview: Alex W. Howard, CFA, ASA
https://www.stawealth.com/interview/alex-w-howard/

Interview: Jennifer Mailhes, CPA
https://www.stawealth.com/interview/jennifer-mailhes-cpa/

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