Generational Succession Planning for Closely-held Family Businesses

A Critical Success Factor for the 21st Century Economy

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Abstract

Transitioning a closely-held family business to the next generation presents a special challenge for its owners.

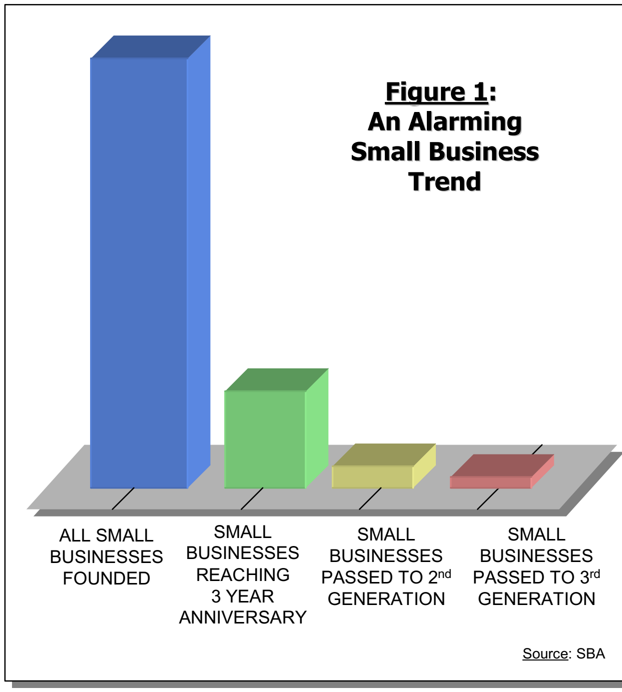
Family businesses can avoid the painful experiences of estate conflict, family feuding, over-taxation, and business failure. This is possible only by careful planning, creative succession coaching, and deliberate execution over time.

Background Information

Owners of family businesses are doubly blessed. They have found the magic in combining one's career with the opportunity for family enrichment and the ability to pass on an opportunity for the next generation to build upon their lifelong efforts.

Less than 1/3 of US family businesses successfully pass to the second generation.

Most closely-held business owners when asked say they would very much like their children to continue to drive and grow their businesses after their exit. But less than 30% of these businesses ever make it to a second generation. And of those fortunate to do so, less than half of them will continue that business into a third generation. Since more than 90% of all the businesses in the United States are closely-held family businesses, these statistics are of particular concern.



Perhaps more alarming is US economic shift from large companies employing thousands of people for their entire careers while providing health care and retirement benefits, to the 21st century "lean" model of job outsourcing, benefits reduction (or elimination), under-funding (or termination) of pension plans, and quarterly rightsizing based on financial results. This shift places the closely-held family business in an even more important place in the US macro-economy. More jobs and economic growth will come from family businesses than ever before. So we must as a society strive to ensure that the closely-held small business can thrive over the long haul and drive the new economy.

At the heart of this effort is the transition of the family business upon the retirement of the owner/founder. How can we increase the chances of success of the small business at this critical juncture?

SBA, p1

You Can Fake Your Business Plan, But Not Your Succession Plan

Many of the 21 million American family businesses have never had a written business plan. Although those of us in the professional services field often preach that the business plan is critical for success, this evidently is not always the case, as owners can and do get by with a quality workmanship, strong relationships, good work ethics, and a drive to succeed.

However, a generational succession plan is ***mission critical*** for a successful business transition.

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Why? The succession plan:
- is a 3 to 5+ year undertaking to transition a business to maximize probability of a successful transfer;
- outlines the exit strategy of the current owner/founder from the business;
- outlines the conversion of the next generation family member(s) from employee to manager to leader. It involves training, education and relies on building on-the-job experience over time;
- outlines incentivization of the succeeding generation, which can include equity gifting, option-type incentives, earn-in incentives, and retirement benefits;
- impacts the personal estate planning of the current owner/founder, and can greatly reduce/eliminate family feuds upon estate transfer;
- outlines actions to minimize the taxation of transfer of ownership;
- outlines actions which may include financial issues of business valuation, recapitalization, accretion, separation of business value versus control, and can involve decisions regarding legal entities, agreements, and corporate structure;
- enables the current owner/founder to initiate and assist in formulating the vision of the business for the next generation.

The listing above shows that the basis for success of a generational transition simply cannot exist without a long-term vision, planning, and execution. This is why so many businesses fail at this juncture. Also, we must recognize that succession transitions are fundamentally a business exit plan which may have legal, tax, and financing components, rather than approaching the tax issues and/or legal issues while not addressing the fundamental exit strategy. This is where a business succession specialist becomes extremely beneficial.

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The Facets of a Succession Plan

The facets of a complete succession plan include:

- Succession Preparation
- Strategic Initiatives
- Business Valuation
- Managerial Transition
- Ownership Transferal
- Post Transition / Transfer

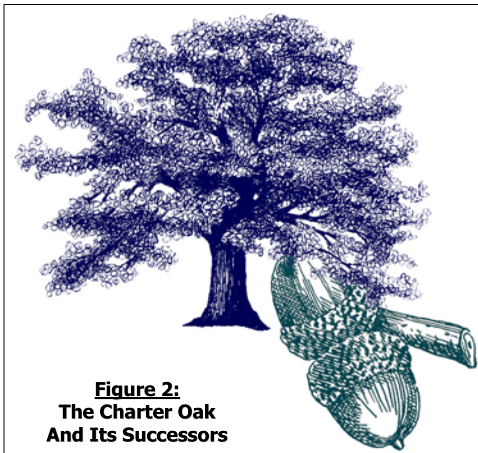


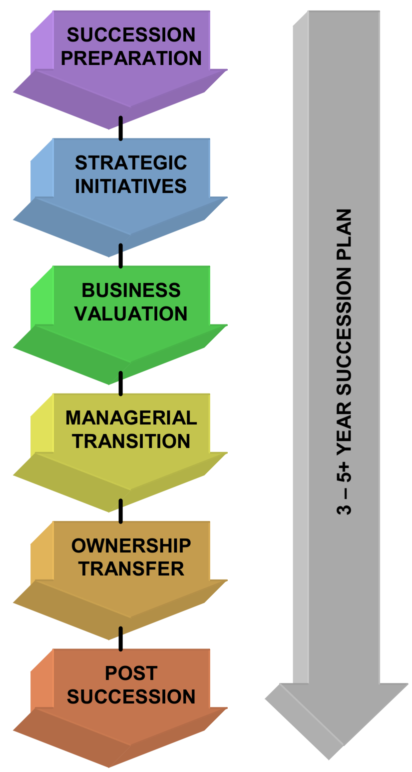
Figure 2:
The Charter Oak And Its Successors

The Components of the Plan

Each facet of the plan is specifically tailored to each individual company, and may include most or all of the following components:

1. Succession Preparation:
   - Examination of personal life goals, family relationships, financial security, and retirement plans.
   - Review of the current business strategy, history, goals, and successes.
   - Identification of potential individual(s) for generational transition
   - Commitment to a long-term generational transition.

Figure 3:
The Facets of a Generational Succession Plan



2. Strategic Initiatives:
   - Education of potential successor(s)
   - On-the-job training of potential successor(s)
   - Market, competitive, and growth initiatives
   - Business financing
   - Legal / business structure issues.

Components of enterprise value, including: net asset value, company or brand name(s), customer relationships, intellectual property, planned future cash flows …

3. Business Valuation:
   - Components of enterprise value, including: net asset value, company or brand name(s), customer relationships, intellectual property, planned future cash flows, etc.
   - Prospectus authoring
   - Tracking changes to enterprise value over the transition/transferal timeframe.

4. Managerial Transition:
   - Driving the change in management
   - Gradual assumption of managerial control
   - Changing roles from leader to advisor.

5. Ownership Transferal:
   - Separation of business ownership versus control
   - Incentivization of potential successor(s)
   - Taxation issues and gifting
   - Buy/sell agreements
   - Recapitalization
   - Freezing the value of the business for the current owner(s).

6. Post Succession:
   - The emeritus role
   - Retirement and estate planning
   - The very different strategy of the successor(s)
   - Family members not associated with the business.

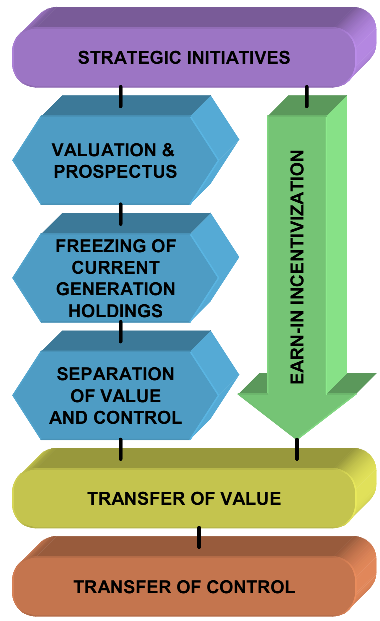
Initiating and implementing a plan which includes the above components will yield a high probability of a successful succession.

Key Ingredients of the Amplytude Approach

Beginning a Long-term Process
The first step is the most important (and often most difficult) step – realizing and planning the conversion, and putting the strategic steps in place to initiate the transition.

The Gene Pool
Careful selection, education, training, and oversight of the successor(s) over time is the difference between companies that are successful in their transitions.

Figure 4: The Amplytude Succession Approach



The Prospectus and Business Valuation
By committing the transition strategy to paper, three quarters of the items typically found in a prospectus (or offer memorandum) are addressed. By completing the prospectus authoring exercise and valuing the business at the time of transition, the next key ingredient can be achieved.

Freezing the Business Value for the Current Ownership
This means that any future accretion, (change in value) will be due to the next generation's efforts and execution. By drawing this preverbal "line-in-the-sand", the current owners may begin their personal estate planning without the worry of a future "moving target", the movement of which may be beyond their control. An example of a $1 million business at the time of transition growing to a $5 million dollar business in 10 years by the efforts and execution of the founder's son would present an estate planning nightmare to the remaining family siblings which are not directly involved in the business. This nightmare is averted by the (a) authoring of the prospectus, (b) valuation of the business, and (c) cessation of business accretion for the current ownership. These three keys effectively allow the current ownership to separate the company as a tangible piece of their personal estate planning efforts.

By drawing this preverbal "line-in-the-sand", the current owners may begin their personal estate planning without the worry of a future "moving target".

Recapitalization of the Business to Separate Value Versus Control
Separating value from control is necessary for a phased transition over time. In order to maintain a frozen business value while not passing fiduciary control (board election, general partner, controlling LLC membership, etc.) requires a creative capital structure. This is also the time to carve out a current or future plan for other key employee ownership, which is typically an accretive, non-controlling offering backed by a vesting schedule and can be adjudicated by achieving business performance targets.

Incentivization of the Successors for Growth – The Earn-in Approach
Gifting over time is a good way to minimize tax exposure, while also acting as an incentive for optimal performance. As part of the conversion of the next generation from managers to leaders, establishing business targets which lead to equity or other remuneration is a powerful tool to ensure that the successors pull the weight they are expected to. This can allow more substantive business growth during the transition phase,

as there are more stakeholders within the business available to drive the execution of strategic growth initiatives.

Selecting a Business Advisor
Finding a business coach who can help you through the complexities of the above components can greatly improve the chance of a successful transition. Lawyers, accountants, and financial planners can assist in key areas of the process. Teaming with an advisor that is experienced in all the facets of succession can make all the difference.

Concluding Remarks

Transitioning a family business requires a specialist experienced with all facets of business planning.

You founded the business. You built the business. You earned a living. You created value. Transitioning a closely-held family business to the next generation is the pinnacle of this history – and it's the toughest part of the climb.

To be successful, creative strategic planning and diligent execution are required. Current owners can empower themselves now to drive business transitions.

- Avoid estate conflicts.
- Prevent family feuding.
- Eliminate over-taxation.
- Insure business success for the next generation.

This is good news.

Transitioning a family business requires a specialist experienced with all facets of business planning. Amplytude offers expert business advisement and consultation in closely-held business succession planning.

We are happy to speak/present at group functions on the topic of generational business succession. We include presentational materials and distribution materials to participants.

References & Related Information

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About the Author

Vincent Pietrorazio is an owner/principal of Connecticut Combustion Corporation, a closely-held family business which is currently in the 6th stage of succession transition under his advisement. This business served as the catalyst for development of the methodology for this paper.

Vincent is also the Managing Partner of Amplytude Partners, a professional consulting practice dedicated to maximizing long-term value in small businesses. He has particular strengths in succession transitions, business planning, and strategic marketing. He has hands-on experience in business investment initiatives from both buy and sell perspectives, including strategic planning, market research, finance, target valuation, transaction negotiations, and change management. This expertise is complemented by a rare combination of interdisciplinary operational experiences in marketing, product management, engineering, field service, and accounting, which creates a broad foundation for identifying opportunities and building value. He holds an M.B.A. from Connecticut State University, a B.S. in electrical & systems engineering with a concentration in economics from the University of Connecticut, and an A.S. in electrical engineering technology from Waterbury State Technical College.

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- ***Business / Financing Plans***
- ***Transaction Advisement***
  (Acquisition / Divestiture / Change Management)
- ***Product / Project Management***
- ***Closely-held Family Business Succession Planning***

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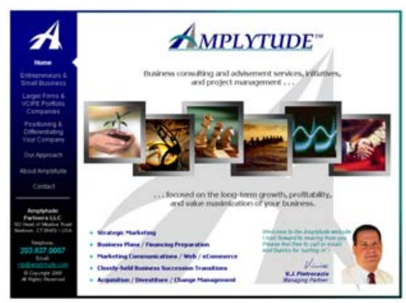

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