5 STEPS TO SUCCESSION PLANNING TO HELP MAXIMIZE COMPANY VALUE

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For the majority of family-controlled businesses, owners are unprepared for the transition of leadership that they know is someday coming

Owners can make faulty assumptions as they assess their exit options. By taking steps to evaluate your business and prepare it strategically for a transition — whether in the family or sale to outsiders — you can maximize value and bolster the company's position for the long term.

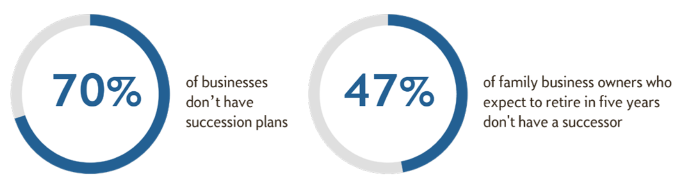
The importance of succession planning

To maximize the value of a family-owned company — whether it's a small local business or an operation grossing hundreds of millions — the generation at the helm must make a directed effort to plan for succession. The succession plan needs to support the company's long-term strategy, and the company's long-term strategy needs to support the succession plan. This is critical, whether the goal is to transition to a next-generation family member or sell to an outside party. Only with this strategic alignment can the company thrive and maximize its value over time.

Roughly 40% of family business owners aim to retire within 10 years, according to MassMutual's American Family Business Survey. In today's mergers and acquisitions (M&A) environment, the question of how to monetize a founder's share, and facilitate their exit, is taking on even greater urgency. Since the market rebound began in mid-2020, market valuations for small- to medium-sized businesses have surged beyond pre-pandemic levels, and the pace of M&A transactions is robust, according to the Lincoln Middle Market Index.

Meanwhile, the potential for an increase in the capital gains tax rate also looms over owners' considerations of when and how to exit their companies. Since his campaign, President Biden has said he aims to raise the capital gains tax rate to match the top income tax rate for the highest-earning households (and his plan also proposes an increase in the top income tax rate. If such legislation passes, the profits from the sale of a business would be taxed at that new level, higher than the current 20% maximum capital gains tax rate (plus a 3.8% surcharge). While the tax rate may or may not change, depending on policy developments, favorable valuations will continue drawing would-be sellers to the market.

The Importance of Succession Planning



Family Business Survival Rates

Sources: PWC's 10th Global Family Business Survey and SCORE

In this environment, business owners must approach succession planning strategically. Here are five considerations that are critical to maximizing your company's value and achieving the exit strategy that best suits both your family's and the business's needs.

1. Explore the exit strategy options

For many family-owned businesses, a transition within the family is ideal, but for the majority, that is not the ultimate outcome. A transition within the family obviously depends on the skills and interests of the next generation. But owners must also consider the competitive landscape of their industry and what the operating environment will look like for their successor. For instance, industry consolidation trends could change the viability of the company for the next generation, especially if the business has to assume a high amount of debt to pay out the current owner's share.

Like any business decision, owners have to approach succession planning by first assessing the available pathways — and the relative benefits and drawbacks of each. There are fundamentally three choices available to family owners who are ready to exit:

- **Transition within the family.** A majority or minority stake can be sold to the next generation with the help of a bank loan. A leveraged dividend, or dividend recapitalization, is another mechanism that can enable a change in ownership, putting debt on the company's balance sheet in order to pay out a dividend to the owner. Typically, either the company or the next-generation owner would take on debt to monetize the exiting owner's stake.
- **Sale to a strategic competitor.** A sale of the business within its industry often brings the highest valuation. Competitors can realize synergies both on sales and expenses, which are dual levers to boost profitability. Strategic buyers are also more likely to bring management resources to the business.
- **Sale to a financial investor.** Financial investors, such as private equity firms, can bring both strategic and operational expertise to the businesses in their portfolios. Compared to strategic-competitor buyers, financial buyers are more likely to want existing management to remain in place, which may appeal to the family stakeholders. In some cases, financial buyers are medium-term owners who will hold the company for three to seven years before exiting.

2. Avoid the common missteps in valuing a business

How much is a family-owned company worth? The answer is a major factor for succession planning, but unfortunately it is hard to assess without professional expertise. Owners often struggle to put an accurate estimate on their businesses and are just as likely to undervalue their business as they are to overvalue it.

An accurate valuation demands a disciplined approach, including technical knowledge of the various valuation methodologies and detailed, up-to-date information about the current market environment. Owners have to consider the company's value in a range of scenarios: How would a private equity firm value it versus a strategic competitor? What is the control premium for selling a majority stake compared to a minority stake? If the company has to take on debt in the transaction, how does that change its ongoing value? Ultimately, what is the market paying today for similar businesses? The issue of valuation is too important to treat carelessly.

Frequent errors in valuing a business

Relying on a single input. "My good friend said based on x, the company is worth $y." In unfamiliar territory, owners often accept a valuation suggested by a trusted peer.

Ignoring scenario-value changes. A company's value depends on numerous factors, with one major factor being who the buyer is and the particular situation. An accurate valuation would determine the company's worth in a leveraged buyout (LBO), an IPO/public company comparison, an M&A comparison, and a calculation based on future free cash flows.

Neglecting the control premium. A minority stake and a majority stake will drive different per-share values of a business, thanks to the control premium that typically increases a valuation by 20% to 50%.

Misjudging the market. The "going rate" for companies changes with the market cycle and policy environment.

3. Assess the business strategy and operations like an experienced buyer

The process of preparing a business for sale is of paramount importance. Owners must assess the company as a buyer would and take steps to put things in order to present the business's full potential to prospects. For many companies, there is cleanup work to do with the workspace, physical plant and operating processes, in addition to the financials, as prospective buyers will heavily scrutinize financial records. Sellers will need to present the company in the best light possible.

An experienced buyer will also be quick to notice concentrated exposures, such as revenue that depends too much on a single customer or sourcing that is overly dependent on one supplier. Likewise, a buyer will evaluate the broader operating environment – consolidation trends, significant technological advances or changing global market dynamics – to assess all of the factors that affect the company's competitive position. The strongest candidates will have taken the time to diversify relationships before going to market and addressing weak spots in their strategies.

4. Plan with family and key business members

Whether the plan is to transition the business to a family member, or sell to an outside party, the owner's inner circle needs to be part of the planning process. Among family business owners who expect to retire in the next five years, less than half have selected a successor, according to MassMutual's American Family Business Survey.

The grooming of management and other long-term strategic planning matters are necessary for those who anticipate selling to a third party. Potential buyers and investors prefer a company with a strong management team to maintain its status as a well-run business. The board of directors, if the company has one, must also be supportive of the shared goal of a successful transition.

5. Build a team of trusted advisors

Selling a company is a complicated and often intense process — and one that will demand much attention from the company's management team.

It's also a sensitive process. Data and conversations must remain confidential and protected throughout the course of an anticipated transition. Owners will need a team that can work together and trust one another.

Within the company, that team often includes the chief financial officer, the chief operating officer, and the head of sales. This core team will be crucial in an owner's efforts to implement operational changes and provide intensive financial, operational, and legal data to advisors and prospects throughout the process.

In addition, most companies aiming to sell need a small crew of outside advisors.

An investment banker is perhaps the most crucial partner for companies looking to sell their business. A good investment banker will involve themselves in almost every phase of the transaction and work closely with the company's management team, lawyers and accountants throughout the entire process. In addition, sellers benefit from partnering with an attorney who has extensive M&A transaction experience — usually not the same person who handles the everyday legal matters of the business. A certified public accountant (CPA) firm with transaction experience is also a key asset to companies in the transition process.

Succession planning sets a select group of businesses apart

The majority of family business owners are unprepared for the transition that they know is coming. By tackling these five steps, owners can best monetize their stake in the business they've built and see the company successfully through a transition that best fits both the family's and the business's needs.

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Actions to get started on a succession plan

1. **Assess the talent pipeline.**
   Sit down with another trusted stakeholder of the company and evaluate the management pipeline objectively. Identify the strengths and weaknesses of the company's team across the tiers of management and across lines of business.

2. **Evaluate key business risks.**
   Appoint the board, the chief operating officer or the company's financial team to conduct a 'key relationship risk' assessment across revenues and costs, as well as an assessment of strategic risks such as consolidation trends across the industry. Begin reporting those assessments in internal quarterly materials so that the board and management begin to align on the issues that could affect transition or sale.

3. **Begin to build a team you can trust.**
   You can't fully evaluate your options until you have met with the advisors and partners who could lead you through a sale; they can provide insights that are crucial to your ultimate decisions. Whether you expect to sell your company or transition within the family, you'll need a team to help.

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