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WEALTH MANAGEMENT

Introduction to succession planning for business owners

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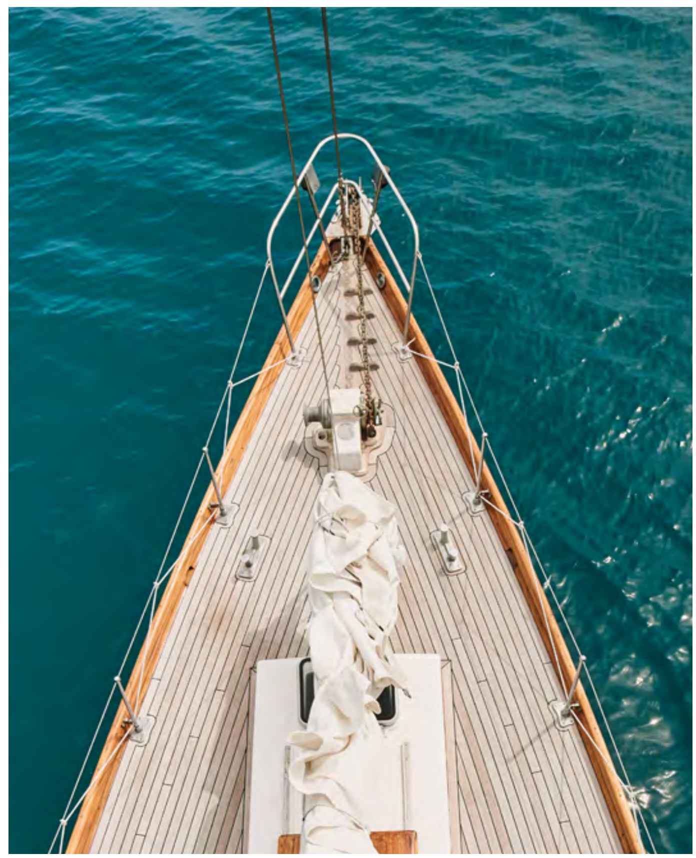
Every business will inevitably go through a transition of control and ownership. This transition can be the chaotic result of the unexpected death or incapacity of the owner, but more preferably should be the successful conclusion of a deliberate and methodical planning process designed to enhance business value, to minimize taxes, and to create an orderly transition (for example, to co-owners, to heirs, to management, to employees, to a third party, to a strategic buyer, or some combination thereof). The purpose of succession planning is to ensure that any transition happens on the owner's terms and timeline rather than be left to chance. 76% of business owners plan to transition over the next 10 years, representing 4.5 million businesses and over $10 trillion in wealth.[1]

[1] Scott Snider, *"Exit Planning Reinvented,"* Exit Planning Institute, 2023, page 10.

And yet, the unfortunate reality is that many business owners may miss potential opportunities and experience unfavorable outcomes because they do not engage in adequate succession planning, if any at all. Only 35% of businesses overall have established a formalized succession planning process,[2] and over 61% of family-owned businesses in North America have no formal, written succession plan in place.[3] These owners can miss the opportunity to create a lasting legacy, to optimize the transfer of wealth to their heirs, to maintain jobs for their employees, and to continue to support their local communities. The disparity between the number of business owners who want to transition and the number who are actually prepared to do so constitutes a potential opportunity.

It is estimated that one half of all exits are caused by one of the "five D's" (death, disability, divorce, distress, disagreement)[4]. Without robust planning well in advance of a transition, whether planned or unplanned, a business that is profitable and providing its owner with a good income may be unsellable if the owner is so essential to the business that it cannot operate independently. An insightful question for a business owner to ask themselves is "could I go away on vacation for 30 days, have no contact with the business and come back to find it operating well?" If the answer is no, that business is not ready to transition.

A business only has value to others when its assets – primarily intangible[5] – are readily transferable to a buyer. Indeed, historical data indicates that over 70% of businesses put on the market never sell because their assets are not easily transferable.[6] Owners should consider what would happen if they are not in the fortunate 30% of businesses that eventually sell. And transferring businesses to family members is equally difficult—only 30% of family-owned businesses transition successfully to the second generation and only 12% survive to the third.[7]



2 https://blog.benchmarkcorporate.com/family-business-succession-planning-and-success-rates, accessed 22 December 2023

3 Id.

4 https://www.btcpa.net/insights/prepare-for-the-5-ds-and-exit-your-business-on-your-terms, accessed 24 January 2024

5 Studies show that intangible assets, commonly referred to as the Four C's (human capital (such as strong management and committed and talented employees), structural capital (such as intellectual property, strong internal systems and processes that are documented in writing and can be replicated by others), customer capital (such as a diversified and dedicated customer base with ties to the business as opposed to relationship with the owner) and social capital (such as the perception of the business to customers and the general public), constitute upwards of 80% of the value of a business and frequently demarcate a significant difference between businesses that can command a premium value in the market and those that are unsellable at any price. Christopher Snider, *"The Exit Planning Process and Value Acceleration Methodology,"* Exit Planning Institute, 2023.

6 Scott Snider, "*Exit Planning Reinvented*," Exit Planning Institute, 2023, page 10.

7 Christopher Snider, "*Walking to Destiny, 11 Actions an Owner Must Take to Rapidly Grow Value and Unlock Wealth*," 2nd edition, page 7.

Why many transitions fail

Some statistics stand out to indicate common reasons why many transitions never happen[8]:

[8] Exit Planning Institute, *"State of Owner Readiness Survey,"* 2022.

While these statistics may feel sobering, a successful transition is possible for many of these businesses if planning begins early. Here's where they can start:

First step: Building your team

Successful business succession planning is the ultimate team sport and requires a coordinated and collaborative group of professionals who each plays a critical role in assisting the owner get to the finish line, however the owner defines it.[9] This team will typically be comprised of a financial advisor, a certified public accountant, attorneys (business and estate planning), a business valuation professional, insurance advisors, investment bankers and/or business brokers. The team should also include key members of the owner's family as well as certain key members of the business' management team. The need for such a team can make the process appear unnecessarily complex and expensive to an owner, but experience demonstrates time and time again that a collaborative and experienced team can help guide the owner to optimal results.

As anyone who has ever coached others can attest, building a high-functioning coordinated team who are each collaborating and committed to a single goal can be challenging. Assembling this team at the inception of the succession planning process will require significant time, effort and money from an owner. The difference between a business that sells at a premium versus a business that sells at a discount versus a business that will never transition at all can – in many cases – be directly tied to the skill and effectiveness of the team that advised the owner in the planning process. Spending time, effort and money upfront can help drive more favorable outcomes in the end.

[9] Amy Wirtz, *"Importance of Teams"* Exit Planning Institute, 2023.

Second step: What is this business worth today?

If owners do not know what their business is actually worth today, they lack critical data that helps guide a succession planning process. An essential early step in the succession planning process is working with an accountant and/or a business valuation professional on an objective business valuation, which helps owners benchmark their business against similar businesses in today's market. Through the valuation process, the owner can objectively and dispassionately assess what aspects of the business could be improved to increase its value and what aspects of the business are currently depressing value. The owner can learn what characteristics of peer businesses drive value creation, and create written plans to take specific actions over time to adopt best practices of similar business that are obtaining the highest multiples in the market.

While some business owners may have a very good sense of business value, many can be flying blind, without any insight into how they compare to similar businesses and/or how to evaluate the attractiveness of unexpected options like unsolicited purchase offers from third parties. For example, how does one know if an unsolicited offer is objectively "good" or "bad" without an accurate snapshot of business value of comparable businesses in today's market? Moreover, a formal valuation analysis that can survive IRS scrutiny is necessary if the owner wants to take advantage of wealth transfer opportunities in advance of a liquidity event.

For most businesses, a business owner's accountant should, on a routine basis, be providing the owner with a baseline value of the business' earnings before interest, taxes, depreciation and amortization ("EBITDA "), adjusted for certain items. This valuation will be the core that an appraiser can use to then find the reasonable range of value of the business.[10]

[10] In addition to the "market approach" to enterprise value described here, business valuation experts also use a variety of other methodologies for business valuation, such as "discounted cash flow," "capitalization of earnings," an "asset approach," and others, depending on the specific circumstances of the company, the industry, market conditions and the potential buyer. Shina Culberson, *"Basics of Business Valuation,"* Exit Planning Institute, 2023, pages 19-30.

One critical component to valuation is making sure that the business value reflects only business assets, liabilities, income and expenses. For many private business owners, the line between personal and business expenses can be unclear. Similarly, enterprise value can be artificially inflated if the owner isn't paying himself or herself a salary commensurate with those of comparable companies. One goal of the valuation exercise is to "normalize" the financials to make it clear that the business' books reflect only those items that belong to the business.

Valuation professionals provide the other critical piece of the value equation: the range of multiples for comparable businesses. Determining what an average multiple is and comparing it to a multiple from a top comparable business can be critical for a business owner to benchmark where they might fall in the range. Whether this valuation is arrived at through a formal qualified appraisal or an informal valuation, the exercise of determining present value and comparing one's business to others is invaluable information in the planning process.[11]

[11] In addition to the "market approach" to enterprise value described here, business valuation experts also use a variety of other methodologies for business valuation, such as "discounted cash flow," "capitalization of earnings," an "asset approach," and others, depending on the specific circumstances of the company, the industry, market conditions and the potential buyer. Shina Culberson, *"Basics of Business Valuation,"* Exit Planning Institute, 2023, pages 19-30.

Third step: Personal financial and estate planning is essential

Concurrently with determining the present value of the business, owners should be actively working with their financial advisor to engage in comprehensive financial planning. One important purpose of such a process is to identify whether the owner's retirement and personal goals can be sufficiently met with current investments apart from the equity in the business. Alternatively, because the vast majority of the typical business owner's net worth is in the value of their business, for many, the value in the business may need to be "harvested" to satisfy the owner's goals without altering their lifestyle or reducing spending in retirement. Only comprehensive financial planning can identify the gap between the amount of investment assets an owner has today and the amount of investment assets an owner needs when they're no longer involved in the business sufficient to accomplish their goals with confidence that they won't run out of money. Nevertheless, 75% of business owners tend not to have a written financial plan.[12]

The financial planning process can provide invaluable information to the owner about succession planning alternatives and can be a strong motivation to take action. For example, if the value of the business equity is essential to supplement current investments in supporting a comfortable retirement, that owner will need to explore options to sell the business and will have a clearer sense what value the owner would need to "harvest" after tax adequately to meet their goals.

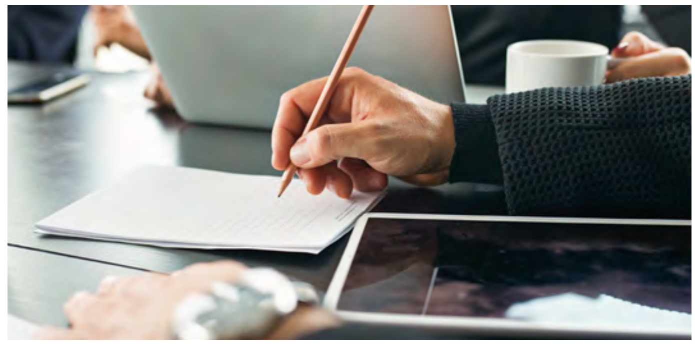
[12] Justin Goodbread, *"Financial Planning for Business Owners"*, Exit Planning Institute, 2023, page 11.

Third step: Personal financial and estate planning is essential (cont'd)

There are common warning signs that an owner has not done adequate financial planning to be ready to transition[13]:

- Owner is unaware of his or her actual income needs post transition and whether an adjustment to one's standard of living may be required;
- The owner has not considered their "needs" versus their "wants";
- The financial plan does not consider the actual value of the business as opposed to an unsupported opinion of value;
- The owner has not considered the effect of taxes on net proceeds from a transition;
- The owner's non-business investment assets are inappropriately allocated.

Concurrent with financial planning, business owners should be working with estate planning attorneys who have experience in working with business owners to develop estate plans that may, among other goals, minimize the risk of lifetime incapacity on the value of the business, protect the value of the business for the benefit of an owner's family, minimize estate and income taxes, reduce the likelihood of family disputes, and leave a lasting legacy long after the owner is gone. The basic estate plan for most business owners should include: a revocable trust, a will, a financial power of attorney, a health care power of attorney and beneficiary designations. All of these documents must be periodically reviewed every few years to ensure



that they remain consistent with the owner's goals and objectives and are up to date with changes in the law. Many business owners may benefit from more complex estate planning strategies to help minimize estate and income taxes and allow an orderly transition of assets to heirs that are addressed in other publications.

One key reason to consider engaging with personal financial and estate planning early is that it will require the owner to think hard about what he or she wants to accomplish, and how to balance competing priorities. If a spouse is involved, the spouse should be part of the process. Financial and estate planning can be an intensive experience. If you are running your business day-to-day operations and are also in the midst of a sale process—working with investment bankers, assessing offers, negotiating with buyers—you already will have two full-time jobs. Comprehensive personal planning is itself another full-time job, albeit one that can take far less time to finish than the other two. But doing the foundational planning early can help you focus on other priorities when you need to.

[13] Christopher Snider, *"Introduction to the Triggering Event,"* Exit Planning Institute, 2023, page 16.

Consider starting the exit planning process early—owners ideally need three to five years to truly enhance value[14]

Building a business optimally attractive to potential buyers means building a business that is growing and largely independent of its owners. Demonstrable sustained growth is an essential component to succession planning. Few businesses are already operating at their best level of performance similar to peers that are obtaining the highest multiples in the market, meaning, there is almost always room for improvement in the area of value enhancement. But adopting best-in-class practices can take concerted effort of a team (and associated expense), so it doesn't happen overnight – indeed, strategies that are designed to help owners obtain a favorable harvestable value may take years to successfully implement and bear fruit. The common suggestion is that this process should ideally begin three to five years before the desired transition.[14]

In some cases, the owner does not have three to five years to enhance value. An attractive unsolicited offer may be presented, which is not bad news. However, sometimes an owner may be experiencing health issues, may have lost the motivation to engage in the effort that getting a company optimally ready for transition may require, or may have other urgent issues that prevent a longer time frame. In such cases, the owner's team of professionals should be able to guide them on what efforts can help enhance the value in the shortest period of time.

[14] Sean Hutchinson, "Value Enhancement Process," Exit Planning Institute, 2023, page 13.

Risk management has the potential to enhance value

Though many steps are involved to help enhance a business' value for an eventual exit, many of these processes can take time to yield results. "De-risking" the business—assessing risk management for potential problems—can help enhance value with relatively small effort compared to other succession planning processes. Business owners could therefore be well advised to prioritize risk management early in the planning process.

- **Buy/Sell Agreements:** Buy/sell agreements are an essential component to effective risk management. When a closely held business has several owners, a properly drafted buy/sell agreement can provide stability and continuity of the business. In a nutshell, the owners of the business agree to purchase and/or sell interests in the business to each other or to the business itself based on certain triggering events such as death, disability or divorce of an owner, an offer by outside parties to purchase an owner's interest, or termination of an owner's employment. Buy/sell agreements are analogous to prenuptial agreements in a marriage, in a sense that they are both intended to minimize uncertainty, prevent future disagreements and to preserve the value of the company in a variety of otherwise uncertain circumstances.
- **Life Insurance:** In the context of a business, life insurance can play many valuable functions.

Life insurance can be used:

» as income replacement for an owner's family if an owner dies prematurely;

» as a method to repay debt the business owner may have incurred in operating the business;

» as a method to compensate the business if an essential person in the business dies and cannot be easily replaced, commonly referred to as "key person insurance";

» as all or part of the funding mechanism when a buy/sell agreement is triggered;

» as an additional method of saving for retirement in a tax advantaged manner once other retirement savings plans (e.g., IRAs, 401ks, SEPs, defined benefit plans) have been fully funded;

» as a tax-free source of liquidity for heirs to pay estate taxes after the death of the owner.

- **Other insurance coverages:** In the context of risk management, business owners should consider engaging in an insurance "audit" with their professional advisors and consider a range of risks that can be insured against in order to preserve the financial security of the owner and the health of the business:
  - » Health insurance
  - » Personal liability (umbrella) insurance
  - » Product liability insurance
  - » Property insurance
  - » Disability insurance
  - » Long term care insurance

We've stressed in each section that the sooner you engage—whether building a team, enhancing value, personal planning, understanding the business' valuation, or de-risking—the better. But to order them in time, the de-risking strategies can reasonably be seen as the first step—a buy-sell agreement and appropriate insurance should be part of a business owner's early focus, potentially long before you're thinking about a transition. And many business owners build a team slowly over time, although the need to reevaluate team members as your business grows is crucial. Value enhancement and personal planning should come next, and finally isolating and understanding the business' value.

What's next for you?

In planning for a successful exit, owner readiness to sell is at least as important as enhancing the attractiveness of a particular business to third parties. If an owner doesn't have a well-developed plan for what they will do next with their life that will provide equal or greater personal satisfaction (whether that is an active retirement, the pursuit of hobbies or "bucket list" items, or the exploration of other entrepreneurial activities), the owner is not optimally ready to sell and will likely be disappointed after the transition. When surveyed one year after selling, three out of four business owners "profoundly regretted" the decision.[15] This wasn't primarily because they missed being in their business so much as it was because they had not given enough thought to what they were going to do after they were no longer going to the office or factory every day.

We had an experience with one owner who enjoyed golf and envisioned a retirement of golf, and who, after about six months of a daily round or two, found himself tired of golf but with no other thought to what he could do. Ultimately he decided to teach as an adjunct business professor at a local university—but had he thought beforehand about what a life of unending golf with nothing else really looked like he could have had an easier transition.

THERE ARE COMMON WARNING SIGNS FOR BUSINESS OWNERS WHO ARE NOT PERSONALLY READY TO TRANSITION:[17]

» The owner has no personal goals, objectives or hobbies;

» The owner has given no serious consideration to "what's next?";

» The owner has not adequately addressed risk mitigation and contingency planning;

» The owner and his or her family members are not on the same page.

While this may seem like a "soft" topic and not worthy of serious consideration, the reality is that owners who have not carefully crafted a personal plan for their life after the transition are much less likely to successfully close a transaction and are much more likely to regret their decision if they do successfully close.[16]

Working with family members, a trusted financial advisor, and professionals who are experienced in helping families align on their personal and financial intentions, owners can become more personally ready to transition to their post-business life.

[15] Christopher Snider, "*Walking to Destiny, 11 Actions an Owner Must Take to Rapidly Grow Value and Unlock Wealth*," 2nd edition, page 62.
[16] Christopher Snider, "Walking to Destiny, 11 Actions an Owner Must Take to Rapidly Grow Value and Unlock Wealth," 2nd edition, page 62, 122, 167.
[17] Christopher Snider, *"Introduction to the Triggering Event,"* Exit Planning Institute, 2023, page 15.

What transition options are there?

It is important that business owners begin to educate themselves as soon as possible on the range of potential options they may pursue when a transition eventually becomes necessary. Professional advisors can help illustrate the pros and cons of these many options and help the owner identify options that align with the owner's financial goals and personal objectives. One size certainly does not fit all in the highly complex world of succession planning and the circumstances of each owner and their family can vary widely.

Business owners must realize that there are a limited number of potential paths for their business to follow over time. Each of these options is complicated and these descriptions barely scratch the surface, but for ease of reference, the paths can be broken down into two categories: "inside options" and "outside options." (The list below is not exhaustive, but it encompasses the most common paths we encounter for the majority of family-owned businesses.)

INSIDE OPTIONS:

- **Intergenerational transfer:** transfer or sale of equity to a successor generation, usually but not always children. Estate and tax planning may play a significant role. 50% of family business owners want to exercise this option but in reality, only about 30% do so.[18]
- **Management buyout:** a management team can purchase the business.
- **Sale to existing partners:** other co- owners can purchase your interest.
- **Sale to employees:** Employees can purchase the business, typically through an Employee Stock Ownership Plan or "ESOP". This strategy is complex and subject to government regulation, but the tax benefits to the owner can be extremely attractive and ownership can give employees a motivational boost to continue to grow the company.

[18] Sean Hutchinson, *"Exit Option Analysis,"* Exit Planning Institute, 2023, page 12.

OUTSIDE OPTIONS:

- **Sale to a strategic third party:** A strategic buyer may be a competitor, or another business looking to add capabilities, customers, geography, people or intellectual property and may be willing to pay a premium to do so.
- **Sale to a financial third party:** Similar to a strategic buyer, but a financial or private equity buyer would typically be looking to grow the business, increase profitability, potentially roll it together with other synergistic businesses and then look to sell the larger, more efficient business within a relatively short time frame (often three to eight years).
- Sale to a buyer who is approaching entrepreneurship through acquisition—someone who may not be in a position to start a company but who wants to run and grow an existing business by acquiring it from a founder who is ready for a transition. This is an often-overlooked route to entrepreneurship and related wealth creation for minority would-be business owners and one that is broadly underutilized.
- **Public offering:** a sale of some or all equity to the public through capital markets. This option is typically not going to be available to most middle market businesses, and it comes with significant regulatory and administrative burdens.
- **Orderly liquidation:** a planned and organized sale of the assets of the business after which the business does not continue.
- **Disorderly liquidation:** collapse and failure of the business; the least attractive of all options, frequently resulting in a massive destruction of value, financial harm to the owner's family, as well as to employees and communities. "Studies show that almost half of all family business collapses are caused by the owner's death."[19]

[19] Sean Hutchinson, "Exit Option Analysis," Exit Planning Institute, 2023, page 12.
https://blog.benchmarkcorporate.com/family-business-succession-planning-and-success-rates

In conclusion

Successful transitions of businesses don't just happen by chance – they are the result of a methodical planning process with a team of experienced professionals and require significant effort and attention over a period of years. There is a silent crisis confronting business owners: the vast majority are ignoring this essential planning process – resulting in often tragic consequences for the owner, the owner's family, employees and communities. This paper is only an introduction to some of the critical topics relevant to business owners planning for a transition of a business; we will be following up with deep dives in each of the areas we've addressed here at a high level.

Continue the legacy of what you've built by considering working with a J.P Morgan professional to help create a personalized, written transition plan – a succession planning roadmap to help you better understand what to address and when, so that you can enter the next stage in life with knowing that you have done everything you can to position yourself for success.

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