Transition and Succession Considerations – An Overview with DHG Corporate Finance

Schuyler Vaughan, Manager | DHG Corporate Finance

As an owner or a member of the senior management team, it is never too early to begin thinking about transition and succession planning. Prior experience tells us that it is better to proactively develop a plan that outlines the strategic options that you may consider for the future of your business than to react to a sudden change in your business without having a plan in place. Transition and succession planning are essential to maintaining a healthy business and a lasting legacy as the process allows you to thoughtfully prepare for the future and still maintain the company's brand and culture. A proper succession plan may also ease the minds of your board members, other owners and employees who may be concerned about an eventual and inevitable leadership change, as well as the corresponding potential disruption to your business.

We understand that there are many aspects of transition and succession planning, which is why DHG Corporate Finance has compiled a few key considerations below, including a high-level summary of transition and succession planning, an overview of strategic alternatives, key factors for decision making and strategic alignment with personal goals.

What exactly is transition and succession planning?

Transition and succession planning are the intentional preparation and established processes that can enable business owners to meet their objectives and transition their business at the right time and on the best possible terms and conditions. The key components of the transition and succession planning process are summarized in the diagram to the left.

Setting realistic goals that are tailored to you, your business and any key stakeholders is the first crucial step in planning for successful transition and succession. Working with a team of advisors, you should expect to spend a significant amount of time reviewing an array of strategic options, in addition to conducting detailed reviews and valuations of your business and performance. Only after fully vetting your strategic alternatives can you then begin to develop a plan of execution to achieve your strategic goals.

Why is transition and succession planning so important?

According to the BEI 2016 Business Owner Survey Report, most business owners do not have a written succession plan, even though only nine percent of owners claim that they want to stay in their businesses forever.[1] A properly established exit plan can help owners create a roadmap to realize future value and performance, as well as avoid the following challenges:

- **Financial Security** – Owning a business indefinitely subjects owners to ongoing business risks, economic downturns and/or personal health issues.
- **Time Factor** – Owners often wait too long to initiate transition and succession planning, which may limit the strategic options available to them when the time comes for them to exit the business.
- **Values-Based Goals** – A business owner's post-succession goals, such as benefitting employees and the community, or maintaining the legacy and culture of the business, may be difficult to achieve unless advisors prompt them to plan for an inevitable transition.
- **Successor** – Because many owners without a transition and succession plan often refuse to delegate company responsibilities, any harm that comes to the owner can transfer to the business, its employees and/or its clients.

What should I consider if I plan to transfer ownership to family member(s)?

If your succession plan means transfer of ownership to family member(s), consider strategies to minimize estate and gift taxes, as well as income taxes. With proper estate planning, a business owner can make full use of the available deductions and transfer tax exemptions in the event of the owner's death. Also, lifetime gifting strategies can help the owner transfer interests in the business while still living, allowing future appreciation in the value of the business to accumulate outside of the owner's estate, while the owner maintains control of the business. Transfer of value to the owner's intended beneficiaries can also take place through the use of voting and non-voting interests in a business. This strategy is useful when the owner wants to maintain right to control the business until ready to transfer to the successor.

Other key considerations in the transfer of a closely held business to family member(s) include confidentiality, efficiency of the transfer and asset protection, which can all be addressed with trusts, separate holding companies and other strategies within your estate/generational wealth planning. With the right plan to suit your needs and desires, you may be able to take advantage of substantial tax savings for you as the owner and for the transferees of the business. In family ownership situations, it is also important to develop a plan on how the business will be governed and managed, especially if ownership is dispersed to numerous owners.

What other strategic alternatives are available for transition of my business?

For business owners who are not seeking to transfer business ownership to family member(s), there are several other viable options for transition.

1. **Majority/Minority Sale of the Business** – A common strategic alternative for business owners is a majority or minority sale of the business. Those who wish to retire, complete a full ownership transition or simply relinquish a controlling stake in the company (while still maintaining a minority position of equity ownership), a majority sale may be the right option. However, majority sales can be more impactful on the business and necessitates that you have full confidence in the buyer and a clear understanding of their vision for the future. In some instances, a buyer will want an owner to "roll over" some of their equity and to be involved for a period of time (typically three to five years) and then allow them to sell their remaining ownership stake.

   Minority sales may be for business owners who want to test the waters regarding a transition while still maintaining a majority ownership of the business, as well as maintaining some control. Minority sales are also a viable method for business owners to remove some of the responsibility and burden of full ownership, or for those seeking a partner to add an influx of capital in the business. In such cases, a properly aligned partnership is crucial for minority sales, where they should aim to share a common vision, similar values and desired intentions.

2. **Employee Stock Ownership Plan (ESOP)** – An ESOP is a qualified and defined contribution employee benefit plan that can be used as an alternative structure to transition ownership in privately owned businesses. ESOPs are attractive because the transaction can potentially maximize tax efficiency for the company and its shareholders, while also providing improved cash flow for the company. ESOPs

1. Business Enterprise Institute, Inc.

also provide an opportunity for shareholders to create a liquidity plan while maintaining control of the business and avoiding the headache of disclosing confidential information. In addition, ESOPs may become a viable talent strategy within the business by creating more flexibility to retain key talent through the offering of additional incentives (mainly the opportunity to take ownership).

An ideal ESOP candidate would preferably have the following key attributes:

- At least a portion of the shareholders have interest in maintaining the legacy of the business;
- The company has sufficient payroll for 25+ employees;
- The company has a history of stable cash flow generation; and,
- There is adequate debt capacity to fund an ESOP transaction, likely via seller or bank financing.

While the potential advantages are significant, ESOPs do present a more complicated administrative and financial burden on the business since they require very specific conditions with numerous limitations, liabilities and administrative costs. Businesses without a stable and forecasted cash flow for the next five to 10 years may run into challenges with an ESOP, particularly in the down turn in the life cycle of a business. Therefore, a full evaluation of your business's unique situation and your goals are crucial to determine if an ESOP is right for your transition and succession strategy.

3. **Management Buyout** – Unlike an ESOP, ownership of the business via management buyout would reside with a select senior management team, allowing them to inject capital back into the business by their own means or through a combination of debt and equity. The transition is much easier and smoother than with an ESOP and requires fewer administrative costs. Management buyouts can also incentivize senior leadership to drive the vision and direction of the business when they receive ownership, which could provide peace of mind for business owners as they transition the business with a trusted, tightly held group of employees. The challenge with a management buyout is that it doesn't always provide sufficient liquidity to the selling owner.
4. **Recapitalization** – Business owners may choose to take some of their equity off the table via a recapitalization of the business through bank or private debt sources. This approach will allow the owners to convert their equity to cash proceeds and still retain control of the business. The owners will continue to benefit from future potential upside, while also allowing the company's earnings to pay down the debt and rebuild their equity position. However, business owners and senior management should be aware of the requirements and covenants that come with managing a business under a leveraged environment. Highly cyclical businesses should pay special attention to the company's cash flows in order to meet the potential debt obligations. For businesses with stable cash flow generation, a recapitalization may be an effective strategic option.

What should my role be post-transaction?

As a business owner, you should account for your post-transaction role as you determine your goals for yourself and the business at the beginning of your succession strategy. Be willing to be transparent about how much control you wish to maintain, what your responsibilities should be and how you will be involved in making future decisions for the business. This will shape how you plan and execute your succession strategy and ultimately protect your desires and interests once a potential transaction has taken place. Your financial advisor can help you determine what you hope to accomplish and work toward making those desires a reality.

Conclusion

Transition and succession are part of an inevitable and crucial journey for all business owners, meaning that it is never too late to begin assessing your personal and professional long-term goals and to start developing the right strategy with your financial advisor. Before embarking on the path of transition and succession planning, remember to give adequate time to process through the following fundamental steps:

- Determine your personal and professional objectives.
- Complete relevant personal financial planning.
- Understand and address any business issues.
- Establish process guidelines and a strategy.
- Understand and be transparent about what results you hope to anticipate.

By planning for the inevitable, you can do your part to safeguard for a smooth, planned transition that sends a positive message about the organization and its leadership, both currently and in the future.

About DHG Corporate Finance LLC

DHG Corporate Finance is a premier middle market investment bank founded by experienced professionals dedicated to advising middle market companies. Our senior banking team has 75+ years of transaction experience directly relevant to the issues companies face such as mergers and acquisitions, liquidity events, business succession planning.