Newsletter Article

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SUCCESSION PLANNING STARTS WITH TRANSFERABILITY

By Paul Lally

ABOUT THE AUTHOR(S)

Paul Lally leads Wipfli's business transition group, specializing in transition and succession planning for business owners. Leveraging 28 years of experience, he assists clients in making sound decisions as they navigate the growth and perpetuation of their business.

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Introduction

According to a 2016 Family Business Institute survey, approximately 40% of family businesses expect the leadership of their companies to change hands by 2021, and 56% expect a leadership change by 2026.[1] Moreover, four out of five businesses are still controlled by their founders. With baby boomers retiring at an ever-increasing rate, this is simply unsustainable, and everyone knows it — yet few are doing anything about it. Why not?

Business owners should take after corporate America in considering succession planning a component of an overall growth and perpetuation strategy — but instead they've made succession planning a standalone event unrelated to their long-term corporate plan. Transition planning is a long- and short-term strategy that will allow you to perpetuate your business at a price and time of your choosing while protecting you in the interim against an unforeseen event (e.g., death, disability or some other incapacity). Sounds easy enough, but why aren't more owners putting these strategies in place?

There are two key reasons:

1. *Succession planning means having to deal with tough, emotional decisions. It's human nature to put it off or avoid it altogether.*
2. *Business owners have no problem calling the shots or taking calculated risks, but they do not spend time educating themselves about their options in order to make informed decisions about their future.*

One provision of the TCJA that could affect the determination of compensation for qualified plan purposes pertains to reimbursements for moving expenses. Effective after December 31, 2017, the TCJA eliminated the ability for employers to deduct reimbursements to employees for qualified moving expenses, as well as the ability for employees to exclude those reimbursements from income.

So how do we solve a problem that makes it harder for business owners to preserve the vision and legacy they have worked a lifetime to create? We begin by realizing that transition planning is not an issue unto itself but rather part of a short- and long-term corporate planning strategy. And like any other strategy, we first need to examine our options.

Broadly speaking, there are two potential transition strategies that companies will employ: internal or external. We define internal as a transition strategy whereby the business is transitioned to existing management and/or within a family, typically from one generation to the next. We group these together because, though the ownership may differ, the strategies and pitfalls tend to be similar.

An external transition strategy would then be any transition that is to an outside third party. Both of these avenues have their own set of pros and cons. Internal transitions tend to deliver slightly less value to an owner and generally require a longer timeline to fulfill as the current owner usually offers some sort of financing or earn out. Continued involvement by the prior owner is usually expected by both sides, and owners like to see their values and culture extended through their efforts.

External transitions open up the possibility of receiving a higher value as strategic buyers or competitors may become involved, but they bring with them the risk of culture shock, employee disruption and potential morale issues. Either option can be successful — they just require adequate planning. And it is planning that is really the heart of any successful transition.

How Do You Plan for a Successful Transition?

From Wipfli's decades of experience working with privately owned businesses on a national basis, we have found that the key to a successful transition starts with a business owner. To start, owners must ask themselves the most important question: Is my business transferable? This brings up another key question: What is a transferable business? By definition, a transferable business is one that can be owned and run by someone else without necessitating your constant involvement. Your efforts should not be imperative to the operation of the company.

When Is the Best Time to Build Transferability?

This is one of the most common questions clients ask me. And my answer is simple:

Never too early, and often too late.

The sooner you begin to improve your company's transferability, the better your chances to perpetuate your business into the future. Because leaving a business, or even preparing to leave a business, is often an emotional decision, many of our clients wait to make it. Unfortunately, if you wait to begin building transferability, you will encounter several problems.

First, you will lose the luxury of time. Time is a finite resource; its importance cannot be overstated. Ideally, good decisions are made when business owners have time, money and ability. By procrastinating, you will have the same amount of work to do without adequate time.

Second, if you wait to build transferability, you will have forfeited potentially years of reducing your personal financial risk from the performance of the business. It's the reduction of this risk that creates the true financial freedom that many business owners dream about but never achieve.

Third, by waiting, you may be deprived of a more pleasing ownership experience, because the heart of increasing transferability is making an owner replaceable while improving and growing the business. The first tasks transferred are generally those owners find tedious or unpleasant. Delaying preparation robs an owner of all these things.

Determining the transferability of your business shines a spotlight on the strengths and weaknesses of your people and processes, allowing a business owner to enhance value with minimal disruption to staff, customers or vendors.

How Does Transferability Create Value?

We must recognize there are multiple definitions of value for a private business, but two of them are relevant here:

1. Value to you as an owner (personal value, or what the business is worth to you).
2. Transferable value (what the business is worth to someone else).

"The Value to You"

Personal value, or the value of a business to you, conveys with it rights and privileges and may not be the same for every potential owner. It may be unique to you for any number of reasons, including:

- **Your business represents your life's work.** Frequently, our clients are so devoted to their business that they cannot imagine life without it. In my almost 30 years in the business consulting profession, I have seen clients and other business owners who never left their businesses until the moment they passed away. I've seen others who have missed not only phenomenal opportunities to transition their businesses because they could not let go, but also industry-changing strategic opportunities as well.
- **Your business represents position and prestige.** The bulk of my clients have been mid-sized businesses, and those businesses are the bedrock of towns and cities across the country. Owners of those businesses are intertwined with those communities, and it's easy for them to get caught up in their positions in their companies, their communities and their industries. This makes it difficult to step down.
- **Your business represents your lifestyle.** Particularly with some smaller businesses, but even in businesses of significant size and value, the owners' incomes and benefits may provide a larger lifestyle than they would be able to afford by living solely off of investment income. This can be a real trap. Before a successful transition can occur, this problem must be resolved by an increase in the value of the business, a reduction in lifestyle or both.
- **You are a key person.** Small business owners are usually vital to the ongoing success of the business because of their special knowledge or expertise, customer or supplier relationships, unique operational or sales abilities, or other critical attributes. In such situations, the business is worth more to a particular key owner than it is to any other investors because they have a unique ability to increase value that others simply may not. These types of risks must be significantly reduced or eliminated.

The personal value of your business may make it priceless to you. However, if your business is not transferable, it may be close to valueless than priceless.

Defining Transferable Value

My definition of a company's transferable value relates to the characteristics other investors find attractive — and are willing to pay for. Generally, it stems from the following question: "Have you institutionalized the cash flow generation process at your firm?" Put another way, "Is the business capable of operating, growing and generating positive cash flows without the skills, abilities or oversight of the owner?"

At Wipfli, we often use the acronym **GROW** to provide a shorthand description of the qualities a transferable business has. This acronym stands for:

- **Growth:** Growth is one of the key value drivers in determining transferability. Is your business growing? Does it have a growth culture? How is that growth being demonstrated? By revenues, cash flows or customer growth, among other factors? Demonstrating that you're growing and having a process for continuing to do so is key.
- **Risks:** Many times, our clients forget that there are really three ways to increase value. They can increase their revenue, decrease their expenses or improve their risk profile. The vast majority of them spend time on the first two and almost none on the last. Businesses that understand their risk characteristics and strive to make themselves less risky are inherently more valuable than their competitors.
- **Organization:** By organization, we mean the people and culture developed within a company that have allowed it to succeed and will carry on into the future. A company that lacks the ability to find, retain and motivate employees over the long term is doomed. One that can consistently do so is constantly building value for its owners, regardless of who they are.
- **Wealth Generation:** Is the company consistently generating positive cash flows for the owner? Cash flow can be measured many ways, but we traditionally use EBITDA (earnings before interest, taxes, depreciation and amortization) and then make an adjustment for the owner's salary and other benefits. Companies that consistently understand their cash-flow-generating ability and work to increase it are those that build wealth for their owners.

Every business has value for its owner, but does it have transferable value? Do you understand how the difference applies to your own business? Owners spend a lifetime building personal value. Now is the time to understand your transferable value and strive to increase it so that you can gain the financial freedom shared by few of your peers.

Contact Wipfli to learn more about how you can create transferable value for your business.

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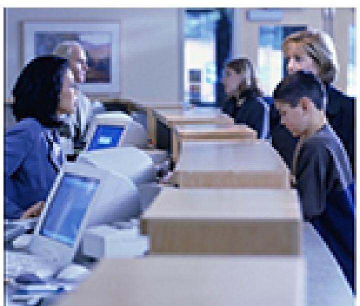

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