National Tooling & Machining Association

NTMA

PRECISION

Business Management Advisory

For Precision Custom Manufacturers

PL18 **File: PLANNING**

BUSINESS SUCCESSION PLANNING

SUMMARY

Business succession planning is directly related to estate planning—but, for most business owners, devoting attention to the issue of business succession will be at least as important in determining the amount of money available for retirement and for distribution to family members. In addition, business succession planning will necessarily have a greater impact on your employees, your customers and the continuation of your business reputation.

SUCCESSION AS PART OF ESTATE PLANNING

Business succession planning is often treated as a part of estate planning, since the value of your business ownership interest is a major element—probably the major element—in your personal estate. Obviously, your ownership interest must be carefully considered in your estate plan.

Succession planning, however, goes beyond traditional estate planning and involves several factors relating directly to the management and operation of your company:

- building the value of your business,
- identifying and training the management team to succeed you or to support a new owner,
- providing for retirement income,
- continuing the business in case of untimely death or disability,
- establishing the transfer value of your business for gift tax or estate tax purposes,
- funding estate taxes related to your business,
- providing liquidity for transfer of ownership interest to other owners, employees or heirs, and
- protecting your personal interests against challenges by minority shareholders, family members or the Internal Revenue Service.

A few of these factors, such as funding estate taxes, are also important concerns in traditional estate planning. Nevertheless, there is a significant benefit in considering these issues from the perspective of business succession planning: a company-centered approach will encourage you to maximize the value of your business, while helping to assure that your personal plans are compatible with your business objectives. Insurance representatives, stock brokers and estate planners should not be permitted to set your business goals.

BUILDING THE VALUE OF YOUR BUSINESS

To build the intrinsic value of your business, you must create an organization that offers attractive profit potential for a prospective buyer. To accomplish that goal requires more than amassing assets, hiring a group of employees, and having a list of customers.

It's true that someone seeking to own a contract metalworking company might pay a small premium for a collection of equipment already in place, a trained workforce, and a roster of customers who know the company name. But what reasonable assurance can you give a prospective buyer that your equipment is adequate to compete for future business, or that your key employees will remain with the company, or that the engineering and estimating functions can be performed effectively without you, - or that your customers will have any interest in working with a stranger using your company's name on his business card? By dealing with those issues in your business succession plan, you can increase the value of your company.

If two-thirds of your company's sales volume is linked to a single line of business (such as automobiles or oil field equipment), will any potential buyer be willing to gamble on that industry's business cycle? Will anyone pay a premium to risk his investment on the future success of your largest customers?

Diversification is a highly important factor in building value. Even if your business has prospered by means of a close relationship with a single industry—or even with a single company—a prospective buyer should have a reasonable concern about his ability to cultivate the same degree of loyalty from those critical relationships. And, quite naturally, he should be wary of the economic cycles that would be imposed on his new company by a limited number of customers. What has been successful for you in the past will not necessarily be attractive to someone else looking into the future.

Customer diversification is only one element in building your company's intrinsic value. The implementation of a superior or unique production process, the acquisition of extremely versatile or highly specialized equipment, or the development of an unusually effective system of cost control will all add significant value to your company's sale price. (Also see the BMA describing One Dozen Ways to Increase the Value and Marketability of Your Business.)

MANAGEMENT SUCCESSION TEAM

An important factor in building your company's intrinsic value is the identification and training of a management succession team—key employees who can assume management responsibilities or assist a new owner. Such a team can add value to your company in either of two ways: by becoming prospective buyers of your ownership interest or by providing management backup to a new owner. The composition of your management succession team should reflect your company's specific operating needs and competitive conditions, as well as your personal plans for transferring the business (whether to family members, employees or outside interests).

To evaluate the adequacy of your succession team, put yourself in the position of the new owner. What skills will be missing when you leave? Is it realistic to assume that the new owner will be able to provide those skills himself, or should you be training a backup person now?

A major advantage of a succession team is the freedom it can provide you before retirement. With competent management support, you can take more time away from the business. Even if your employees do not perform to perfection, giving them the opportunity to make operational decisions will build your company's intrinsic value while enabling you to enjoy more leisure.

On the other hand, if you do not feel comfortable leaving any significant decisions to the independent judgement of your subordinates, your company's value may be limited to the assets shown on the balance sheet.

RETIREMENT INCOME

Planning to generate sufficient income for retirement years involves more than establishing a pension plan and an investment portfolio outside your company. For the owner of an independent business, estimating the value of income that may be received from the future sale of the company (either in a lump sum or through a multi-year payout) will have a major effect on retirement planning. The possibility of part-time employment or a consulting contract with your company will also influence plans to maintain your life style after the transfer of ownership.

UNTIMELY EVENTS

Death and disability are not events that can be accurately anticipated. To provide for the continuation of your business after such an untimely occurrence, you should consider whether additional funds will be needed for your company to operate until a new owner can be found.

Providing for business continuation can be regarded as a means of supporting you in the event of disability or increasing the sale price of your company to benefit your heirs—or it can be viewed as an obligation to your employees and your customers. In any case, the possible need for life insurance and disability insurance should be considered.

BUSINESS VALUATION

To estimate potential retirement income from the future sale of your company and to establish a value of your business for gift tax or estate tax purposes, you should adopt a valuation formula for your company. You may not wish to have a formal valuation conducted, but you should set forth the method by which the value can be determined. To ascertain that any method you may be considering is actually appropriate for your company, you should work with your accountant to make a quick, first-impression valuation estimate based on that method. Different methods yield different valuation amounts.

A very simple valuation formula, such as unadjusted book value or book value plus ten percent, may be subject to challenge by minority shareholders, disgruntled heirs or the IRS. In adopting any formula, you should prepare written records supporting the reasonableness of the method—particularly if it appears arbitrary because of its simplicity.

Depending on your company's future prospects, certain valuation methods will favor the seller while others will benefit the buyers. For that reason, you should carefully consider which of the many approaches would be most advantageous for you and your company. You should not simply accept the word of your accountant or your insurance representative. Find out, in detail, why your financial advisor recommends a specific method.

A word of caution: a valuation formula may not reflect the actual amount you would receive for your ownership interest. Without a professional valuation, you can only guess whether the eventual sale of your business will yield sufficient proceeds to fund your retirement or your other personal objectives.

In the absence of a formal valuation or any clearly defined basis for determining the value of your company, the IRS can use any of the many variations on their basic valuation formula to assert that your ownership interest had significantly more value than reported—and was, therefore, subject to greater tax liability. When such claims arise, the amount of money at issue is often equal to several years of the owner's personal income.

FUNDING ESTATE TAXES

A reasonable estimate of the value of your business is necessary to assure that there will be sufficient funds in your estate to enable your heirs to pay taxes without having to liquidate their inherited business interests or other property. Life insurance may be the most appropriate method of funding estimated estate taxes.

LIQUIDITY FOR TRANSFER OF OWNERSHIP

A closely related issue is the provision of sufficient liquidity to enable the transfer of ownership interest. If your buy/sell agreement or your will specifies that another individual will have the opportunity to purchase your ownership share, you must consider whether that party has the financial ability to do so—and whether you wish to provide that ability. Once again, life insurance is a common method of making funds available: in this case, to assure that your designated successor will have the financial means to complete the transfer.

PROTECTING YOUR PERSONAL INTERESTS

To protect your personal interests against challenges by minority shareholders, family members or the Internal Revenue Service, you must document the basis for establishing the value of your business (as well as the basis for determining the amount of your executive compensation, particularly year-end bonuses).

If you share ownership interest with others through a partnership agreement or as a shareholder in a corporation or have made provision for the transfer of ownership through a buy/sell agreement, a family trust or a will, you must be prepared to defend your management decisions relating to business valuation and executive compensation. Even in a divorce action, your spouse may assert a claim to the business, often alleging a value many times its potential sale price. It is impossible to predict either the likelihood or the timing of such actions; but in today's increasingly litigious society, you should take proper precautions. An up-to-date business valuation, together with annual documentation of the basis for executive compensation, can do much to defend against the harmful financial effects of unexpected legal actions.

A buy/sell agreement is a virtual necessity in a partnership or a multi-owner corporation. Two key elements in an adequate agreement are: (1) a specific, reasonable, defensible method of establishing the value of the company, and (2) coverage of all foreseeable conditions affecting the buyout provisions. All too often, a buy/sell agreement drafted by an insurance representative covers only death or disability of an owner. Disagreement between owners should also be addressed, to the extent possible. The withdrawal of an owner from the company's day-to-day operations may, for example, be specified as an event which would trigger the buyout provisions.

A properly written buy-sell agreement will include a number of other key provisions of a legal nature. Your attorney should, of course, be closely involved in drafting or approving your buy/sell agreement and any related documents. Your accountant should also be consulted, specifically with regard to the valuation formula and the ability of the owners to fund the transfer of ownership interest.

In the final analysis, however, you must take responsibility for assuring that the critical management issues (such as the method of valuation and the conditions which trigger a buyout) are addressed in the agreement or are omitted for good reason.

SELLING YOUR COMPANY ON THE OPEN MARKET

If you decide to sell your company on the open market, you should consider using a professional organization which can represent you in the confidential sale of your company. Make certain to consult your accountant or your lawyer before providing any confidential information or signing any agreement (for consulting, valuation or sales representation) with an outside organization. In some cases, your accountant or your lawyer can assist in the actual negotiations with prospective buyers, but professional guidance from a firm that specializes in sales of closely-held companies is usually advisable.

Employing a professional organization involves several major financial considerations: the size of the fee, the value of your time, the downside risk of an unsuccessful transaction, and the sale price you will ultimately receive. The reason for seeking outside assistance is obviously to reduce the risk (of failed negotiations, an improperly drawn agreement or an irresponsible buyer) and to obtain a higher sale price that will more than offset the amount of the professional fee. There is, however, no guarantee that a firm with an exorbitant fee schedule will necessarily represent the seller more effectively or secure a higher price.

In very general terms, there are two types of organizations involved in the sales of closely-held companies: (1) firms that represent only owners seeking to sell their companies, and (2) business brokers that represent either the buyer or the seller, depending on the specific transaction.

Firms that represent only sellers tend to offer more individualized evaluation and guidance, since they are seeking buyers in the broad marketplace. They typically tailor their services to the specific characteristics of the seller.

A business brokerage which represents both buyers and sellers may offer an advantage in arranging a quick sale by virtue of having an existing roster of potential buyers. However, it is important to find out whether the brokerage typically operates on a high turnover with a lower commission structure (resulting from quick sales at lower prices). A business brokerage may also have close ties with certain large buyers that do repeat business, possibly because of comparatively low acquisition costs.

As in all aspects of business succession planning, you must devote management attention to protecting your personal interests and those of your company.

This BMA was prepared by Barry E. Miller, Principal Consultant of the Barry E. Miller Company, which produces the Operating Costs and Executive Compensation Report and the Wage and Fringe Benefit Report for NTMA. Mr. Miller provides consulting services in business valuation, executive compensation and strategic planning to NTMA members. He does not sell insurance, recommend personal investments, administer pension plans, or act as a business broker.