Business Succession and Transition Planning

The Importance of Mentorship

Business Succession and Transition Planning is an increasingly popular topic in the world of Financial Planning. Many small business owners have a successful operation that can range from one key employee to several key employees. These employees are typically individuals who have worked hard to learn the business side of your operation or family members who have taken pride in the success of your business. If you have one of these types of employees, or potentially a combination of both, you have likely thought of them as a successor to your business once you are ready to retire. The daunting question is how can you be sure they are ready to take on the added responsibilities that come with running a business? Many individuals are extremely hard working and valuable employees but lack the managerial experience necessary in taking over the business. The best way to ensure you are not handing the keys of your business to someone who is ill-prepared is to spend time with them on the management, financial and operational aspect of the business. This can be very time consuming for you and could require you to disclose company information to them. The benefit you will get from this is the earlier you start grooming the successor(s), the smoother the transition will be once you pass the torch to them.

You will also be able to educate them on some successes and mistakes you made in your years as a business owner. This will be valuable information for them as they become more experienced and will be forced to make decisions on their own that carry significant importance. As you work with the successor(s) and they become more familiar with the business, you can begin to hand additional responsibilities to them. You can monitor them closely to avoid any major mistakes but allowing them to take on these tasks will build their confidence and sharpen their tools as the process moves forward. The sooner you begin this process, the earlier you will be able to scale back your involvement. Once you and the new owner(s) are comfortable with the transition it will be the opportune time to step back and transfer your ownership stake. This can either be done all at once or portions of ownership can be transferred over time to allow for a more gradual transition. Some business owners we have worked with even decide to work in the business as an employee for a few years after the transition occurs. This is perfectly normal and can actually benefit the new owner(s) in the early stages of their new role. As always, advice from all of your professional advisors throughout the transition will facilitate the process.

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Finding a Fair Number

When dealing with family members specifically, business succession can have some added layers that you should ensure are addressed. To begin, let's assume you have 2 children. Child A has been working in your business since the age of 18 and is now 28 years old. Child B decided to take a different career path and is now working as a Teacher at the local high school. Child A has always been there when you needed extra help and has devoted late nights and weekends to ensure your business is operating seamlessly. You are 55 years old and want to significantly scale back your involvement in the business over the next 5 years. You begin to mentor Child A by increasing their involvement in the managerial, financial and operational aspect of your business. You have worked with Child A on a financing strategy to compensate you $500,000 for the business which will allow you to fund your retirement. You determined this amount by working with your financial professionals to find a dollar value that allows you to comfortably retire given your retirement income needs, while also not putting the new owner(s) at a significant financial disadvantage. This amount is much less than the $2 million you estimate you could sell your business for to a third party, but you understand the long hours Child A has put into the business over the years and your desire to have the business remain in your family. Outside of your business, your net worth is comprised of savings you have invested with your Investment Advisor, real estate properties and your home. Now that you have developed a plan for Child A you might be wondering how Child B can be fairly compensated. Although Child B hasn't been involved in the business, you feel they should still receive a financial benefit since Child A was given the family business at a significant discount relative to its market value. Throughout the process you will need to work with Child A, B and your professional advisors to determine an amount that is fair for Child B. You want to ensure both children are content with the outcome to avoid any future conflict when the time comes to distribute your Estate assets. You have the option to equalize the distribution of wealth through your Estate, or work with your current assets to compensate Child B while you are still living. Depending on the age and financial stability of Child B, you and your professional advisors will be able to assess whether it is more beneficial to compensate Child B now, later, or a combination of both.

Putting It All Together

Now that you have been able to hold open conversations with Child A and Child B, you can begin to work on a course of action with your professional advisors. This means you will need to determine how you will be compensated the $500,000 for your business and how Child B will be compensated as an equalization payment. In most cases, Child A will not have the liquidity or financing ability to personally cover the cost of purchasing the business from you. You will also likely require a decent portion (if not all) of your current savings to fund your retirement. This is where you have the ability to leverage your business to produce the funds necessary to make it all work. Whether your business has the required amounts in cash or has the ability to acquire financing, it is typically the most efficient place cash can be raised to fund the succession plan. You will need to work with your professional advisors to run a cash flow analysis to ensure your business will continue to run smoothly and have the financial flexibility to grow for the future owner(s). This will be done by running multiple payment schedule scenarios (lump sum, annual...) to determine which option works best for everyone involved. This will give Child A a clear understanding of the business' financial obligations to you and Child B once they have taken over as an owner. This arrangement can be documented and stored with your professional advisors as a reference point. Once everything is in place and all parties understand their involvement, the process can begin. You will receive the $500,000 (either in a lump sum or over a pre-determined number of years) and Child A will be issued new common shares in the business. Your common shares will then be converted to preferred shares which will be frozen at their value at that time. This process is known as the Estate Freeze and allows the future growth of the business to be transferred to Child A. Depending on the agreement with Child B, they may also receive compensation at this time (or alternatively through your Estate). Once complete, the new owner(s) will be properly mentored, have a clear understanding of their obligation to everyone involved and will be prepared to begin their role as a business owner. Succession planning is a process that has no defined timeline. There are many factors that contribute to the length of time it takes, but having the proper team of professionals in front of you can help ensure every decision is reviewed with the appropriate legal, tax and wealth management perspective. Contact us today for more information and for a complimentary business succession and transition planning package.

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