Succession Planning: The Problem is Growing (and so is the Solution)

John Mill, author of Hire Your Buyer *shares his views on small business owners (and buyers), the pitfalls of traditional succession, and the need for an unorthodox, yet proven approach – an idea that you may be ideally positioned to present to your most valuable clients.*

With small business accounting for 98%[1] of *all* Canadian businesses, entrepreneurs have become a sweet-spot client for Advisors in their books. Reflective of current demographics, that translates to more than 59%[2] of Baby Boomer business owners contemplating succession in the coming years. For those with clients between the ages of 55 and 75, this presents an issue: approximately 83%[3] do not have a formalized succession plan, and statistically, many of those business will end in disaster[4] – potentially leaving a wide swath of retirees without the means to fund their future.

55% of business exits occur as a result of one of the six Ds: death, dismemberment, debt, dispute, disaster or divorce.[5]

With 25 years of experience as a small business lawyer – and specializing in tax – I encountered many business owners running thriving enterprises, with $500,000 annual profit, only to discover that if they were to sell, the business would only be worth $1,000,000. The trap they had fallen into was to equate *profit* and *value*. And with typical valuation multiple of 2-4x earnings for a small business, 85%[3] of an owner's net worth is tied up in what would be deemed a *high-risk enterprise*. Why the risk?

It results from the "*being hit by a bus problem*." To put it bluntly, if a bus hits the owner tomorrow, the business would disappear because the company is owner-dependent, and therefore non-transferable. The enterprise also has very little value if the owner leaves – perhaps the single biggest influencer on the low multiple. Having the vast majority of assets tied up in a high-risk business explains why *disaster* is the most frequent exit plan.

It all begins with a financial plan

Most business owners I've met over the years have no idea how big their value gap is; in other words, the shortfall in assets available to fund the cost of retirement and legacy. While this seems like a simple enough concept, there's complexity and nuance in some of the components of the formula, such as business valuation, and there's also some introspective work in figuring out *why* the gap exists.

retirement & legacy costs - net worth outside business + transferable value of business = value gap

Like every Canadian with assets and a vision of wealth, every business owner needs an evolving financial plan. While many Advisors already consider financial planning core to their offering, and some clients consider it merely a nice to have, it's absolutely critical that small business owners know, and are able to identify and articulate, their "walk-away point" – often expressed in terms of how many more years the owner needs to work. This in turn helps to determine the excess value (*i.e., free cash flow or earning power*) required to be generated in order to successfully exit. A **value creation plan** can substantially reduce the time between now and walking away.

Value creation is a risk mitigation tool

Most owners in the Baby Boomer demographic have been in business for 20-30 years. It's not uncommon that they have built a very solid foundation, and then, effectively, stopped growing the company. What they have is a "lifestyle business" – profitable and successful, but not saleable at a price that's reflective of true value, or a price that allows the owner to "walk away," as alluded to earlier.

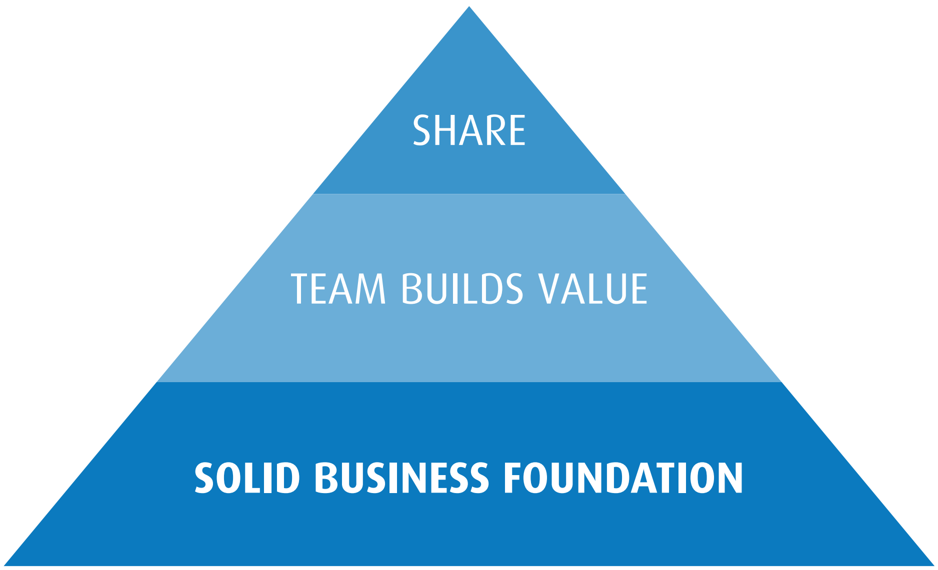
The solution lies in creating additional value on top of that very solid business foundation. Unfortunately, most owners don't understand the mechanics of *maximizing* value. When asked, they'll say that it's about doubling sales, but that's a pretty tough and lengthy process. The simpler path is to initiate standardized processes that allow the business to run without the owner at the helm… to eliminate the "being hit by a bus" problem.

This basic strategy substantially reduces inherent risk (i.e., owner dependency) and can therefore – in terms of valuation – increase the multiple to 4-8x earnings. The approach also creates the necessary second level of the business (e.g., new growth, new management) required to further advance value creation levels.

Converting trapped equity and increasing AUM… by 3-4x

Time and again, I've seen the issue of a small business owner with a big problem: a shortfall in assets available to support lifestyle in later years, not because there was an absence of value in the business, but because the value was actually *un-transferable goodwill*. It was this realization – that owner-dependent value needs to be harnessed and converted into something transferable – that led me to develop a system with a set of guiding principles for alignment, and share it in the book I wrote, titled *Hire Your Buyer*. The premise is based on the idea that the delegation of business practices, processes and knowledge creates value. Building an engaged team creates trust. And *trust* creates value.

HIRE YOUR BUYER



Delegation converts the equity “trapped” in the owner and transfers it to the team, effectively turning *personal* goodwill into *enterprise* goodwill. In many instances, it is an engaged team itself that becomes the optimal buyer. Team members understand the business, and already have *skill in the game*. Because they’re equipped to drive business value – and therefore sustainable growth – they are far less influenced by a minuscule multiple that may be offered by the market. Many sellers ask their internal buyer to conduct a due diligence audit, as if the company was their client, to fix/systematize everything possible in order to reduce risk, which literally unlocks value in the business.

The goal of the entire process is to reduce risk for the business, its seller and buyer. What better way to do that than through a transparent and unified purpose in creating a solid nest egg to allow the owner(s) to retire and enough buyer-created value for the successors to flourish? The expectation in many cases is to achieve a 300%-400% increase in the price for the business. The buyer gets more (i.e., a less risky, more valuable business), the seller gets to retire faster and wealthier – and the best interests of the team supersede all else.

Why hire your buyer?

- More control over buyer (and working relationship)
- Traditional due diligence unnecessary
- Seller sets terms (retirement goal)
- It’s non-adversarial (win-win)
- No risk of sales failure (mutual agenda set)
- Price based on fair market value (PLUS buyer-created value)
- Ownership transfer period malleable

Financial Advisors: quarterbacks in the long game

While technical professionals, such as tax lawyers and accountants, play an integral role in this type of business transition, they innately look at the situation through the traditional *transactional* lenses. Succession planning is, however, *holistic* in nature and requires a more comprehensive approach. It's also a process that needs a guide and champion, one who knows the people involved, has their trust and brings expertise in financial planning, assessing retirement needs, estate planning, et cetera. Succession planning is easily postponed and, let's face it, a meeting with you is the logical opportunity for your client to address it.

All of this makes succession-planning counsel particularly well-suited to Financial Advisors – a group adept at nurturing the relationship and quarterbacking a professional network; skilled communicators who regularly engage in difficult and important conversations; part of a trusted inner circle; and stewards that seek to add value beyond investment management. Who better to initiate the succession planning process than someone with a holistic view?

At its core, the purpose of a *hire-your-buyer* type plan is for seasoned entrepreneurs to identify and collaborate with the next generation of owners, using a defined process of value creation. As a key member of the team associated with re-engineering a business by advocating a win-win philosophy, you the financial advisor – alongside legal, accounting and tax experts – will be in an optimal position to help your clients and likely reap some reward from the additional value that is created. It stands to reason that sellers (and buyers) in this type of scenario retain the strategic counsel that helped them to achieve succession in the first place.

Additional Resources:

Wealth Management for Business Owners >

Enhanced Estate Planning >

[1] Government of Canada, *Key Small Business Statistics*, June 2016.

[2] Statistics Canada, *Survey on Financing and Growth of Small and Medium Enterprises*, 2014; and *Innovation, Science and Economic Development Canada* calculations.

[3] Deloitte LLP, *Wealth Generations: The Importance of Succession Planning for Family Businesses*, 2014.

[4] John Lorinc, "Succession planning is even more important with billions at stake," *Canadian Business*, December 4, 2014.

[5] Exit Planning Institute, Chicago, 2013.

John Mill, LL.M.

John practiced in tax litigation and tax planning for 25 years. In 2014 he wrote and published the book *Hire Your Buyer: A Philosophy of Value Creation*. John currently works with Advisors and owners as a team member on succession planning and value creation teams. He is currently writing a course for business owners called "On Connected Culture," which is available to the public on his website at ConnectedCulture.ca.