Getting the most out of planning for transition

BY BRUCE C. STEVENS

Perhaps the most important—and the most frightening—decisions that business owners will face are when and how to transition out of the business they have built. Yet most owners procrastinate about addressing these issues. They then have to make rushed decisions under duress, substantially reducing both the value of the business and their comfort with the outcome.

Why don't owners plan their transition? Most are uncomfortable with facing their departure from the business. This is a pity, on two levels. The first is that departure is inevitable, and planning will make it more orderly. But the greater pity, and the irony, is that planning for transition will actually increase the company's value and enhance the business owner's satisfaction and peace of mind, both before and after the transition. Delay costs money and promotes ulcers. Rather than shun and avoid the transition process, you should embrace it.

To get the most out of the effort, I recommend that you develop a Transition Strategy, which combines a rigorous strategy for the business with a thorough and comprehensive transition plan. To formulate this plan, be sure to consider all the transition options that are open and appealing to you.

The business strategy will help maximize the value of your business; the transition plan will help you groom the organization for your preferred option and will also help you reap the business's value, while giving you the comfort of knowing that you picked the optimal alternative for you.

Business strategy

Your business strategy should build on the solid foundation of financial research that has shown that businesses create value by first obtaining a return on investment above the cost of capital and then—and *only* then— growing the business. The cost of capital is likely to be in the 12% to 15% range. Seek to exceed this threshold, then drive to grow the profits—not sales, which are irrelevant to value—as quickly as you can.

Also assess your competitive environment. Some environments allow only a few competitors to create value, some many, and others none. If your business is in a difficult environment, try to break out of it.

> ***Formulating and executing a clear and effective business strategy will enable you to maximize the value of your business.***

When developing your strategy, focus on the details of your company's economics. For example, analyses of a wide range of businesses have found that only a relative handful of customers, products and services generate the majority of a company's profits, while the rest are money losers. Figure out whether this is true in your business and either improve the margins of the losers or show them the door. Doing so will put you well on the way to increasing your returns and your company's value.

Determine how fast your company is likely to grow —and how fast it can afford to grow. Make sure you can finance your growth in a way you can be comfortable with. In your company, your personal preferences, including your personal risk tolerance, are critical and legitimate considerations. So if you don't want to take on the financial risks required to grow as fast as your market, you are free to make that choice—but make sure you know what that means strategically for your business and its value.

As you develop your business strategy, you should obtain a clear idea of what the business value is today and how it should change over time. This will in turn give you insights into the best times to consider transitioning out of the business and coordinating that with your own personal preferences.

For example, suppose your business appears to have a decade of clear growth ahead. You want to set aside some of the burdens of running it sooner than that, yet you want to realize the benefits of growth. You can consider grooming or hiring a CEO to lighten your load without prematurely giving up your ownership.

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Transition options

Your transition options are: selling the business to an outsider (too often the default for owners); passing it to heirs; selling it to one or a few managers; selling it to all the employees (often through an ESOP); hiring a manager to run it while you retain ownership; taking it public (an option only for companies that have the ability to generate earnings exceeding $100 million or are willing to risk becoming tiny-cap orphans); and—least desirable of all—leaving the problem to the Almighty, the IRS and your estate attorneys.

To help you identify the best option, seek the advice of trusted confidants with relevant experience. These could be friends, family, board members or professional advisers. But beware of the potential for conflicts of interest. Many advisers, especially intermediaries (such as business brokers and investment bankers), have strong incentives to encourage you to sell the business, which may not be your best option. Intermediaries have another potential conflict: While they represent a private business owner just once, they may work with private equity and corporate buyers many times as both buyers and sellers of businesses, and therefore may be more attentive to these repeat clients than to the private business owner.

Throughout the transition planning and execution process, bear in mind the old saw about ham and eggs: For the chicken, it's just a day's work, but for the pig, it's a lifetime commitment. So choose advisers with enough experience to help you level the playing field against the professionals with whom you'll have to deal.

If you opt to transfer ownership of the business to heirs or employees, you'll probably want to receive cash in return for the equity. To raise that cash, the heirs or managers may have to go to the same financing sources that you would encounter in a sale: private equity firms and subordinated debt or "mezzanine" lenders. Using them will make the process essentially the same as a sale to a third party. Yet if you don't use such financing sources and instead lend your heirs or employees the money, you are essentially taking the same risk as the financial pros would, but without their training and experience.

Selling a business is a complex, time-consuming, expensive and risky proposition. The greatest risk is a transaction that collapses after the company's confidential information is disclosed to a competitor. If you decide to sell, you should go into the process with your eyes wide open after weighing the risks and rewards. Too many business owners leap to the sale option without understanding these tradeoffs and without exploring their other options, sometimes to their great regret.

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If selling the business is your preferred option, you'll want to consider whether the buyer is likely to be a competitor (a "strategic buyer" in industry parlance) or a private equity group (a "financial buyer"). The type of buyer you want to attract will affect the sort of organization you will need to build. Financial buyers prefer to see fully staffed, fully functional, cohesive management teams, while strategic buyers don't necessarily even want such capabilities. This is an important reason to consider your transition options well in advance, because if you expect to sell to a financial buyer, the value of your business will be penalized if you haven't had your team in place for a reasonable amount of time.

The type of buyer you court will also depend on your willingness to stay with the business for a transition period, or even indefinitely. Financial buyers tend to look for this, while strategic buyers don't.

Embrace the opportunity

These are but a sampling of the issues you should wrangle in developing your Transition Strategy. You have a number of personal preferences to consider: for liquidity; for ongoing involvement vs. immediate departure; for passing the business to family or managers; and many others. You have a wide range of options for transitioning and for realizing the value you build in your business. Formulating and executing a clear and effective business strategy will enable you to maximize that value. Embrace that opportunity and develop your Transition Strategy now. FB

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