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Succession planning: It's everybody's business

Finance professionals can strengthen a company's management while helping its owner find a suitable successor.

by Eric R. Klein

CONSIDER THIS SCENARIO: FOR THE PAST SEVERAL YEARS, you've been a finance professional with a successful Canadian business. Recently, the business owner approached you and told you he was thinking about passing the business on to his daughter. This peremptory announcement surprises you for several reasons.

First, over all the years you've worked with the organization, you've never met the owner's daughter. Second, despite frequent board meetings and informal conversations, the owner has never mentioned the existence of a succession plan. Yet, when you raise these issues with the owner, he just smiles, pats you on the back and tells you everything will be just fine.

While this scenario may sound unlikely, it actually mirrors a growing reality among many Canadian businesses. According to a study in June 2005 by the Canadian Federation of Independent Business, 71% of owners of small and medium-sized businesses plan to give up ownership or transfer control of their businesses within the next 10 years. Despite this intention, however, only one-third of businesses have a succession plan, and the majority of those plans are informal.

As Canada's workforce continues to age, issues of succession are gaining prominence. Older owners are increasingly considering retirement. Aging executives are frequently faced with unexpected illnesses or disabilities that can affect their ongoing ability to work. To remain viable, evolving organizations must often begin to consider

replacing an owner whose ideas or skills may not be keeping pace with changing market requirements. Similarly, these organizations may be eager to groom younger executives who may be capable of assuming leadership in coming years.

Succession planning is not something that can be left to the last minute – especially not for owners who are hoping to derive some value out of their businesses. Too many business owners fail to consider the implications if the company is left without solid management at its helm. In many instances, it's up to finance professionals to bring this issue to an owner's attention.

While no one would dispute that business owners must be personally engaged in the development of a succession plan, it can be a challenge to place the issue on their list of priorities. After all, for many owners, building a business is like raising a child. The prospect of ceding control can present an enormous emotional hurdle.

Finance professionals can play a key role in helping them overcome this hurdle by defining the difference between personal and institutional goodwill.

Personal goodwill is the value that

the owner brings to the business. It is often a value the business will not retain upon the owner's departure. Institutional goodwill represents the company's underlying intrinsic value, which notably exceeds a company's net asset value. It is this value that the market places on a company.

Business owners must understand that the market will not take their personal goodwill into account when assigning value. The market will also disregard their personal financial goals. Too often, owners try to define business value based on the amount of money they need from the sale of the company. Regardless of how much wealth an owner has tied up in the business, an independent third party will measure the organization's true value by the actual amount of money he wants to pay for it, rather than how much money the owner would like to make on the sale.

Although business owners may be hesitant to consider succession planning, their closest advisors can help them to understand that they will not realize the full equity value from their business unless they're prepared to plan in advance.

Admittedly, it can be difficult to raise such sensitive issues with an owner. For this reason, many organizations rely on the expertise of external advisors to coordinate succession planning and act as neutral arbitrators. In addition to freeing up the time of internal team members to focus on running the business, financial planners can help define the owner's financial needs; tax plan-

ners can optimize their tax situation; an external accountant can ensure the organization's records and books are in tip-top shape; lawyers can update the corporate resolutions and minute books, as well as the owner's will; business valuers can provide a realistic expectation of value; and an external corporate finance professional can coordinate the interaction among all these professionals.

By working with outside consultants, many companies can also avoid the common pitfalls of the succession planning process. These include:

Waiting too long: In many cases, organizations fail to begin planning for succession because they believe they have time to consider these issues in the future. However, this decision frequently backfires, particularly when executives unexpectedly fall ill or die without taking the necessary steps to ensure a smooth transition. Take the case of a company I'll call XYZ Corporation, a major Canadian manufacturer of restaurant equipment. For more than 40 years this company was run by its founder. Four years ago, he was diagnosed with cancer and died suddenly. Unfortunately, XYZ's owner did not leave a succession plan, which forced family and management to make critical business decisions during a time of mourning. It took three years and immeasurable stress to stabilize XYZ and position it for sale, a situation that could easily have been avoided had the owner left express instructions regarding his intentions for the business or if he'd actively dealt with the divestiture.

Failing to clearly define their goals: For entrepreneurs with a long history of running their own business, it can be difficult to realize how complex an ownership transition can be. However, owners who fail to clearly define their succession goals often find, too late, that they are unhappy with the way they, their customers, their management and/or their family are being treated. To avoid unintended results, it's essential for owners to consider a broad range of succession issues. These include (among other things) deciding who the next leader will be; how much involvement the owner will retain; what steps the business will take to maximize value before the owner's planned exit; what geographic locations the company will continue to operate in; and which key employees will retain their positions.

Choosing the wrong successor: Some business owners often fail to exercise common sense when choosing a successor. In many cases, family members chosen as successors lack the training or know-how to successfully manage and grow the business. This was publicly highlighted in late 2005 when Jean Coutu, founder of the publicly traded drug store chain in Quebec that bears his name, asked his son to step down as CEO after three years in the top job. Even when missteps are less likely to become fodder for the media, choosing family members as successors can often invite more trouble than owners realize. This is partly because interaction between family members is generally based on long-standing behaviour patterns. That means owners who dominated their children at eight are likely to continue doing the same to a child of 38. By bringing in outside advisors and mentors to help with the transition, business executives can inject a level of objectivity into their choice of successors, decreasing the odds of selecting the wrong person.

Selling too quickly: Owners frequently feel inclined to sell the business to the first bidder, especially owners who never seriously consider the value they'd like to derive from the sale of the business. In these cases, when a bidder comes along, an owner will consider if the offer is acceptable, rather than recognizing that the business may be equivalently (or more) appetizing to a different buyer. By working with external advisors, these owners may come to realize how to maximize the value of their business before an eventual sale. Leveraging their advisors' relationships, they can expand the field of potential bidders to other interested organizations. They can also make a more informed decision about the type of buyer best suited to their business, which may be an unrelated third party or a management group.

Finally, finance professionals may want to raise with business owners the importance of not only developing a succession plan but formalizing it, as well. Just as a business plan provides important guidance on how to grow and add value to the business, an estate plan provides the necessary guidelines to ensure a smooth business transition.

A written succession plan should address a range of issues. For instance, in addition to outlining a process for a planned transition, it makes sense to

include a process for an emergency transition, in case the business owner suddenly becomes unable to perform his or her duties. In this instance, many organizations select one or more interim CEOs who are well-suited to manage the organization's day-to-day affairs while the executive team formally searches for a full-time successor.

It also makes sense for a transition plan to set out the structure of the owner's exit strategy, details of how the transition will meet the owner's (and his or her family's) ongoing financial requirements, strategies for training both family and non-family successors, and key dates for each action.

Organizations may also need a communications plan to advise key members of the business about the owner's succession plans. For instance, owners who are considering management successors must put in place a system of open communication well in advance of the transition. Without open communication and trust, negotiations may falter during a management buyout. On a related note, managers who buy out a company frequently lack sufficient financial resources to support the company's ongoing operations. The new owner/managers often require the owner's ongoing backing and support, making open communication even more critical.

Although it can be difficult to raise the topic of succession planning with a small business owner, finance professionals and other executives who take the plunge are generally rewarded over time. By encouraging their organization to adopt a formal succession plan, they take an essential step towards putting in place strong governance and management systems. By recommending experienced external advisors to aid in succession planning, they also aid the company to develop a workable transition plan, which can only help to increase employee confidence and raise an organization's market value.

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