White Paper - Nº 7

The multi-million dollar dilemma.

So you have worked hard, put in the hours, and built up a successful business. All of a sudden, your view of the future changes. Retirement age is creeping up on you; perhaps there are a few issues with your health - and the important question of what to do with your business suddenly seems as hard as climbing Mt Everest.

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To many business owners, the question of what to do with their business becomes an ongoing worry and a source of anxiety. Yet it need not be. Strangely enough, many other business owners have faced the same issues that you do. They have managed to get through the maze and successfully deal with the question of business succession.

The term 'business succession' refers to what will happen to the ownership, governance, and management of a business in order that the business itself may continue into the future. There are many options and variations on this to consider for your business, and in this white paper we will explore them and set out the pros and cons of each to aid you in your thinking process. However, being able to sit down and talk it through with an experienced adviser can help you see clearly through the fog, and crystallise your thoughts so that you can make decisions to achieve what you want.

So what does the process of business succession involve? Surely it's just a matter of waiting until the time is right and selling, isn't it?

Often this may be the answer, but there is a lot more to it than that. First of all, there is a wide array of options beyond an outright sale. You may neither want nor need to sell the business. Secondly, when is the right time to sell, and how will you know? At present, many business owners believe it is not a great time to sell their businesses, yet we are still seeing very good prices achieved for good, well-structured, and profitable businesses. Thirdly, what can be done to maximise the sale price of your business? This is the key to a good result, as with some foresight and planning it may be possible to increase the amount you receive from a sale by increasing either the profits or the multiplier that is applied to the profits to determine the sale price.

By starting to plan now, we can identify more options, many of which you may not have realised that you had, and usually increase the sales proceeds if indeed it is sold.

We also like to ensure that there is not just one single plan of attack. Usually we will have a backup plan. For instance this could involve putting in place a third party CEO to run the business under a board structure rather than selling if you would rather keep owning the business. This could be a short-term arrangement until the market or profits improve, or a long-term solution for the benefit of your family and future generations.

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The big picture

Before we start to look at the options for your business, the best place to start is by analysing you, and specifically where you are at as the business owner. The answers to the questions we ask will lead us to select the most appropriate options for you personally.

The questions that typically need to be asked to gather the relevant background information are as follows:

- Who owns the business? You, your trust, or a combination of the two?
- Are there other shareholders? Who are they? What is their age and stage in life? How financially independent are they of the business?
- What age are you a nd your spouse?
- What age are your children? What are their qualifications? Do any of them work in the business or show a desire to do so?
- What does the business do? Is it a business that has upside or downside? For example, a technology business may be very profitable now, but in five years' time the business model may be obsolete unless significant investment is made to keep up with technology changes. Usually for businesses like these it is better to sell the technology now or soon, when it is profitable, than to keep the business for future generations.
- What is going on in the market? Is it expanding, or is it a sunset industry? Is there a price war on now or likely to be one in the future? What share of the market does your business control?

There may be other factors as well, but the key point is that you need to consider your options in the light of all the facts that are relevant to you and your family.

What are your options?

The options that best suit you will depend on your particular circumstances. However, the counter to this is that there is a vast number of options open to you. We list the principal options below, but of course options can be combined.

1: Keep running and owning the business

Is time on your side? Depending on your age and stage in life, it may not actually be time to do something with the business yet. In this case, you can simply continue to own and run it as you have been doing.

Even so, it is important that you consider how you will ultimately exit the business (if that is what you want to do), when you will do so, and how you will maximise its value when you do exit. This leaves the door open to looking at any unsolicited offers you may receive in future.

2: Go to market now

Before making a decision on whether to go to the market now or later, you need to realistically assess the value of the business today. A study of past, current, and predicted profits is required. Have profits dipped in the current year, or are they forecast to do so? Also, what do you expect to happen to profits in the next few years?

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Case Study

Case study: Joe's media business

Joe and his wife owned a niche media business. Joe had expressed a desire to sell the business at some time in the next few years.

After a meeting with us he realised that he should get out sooner than later.

There were several factors:

- There was increased competition in the market that could lead to a reduction in profits in future years.
- Joe had already had an informal approach from a competitor looking to consolidate their position in the market. Such offers are often lucrative, as economies of scale mean the purchaser can take a higher profit out of the business than you can, so they will pay a higher purchase price.
- Joe was tiring of the business and his day-to-day involvement.

In the end, Joe sold the business within 12 months, and has since retired. He has found several new opportunities that he is pursuing, and has the financial security of money in the bank to fund his retirement.

The next question to be addressed is how to market your business for sale. Sometimes this is straightforward, as there has been an informal approach from an interested buyer. But failing that, do you really want to cobble together an information memorandum yourself and try to sell the business yourself? It is a bit like trying to sell your home. We all complain about the fees charged by real estate agents and how easy it is for them, but at the end of the day very few of us are prepared to try and sell the house ourselves. Selling your business is the same. Often it is better to get someone else to handle it.

One reason for this is simply the time it will take. You still need to run the business, and make sure it remains profitable during the sale process. In particular, if key staff have not been told of your plans, it may be better for an outsider to handle the sale, and relieve you of what can be a large process and time commitment. They should also be able to give you a good indication of what your business is worth, and be able to assess offers and close out deals with prospective purchasers.

Who should do this? The choice is down to a business broker, who may work for a specialist broking house, or - for medium to large transactions (upwards of $10 million) - investment and merchant bankers. Whichever you choose, get your lawyer to read the contract and make sure you understand what it will cost you. Whilst most brokers operate like real estate agents, only charging a fee if the sale goes ahead, it is becoming more common for them to ask for a small fee along the way to cover their costs in preparing the information memorandum - much like you paying for the marketing costs for your house sale. Typically the fees are refunded against the success fee, but they must be paid up front and are not refunded if there is no sale. Some larger or more specialised accounting firms may also be able to help you sell the business, or at least prepare the financial information.

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You will usually work with the broker to identify both potential purchasers, and those whom you do not want to be approached. If secrecy is an issue, the broker will be able to prepare an information memorandum so that your business is not named and any information provided is general in nature.

In the typical sale process, prospective purchasers usually get very limited information to review. From this they prepare a binding offer subject to due diligence. Once the offers are received, usually 1-3 are chosen to do detailed due diligence and confirm their bids. Some competition between prospective buyers is good, as it will hopefully improve the price you receive!

Whilst economic cycles may affect the time it takes to sell a business as well as the price received, in periods of poor economic conditions and even during a recession, good businesses still sell for very good prices. Although it may be tempting to hang on to the business for a few more years, there are also risks associated with holding that you will need to weigh up.

Finally, you will need to decide whether key senior staff are to be involved in the sale process or not. Do you want them to know about it? Often it is better to involve key senior staff in the process. You would be surprised how often word gets back to them of the sale process - or they work out for themselves what is going on.

In summary, here are the key points:

- Who will sell the business?
- Your price expectation.
- Who to approach, and who not to approach?
- Do you tell staff - or not?

3: Delay the sale and go to market in a few years' time

There may be some good reasons for you to decide to hold on to the business for a few more years before going to market. For instance, you may be waiting for current adverse economic conditions to improve (and thus for profits to go up). Perhaps your competitors are in the middle of a price war (or there are similar competitive tactics going on that would have a negative impact on the value of the business).

You may wish to purchase another business in the meantime to grow your market share and profitability. If the business can be acquired at a lower price-earnings multiple than you will ultimately sell at, then there could also be an increased profit on the eventual sale.

There are some questions to be answered if you do want to delay selling the business. Will you continue to run the business as CEO, or would you prefer to step aside and hire a new CEO? This can be beneficial, as reducing your involvement in the business may make it more saleable, and may even push up the price-earnings multiple when the business is finally sold. It is worth considering what else you can do to improve either the profits or the price-earnings multiplier in the meantime.

Naturally there are always risks with delaying any sale, including:

- That the company's profits decline from their current position.
- That the price-earnings multiplier decreases over time.
- That competitors (or any other currently interested parties) may no longer be interested in buying.

We have seen numerous examples of business owners who should have sold now but didn't, only to regret it later. In some cases the business failed and was liquidated within 2-3 years!

If you believe that there will be an uplift in profits over the next 1-2 years, other very good options are:

- To sell 50% of the business now, and the balance in say 2 years according to a pre-agreed formula; or
- Sell now but have an earn-out clause in the sale and purchase agreement, so that the final price is calculated with reference to profits derived in the next 2-3 years.
- Retain the business long-term for the family

In New Zealand, multi-generational ownership is unusual. But when you study family businesses in Europe or South America it is not uncommon to find businesses that have been owned and controlled by one family for up to 8 generations. Such structures have their own ownership issues, given the number of owners that may be involved, but it does show that for suitable businesses it is possible to see ownership retained within the family and passed down the generations.

This topic is one that could easily be a white paper on its own as there are so many issues to be considered. However, here are some of the factors you need to consider:

- Is the business suitable for long-term ownership or will technological changes mean it is a sunset business? Many technology-based businesses are vulnerable. Think of how MP3 downloads have changed the recorded music business.
- Do you, the owner, need the cash from the sale to fund your retirement or do you have enough independent wealth to support yourself?
- Who will run the business?
- Does the CEO have to be a family member?
- What about the right of family members to work in the business?
- Often if an independent CEO is put in place, including for a short time when the business is to be sold, they will be incentivised with a share-ownership scheme. How well will the family accept this? (For more information on employee share ownership schemes, see our white paper entitled 'A slice of the action'.)
- If you are going to put in place either an independent CEO or a next-generation family member, consideration needs to be given to establishing a board, preferably with some non-family members on it.
- It is also critical to make sure that family's goals are aligned with the goals of the business. We refer to this as the 'parallel planning process'. The most obvious example of this is what to do with company profits. The family may want a large percentage paid out to them, but the business may need to retain the bulk of profits to fund expansion, provide working capital, fund new product lines and the like. Whilst the family will only truly benefit from ownership by way of access to the profits, the needs of both the business and the family must be met.

5: Float and public listing

These options only really exist for very large businesses. The New Zealand Stock Exchange is littered with companies that floated but were too small to do so. Annual compliance costs are easily over $1 million, so company profits should be, in our opinion, over $10 million pa at least before you consider this option.

It may be possible to arrange a merger with a competitor to create the necessary scale to list on the Stock Exchange. Floats and listings are usually the realm of the investment and merchant bankers, not business brokers.

6: Management buy-out

Whilst this approach was popular in the 1980s, there are few true management buy-outs these days. The primary reason is that management simply can't raise the cash to fund the purchase.

It is now more common for a private equity firm to buy in and take the majority of the shares, with selected senior management then putting in enough cash to own a minority stake. If management can't find much cash to put in, they can still be rewarded via an employee share ownership plan.

The second reason that counts against management buy-outs for the majority of New Zealand private companies is simply the reality that there is no layer of senior management. In many private companies, the only senior management are the owners!

7: Close down

While unusual, for some businesses the goodwill associated with the business is just too personal to the owner to sell. In these cases the ultimate decision is simply for the owner to keep working until they are ready to retire, or do something new, then to shut the doors and walk away.

Case Study

Mike's commitment to the community

Mike owned a business in a small New Zealand provincial town. He was nearing retirement and decided it was time to sell. He quickly received several very attractive offers, well above what he had expected. However, none of the prospective purchasers would guarantee to keep the business in that town. This was important to Mike, as he knew how important the business was to the community.

After we worked through the options with Mike, he decided that he would sell the business to a combination of senior management, and a similar but noncompeting business run by a couple of his ex-staff. None of them had any money to pay him up front. However, Mike was financially independent, and it was more important to him to protect the town and the jobs for its people, so he sold the business for an IOU to be repaid over 10 years. There were some controls and safeguards built into the agreement, but the outcome was that Mike, the purchasers, and the community all benefited.

8: Sale to one of your children

One option is to sell the business to one of your children - one who is likely already working in the business and who is demonstrably able and willing to buy it. The sale may be of all the business at a point in time, or a progressive transfer.

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Typically there are other children, who either don't work in the business or who occupy lower-level roles within the business and who are not seen as either senior management candidates or future owners. The key here is to ensure that the child acquiring the business is seen to pay a fair price for it and on economical terms. Typically the child acquiring the business will not have sufficient funds to buy it outright. The sale will usually involve an IOU, whether for all or part of the business. This raises questions such as:

- Should interest be charged on the debt?
- What happens if the business fails and they can't pay for it, bearing in mind that the business usually will represent a large percentage of Mum and Dad's wealth?
- Should the acquiring child be given their share of the business as if Mum and Dad had died?
- If that is done, what about the other children?
- What do they get now, if anything?

These issues are very common in New Zealand family business succession. We see it a lot in farming and primary sector areas, where one child may end up taking over the farm in return for an IOU - but they may never be able to repay their parents, nor ultimately their siblings.

Similarly, in times gone by, it was not uncommon for Mum and Dad to leave the business to their son, and the house and other assets to their daughter, even if there was a significant difference in values!

Thankfully today there are better ways to handle this where parents want children to be treated equally, such as the son having to pay for part of the business so as to equalise value to each child.

If there is to be a debt owing from a child to either their siblings or parents for the purchase of the business, then it is necessary to discuss up front what will happen if they fail to repay the debt. For instance, they would get no future share of Mum and Dad's estate, and may even be required to sell their home to repay part of the debt if they didn't meet the agreed terms. These matters need to be discussed at the outset, not when things have gone wrong.

9: Combinations of the above

Naturally it may be possible to combine some of the options. For instance, it may be possible to:

- Sell part of the business and retain another part;
- Sell part now and another part later;
- Pass a part on to one child and another part to a second child, or do a management buy-out

These variations will depend on your circumstances.

The sales process

Succession planning for your business is a process and a journey. It is seldom, if ever, a simple conversation.

Your business as been built from your blood, sweat, and tears, probably over many years. You have spent more time working in it than with your family, and its staff are usually like a second family to you.

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There will be a lot of emotion involved - and that's only natural.

There should be no preconceived answers when you embark on the journey, as you need to be open to all the various options and possibilities.

Also, you may start out heading down one path and end up on another, such as when you intend to retain a business but out of left field comes an offer to sell at a price that you simply could not refuse.

How can Covisory help you?

We will work with you to help you determine which options are the most appropriate for you, your business, and your family. We don't tell you what to do, as we recognise that its your choice, not ours.

Instead, we aim to guide you through the process.

We are also comfortable working with your existing advisers. It's not an 'us or them' choice. We respect the fact that they have given you long and loyal service. We also believe that many heads are better than one, and that the knowledge they have of you, your family, and your business is invaluable.

But sometimes your existing advisers may not have the depth of experience to advise on succession, or the confidence to do so.

Covisory Partners has also provided succession planning advice to other professional firms, especially chartered accountants.

Our saying is that we start where your existing advisers have finished.

Nigel Smith

About Covisory

The Covisory Group specialise in International and Domestic Tax Services, Trust Management, Succession Planning, Strategic and Business Planning, Accounting Services and Business Valuations.

Established in 2007, The Covisory Group has grown from one business to four with a diversity of clients. Covisory clients are owners of family businesses, operating both in New Zealand and globally. Our team of specialists work either one-on-one or alongside our clients' team of professional advisers to develop appropriate short- and long-term solutions.

We build strong relationships with our clients based around trust, accessibility, and responsiveness. There is no 'one size fits all' about our services. Our solutions are bespoke to each client, drawing on our up-to-date specialist knowledge and our years of experience. providing one-on-one expert advice.

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