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A guide to succession planning

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Succession planning

What is succession planning?
Succession is the process of transition from one owner to the next.

To do it well and profitably takes planning. Start with asking yourself 'Where do you want to end up?' which usually depends on your personal ambitions.

Knowing where you are going and what you want to achieve is important, but so is understanding where you are now.

Why have a succession plan?
Running a business is hard work, you put a lot of effort into it, and it costs a lot of money. You can extract value from the business along the way through dividends for example, but depending on what you want to do in life, you may need to get value out in one, or several, staged payments to:
- retire in comfort
- repay loans, mortgages, kids university fees etc
- have a change and start something else.

You also need to be able to ensure continuity during succession – especially with regards to clients. This is also true for the team; many owners want to 'do the right thing' by their staff. Others want to leave a legacy; you've put so much in you don't just want to walk away without ensuring success for the next owners of the business.

Putting a strategy in place
— Look at developing the team. You need the commercial experience to maintain things during transition.
— Have a 'What if?' plan for other issues 'if you get hit by a bus' etc.
— Structure - have the business set up in the right way - shareholdings etc. Take advice from good accountants and lawyers who understand your personal circumstances.
— Next steps – having a strategy enables you to carry out the steps that are needed while carrying on with the regular job. Without a strategy in place, it drifts, and before you know it you are 5 years into your 10-year plan, and it suddenly looks like you still need 10 years before you can exit.
— Don't mess it up. Do it properly, don't try to cut corners, because sorting out a mess is far more expensive than setting it up properly in the first place.

The present
Where you are now is important. How you are structured as a business influences what form your strategy will take. So, you might want to consider how your business is structured now to facilitate an easier exit in 5 - 10 years.
Finances - personal and business are intertwined. If you're retiring in 5-years, you need to know your starting point.
What are your expectations? People often think they can get more than they can.

There are 3 ways to exit a business
1. Close it - either because you want to, or you are forced to.
2. Death.
3. Sell it – Management buyout (MBO), sale to another business etc.

1. Closing your business
No buyer – sometimes you want to sell, but nobody wants to buy. This is usually because you have nothing to sell. Despite all the hard work you may have put into your business you need to look at things from a buyer's perspective. What do they gain?

Go bust, run out of money – sometimes it happens. If there's not enough money coming in, too many costs going out; Clients with long payment terms; a client going bust – there are many reasons for an agency to go under.
Cost v return - the value from selling not equal to the cost of selling. Legal fees can mount up and you have to budget realistically for these. In some cases with small businesses the value left over might not be enough to justify the sale.
CBA - Can't Be Arsed. Sometimes it is not the money, it is the hassle (although when larger sums are involved the hassle seems more manageable!)

What to consider when closing an agency
Timing – how does it happen? Is it a gradual wind-down, or an abrupt forced closure? If it's gradual and controlled, you need to make sure there isn't also a gradual decline. Do clients want to invest their time in relationships if they think you are winding down?

Premises – what are your premises commitments? Are you tied into a lease?

Staff – to close a business you need to pay redundancies so this needs to be budgeted for. (Redundancy payments are generally more than the owner thinks they should be, but less than the staff expected them to be.)

Tax – take advice on how to structure the process to make it most tax efficient.

2. Death
The death of an owner is obviously very disruptive to the business. If there are multiple owners how does it affect those remaining? If it is you who dies, what happens to your shares, your family?

Wills – not having a will is almost gross negligence. It can pull families apart, but also affects the business and those remaining in it too.

Legal - if you are in a partnership do you have a partnership agreement? The cost is minimal compared to the cost if you fall out or one of you dies. It can get very messy and bitter.

Clients & Staff – what happens after a death of an owner? Is there a continuity plan?

Insurance – do you have shareholder protection? Key employee protection? If a shareholder dies, your agreement might say that the remaining shareholders must buy their shares – can you afford it if that happens? What happens if the family inherit the shares? How would their involvement affect the business?

Have a 'what if' plan for worse case scenarios, they do happen.

And above all, have insurance.

3. Selling the business
Lots of options when it comes to selling. So the first question is, to whom?
— Internal – MBOs are the most popular route in the design sector. Employee Owned Trusts are also growing in popularity.
— Competitor – larger agency buying you and your reputation.
— Merger – often with a complementary agency that is looking at add your skills set to their offer. Usually described as a merger, but it is usually a takeover by the more dominant agency.

How much?
No really, *how much*? People have high expectations when they have nurtured their business like a child and watched it grow over the years. You must look at it from the buyer perspective – what are they getting?

Value to the buyer
In some circumstances you can charge more for your business than the general '3 times annual income'. This is generally when you can tell if your business is allowing quicker access to a particular market. If buying your business enables your buyer to cut 4-5 years off the process of starting from scratch themselves in a particular specialism or sector, then you can add a premium to the cost. But the buyer must see the value, otherwise it will not work.

Lead time
It can take years to sell your business. Finding the right buyer is difficult, but sometimes the stars align and the opportunity suddenly arises. You need to run your business so you are ready to sell at any time. Even if you don't sell, it will mean you are operating at your most efficient, and therefore the business will be doing well.

When a buyer looks at profitability of the business they will go back at least 3 years, so you can't just try to run a lean ship for a short time to maximise profits to fool them into paying a higher price. Continuity of profit is key.

Contracts
What do your client contracts say? Some might have clauses saying that if there is a change of ownership the contract is void. You need to get your contracts aligned.

Contacts
Who owns the relationships with the clients? If it is the person who is selling and leaving the business then what is the value of that relationship to the new owner? What is the chance of them retaining that client?

Dependence
Need to wean the company off its dependence on you. A buyer needs to know that the value in the business isn't going to walk out the door with you. But not too much – if you have absolutely nothing to do with the business, but want to orchestrate a management buy out, the staff might not see the value in paying a lot to buy you out. They could just go and set up on their own and take the clients with them.

Sustainability
To get maximum value when selling, you need to show there is a process in place, that the business can continue at the top level. The top team needs to be happy with the situation

Team
Involve them, you don't want them to feel like they might have 'been sold'. They are not business assets - they are people.

Partners
How many are leaving? If 1 of 4 partners leave, then those remaining can probably afford to buy that one out. If it's more than that, it may be difficult, and you'll need to look at other methods to fund the buy-out.

Timeline is key - be realistic.
Have a plan, even if it isn't written down, you need to be aware. If you are the oldest, they might be waiting for you to go. If you're the youngest, you might be expected to pay up soon to take on more share.

Legal cost
Legal costs can be high. Lawyers try to provide certainty, which takes time and therefore costs. This is not always needed if relationship is good, the deal just needs to get done.

Due diligence
Are you a well-run business? If bought, what might come out of the closet?

Do your clients pay on time? What are the terms in your client contracts? Buyers will want to look at your PAYE etc. If it is an undercover sale, then all this can be very distracting and the business could suffer as a result, you'll need to have a cover story.

Financing the deal
MBOs are the most popular form of sale for design agencies, even though the seller tends to get less money. The problem with MBOs is usually around finance, how can your staff afford to buy in? They can go to the bank, but they are often risk-averse and charge high fees. In many cases it is often the seller who funds the sale with a loan scheme. Future sales and income will buy them out over a scheduled period of time. This ensures that both sides try to make the transition a success. Helping the buyers succeed means that they seller gets their money quicker.

Tax planning
How is this structured? If it is for retirement, then you need a lump sum up front. It could be organised so that you pay capital gains tax rather than income tax.

So, if you're looking to sell, what do you do?
Maintain the business
Don't take your eye off the ball. Don't spend all your time having hushed meetings behind closed doors, this raises suspicions amongst the staff and can have serious effects on morale.

Retain clients & staff
Keep those who can add value to the business both in the run up to a sale, but also afterwards to ensure continuity. This mitigates risk for the buyer.

Sustain
Run the business well, build profit. You could be in a situation where you can extract enough profit over a few years to allow you to just close the business without bothering to sell. If that works for you then that is also success.

Where are you now?
This is the one thing you know. You can do an assessment, and then decide where you want to go. Put a plan together for the future. Start now.

This guide is based on a presentation given by DBA Expert Jack O'Hern at a DBA Member seminar on the subject of succession planning.

About Jack O'Hern
Jack is a partner at the accountancy firm Wright Vigar and also an accredited DBA Expert. He works with owner managed businesses to help them first identify and then achieve their goals, through a combination of strategy and tax planning. Jack heads up Wright Vigar's growing corporate finance department, specifically helping clients buy or sell a business. He firmly believes that you should remember to enjoy running a business, too, or think about doing something else – life is too short!

More information on Jack can be found in the DBA Experts Register.
http://www.dba.org.uk/experts/review-jack-ohern/