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Preparing to Transition the Family Business to the Next Generation

When you run a family business, you must start thinking very early in the company's life cycle about how to pass it on when you retire.

The day you start your business is the day you should develop your exit plan. Realistically, we know that doesn't happen, but ideally you should start planning at least five to ten years before you pass on your business to family members.

We often gets initial calls for advice from business owners who say they are tired of the day-to-day grind and are ready to transition the business to their children immediately.

That's too late to do any longer-term planning like tax mitigation, so it's best to prepare for any business transition several years in advance.

Below are a few points to consider when planning to transition your family business to the next generation.

COMMUNICATE EARLY AND OFTEN

It's important that family-owned businesses positioned for future transitions establish trust and communication among family members and other participants in the business early on.

Vantage points can come from various people with different interests, including:

- **Family Managers.** Family managers are those operating inside the family and inside the business. They include older and younger generations. At times, family managers risk sacrificing the well-being of the business by focusing on family matters and their own personal concerns, such as sibling rivalries.

When it comes to having family members in the business, it can be difficult for everyone to remain objective. Don't underestimate sibling rivalry. Not having a process or procedure to mediate both professional and personal disputes can impact the performance of the company at large.

- **Relatives.** There often are family members who are inactive in the family business but remain concerned with management and outcomes. For instance, an older relative might have her own career but desire a future position in the business for her young children.
- **Employees.** Employees have interests inside the business and outside the family. For instance, whereas older employees may want rewards for decades of loyalty, younger employees may focus their attention on growth opportunities and reasons to stay with the company.

- **Family Outsiders.** This group operates outside of both family and the corporate family as competitors, customers, government regulators and consultants. They impact the family business, but their interests are likely independent of those of the business.

Though situated outside of the business, outsiders should be considered. If the value of the business and footprint in the industry is sufficiently large, outside interests, such as private equity investors, may become involved and affect the owner's decision whether to pass the business to the next generation or seek to sell.

Whether a family business owner should transition the business to the next generation - or sell the business to a competitor or private equity investor in order to cash in on all of the time and money invested into the business - is not an easy question to answer.

It really depends on the specific family involved. It is important that any decision made by the business owner is made after doing a complete due diligence review of the business. There are a few factors to consider, including the readiness of the next generation to take over and drive the business engine to new levels of success, whether essential non-family key employees would react positively or negatively to working for the next generation and the true value of the business if the founders are no longer involved.

TAKE A TEAM APPROACH TO TRANSITION PLANNING

A third party can facilitate discussions to reduce potential family tension.

One of the main reasons family businesses fail is because the owners are not developing a process early enough for management and ownership transitions. One role of a wealth advisor is to talk about these processes and to bring in additional advisors such as attorneys, tax experts and estate planners if they're missing.

It's important to have both the family's estate plan and business plans in alignment.

You don't want to have a succession plan in place that contradicts your estate plan, such as a will that states your business goes to your kids when you pass away and a business operating agreement with buy-sell documents in the bylaws to nonfamily members.

For example, your business operating agreement could give the right of first refusal on your business to a partner, yet your will could provide the same business as an inheritance to your kids.

You may need to explore options for segregating parts of your business so you can sell some parts, and structure a buyout or purchase life insurance to compensate offspring who aren't part of the business and won't get proceeds of a sale, he said.

Often these plans require legal assistance. A lot of people avoid calling an attorney even if they have one because of the expense. We work with families to streamline the questions they need to discuss with an attorney.

OBTAIN THIRD-PARTY BUSINESS VALUATIONS

A business valuation is an essential part of transition planning regardless of the actual plan.

If you plan to gift the business to your family, you need to know the value and to include the value in your estate planning and tax planning. In a way it's no different than if you were to sell the entire business or even just parts of it, you need a baseline understanding of the value.

Because the value will likely become part of relatives' inheritances, valuations are particularly important for families in which some members of the second or third generation are not involved in the business.

In fact, financial and experiential valuations are essential for all stakeholders to understand where the company stands.

For example, a financial valuation encompasses not only the main business's current financial state but also any extra ventures that family members have chosen to pursue.

Knowing the current value of the business and having an understanding of what may affect its value is imperative to proper planning. For example, knowing the value helps the owner see the transfer tax consequences of transferring the business to the next generation, or the projected impact upon the owner's personal wealth from a sale.

A financial valuation is what helps the owner define his or her goals and the consequences of such actions.

The experiential valuation has a different purpose than the financial valuation. Conducted by a third party, an experiential valuation is unbiased and takes a look at a company's people. The valuation determines who is fundamental to the company's future and success and who requires training.

It is important to understand the importance people play in the company and thus develop a strategy to continue to motivate and keep them.

An outside consultant can analyze the work being accomplished by employees and family members in the business and make recommendations for restructuring and possibly additional education to maximize each person's potential.

Determining the owner's goals in advance helps the owner see particular strategies that may enhance the ultimate success of the owner in achieving his or her goals. Still, it would be up to the company leaders to decide whether to implement those recommendations.

PREPARE THE NEXT GENERATION FOR LEADERSHIP

Because a succession plan is only as good as the people involved, an important step is to identify members of the next generation who want to run the business and determine how to prepare them for leadership roles.

Whenever preparing for a change in leadership, it's important to consider desire, education and demonstrated experience. Simply handing over the keys to someone who raised their hand is a recipe for disaster.

Work experience outside of the family business also can be beneficial.

This way, mentoring can work both ways. While the founder passes on wisdom earned from building the business, the younger members share generational insights, external experience and ideas.

ALIGN BUSINESS AND FAMILY VALUES

A fundamental element of a successful multi-generational family business is aligning on the big picture, or finding a way to unite non-family members, family managers and family members outside of the business around a fundamental single purpose.

The first step is to understand the perspective of each of the involved family members. Then, you might look at how best to achieve each of their concerns without sacrificing the overall health of the business. You also might consider the limits by which the business can meet those concerns.

Over time, the business owner should work towards establishing an overall framework for the family to work within. From there, you work towards a plan that will satisfy as many of the concerns as possible.

Whether the business stays within the family or the owner decides to sell to an outside third-party investor or competitor, it is important that the owner works with an advisor who specializes in business succession and transition, who works for families and, most importantly, who understands the business involved and knows the players who would provide the owner with the best opportunity for success.

To learn more contact your Financial Advisor or CNR Senior Investment Consultant or Portfolio Manager.

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