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BDO MANUFACTURING OUTPUT

PLANNING AN EXIT

Owners of small- and mid-sized privately held manufacturing firms in the U.S. are looking to hit the golf course, ride the waves, scale a summit, or simply relax with a cold drink and watch the setting sun. Business successions — planned or otherwise — are on the rise.

One-third of manufacturing executives anticipate a planned leadership succession in the next five years, and succession is possible at another 28 percent of companies.[1] Why? A combination of demographic and economic trends:

- Aging baby-boomer executives are reaching retirement age en masse.
- The revitalized U.S. economy has boosted the value of many retirement plans back to pre-recession levels, so that retirement is again a viable option.
- Many manufacturing markets are seeing an uptick in mergers and acquisitions, fueled by a better economy, and owners want to take advantage while the incipient boom lasts.

SHOULD I STAY OR SHOULD I GO?

Macroeconomics and industry trends might pique the interest of manufacturing owners in selling. But every succession is ultimately a personal business decision.

Some executives reluctantly slouch toward retirement, driven by health conditions or age that makes it impossible to continue. Others weigh their stay-or-go options based on personal wealth and their ability to monetize a lifelong investment of sweat and cash. Yet even when all signs say "go," company considerations often keep leaders tied to their desks, especially if they want to protect the interests of other stakeholders (e.g. employees). What if there's no obvious successor or interested buyer?

The first step in succession planning is to identify the objectives of your own passage. These options usually fall within three types:

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BDO Manufacturing Output regularly examines how manufacturers are rethinking strategies, operations, supply chains, workforces, business systems, products and markets to achieve competitive advantage. This issue, *Successful Business Succession*, will help executives implement and execute a successful succession plan that secures their futures and those of their companies, stakeholders, and workforces.

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PLANNING AN EXIT

CLEAN BREAK

For some executives, years of hard work merit an untethered exit from the companies they've led. Health conditions also may demand this approach. A clean break can mean selling the company to a third party (executives within the company or external investors), dissolving the company (i.e., liquidating its assets), or transferring ownership (such as to a family member).

While the objective of this approach seems clear (no leadership role going forward), it can get muddy when a current executive or family member assumes control. They may want or need advice; you may want or feel that you need to provide advice, whether welcome or not. It's best all around to make sure that both you and the new leaders formally recognize your clean exit via a contract.

The clean break may also represent a loss of regular income from the company (with some exceptions, including pensions or continued minority ownership). Smart succession planning includes detailed pro formas of personal income compared to projected lifespan, incorporating all assets (savings, retirement funds, other earning potential, etc.). Run the numbers for optimistic and pessimistic projections, including appropriate risk profiles for various investments.

A core component of this financial assessment will be tax considerations applicable to the exit (e.g., outright sale, gradual sale, transfer of ownership). The nature of the exit will significantly impact estate taxes, capital gains, etc. For example, if succession can take place over five to 10 years, a gradual transfer of shares to family members as gifts can reduce taxes at time of sale.

And similar to any M&A activity, a thorough business valuation is vital as a baseline from which to project anticipated income from a sale or transfer, as well as associated tax liabilities.

ENGAGED EXIT

Maintaining an active role in the company you once owned can range from retaining leadership to being an ad-hoc advisor. This is an attractive option when there's a need to mentor a successor, and can gradually wind down an owner's involvement. This is often a required condition when an outright sale is involved, especially if key intellectual property or customer relationships reside with the owner.

Keeping one foot in the door differs dramatically from running the company solo. Expect to lose something in the way of authority, like it or not. This is expected when selling a company. But in transferring ownership to family members or fellow executives, the boundaries often get fuzzy. In successful transitions, all parties clearly define their new roles in advance, and communicate those changes to all stakeholders.

SOFT EXIT

No owner can live forever. A forward-looking strategy for leaving the company (i.e., a soft exit) offers an opportunity for a successful transition that leaves the owner and company in good shape for years to come. It can build a bridge from today to tomorrow, yet doesn't impose immediate changes on an owner's role or earnings.

With a soft exit, owners retain a significant ownership position as well as many (or all) of their current leadership responsibilities. Unlike other strategies, this exit can actually add to their duties: the owner will be engaged in developing an M&A strategy and/or finding, mentoring, and coaching a successor (see *Finding a New Leader*).

The soft exit enables an owner to get his own financial situation in order, plan for a clean exit, and organize the future of the company. But even a modestly reduced leadership role can be difficult for some individuals to accept. Craig E. Aronoff, author of *Letting Go: Preparing Yourself to Relinquish Control of the Family Business*, writes: "The single most important factor in the successful transition of a family business to the next generation is the attitude of the person who is sitting in the CEO's chair."[2]

1 2013 Next Generation Manufacturing Study, The MPI Group, 2013.

2 Craig E. Aronoff, author of *Letting Go: Preparing Yourself to Relinquish Control of the Family Business,* Family Business Consulting Group Publications, 2003.

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ENSURING BUSINESS CONTINUITY

YOU MAY THINK THAT THE COMPANY YOU CREATED WILL LAST FOREVER, ESPECIALLY IF IT'S A FAMILY BUSINESS WITH SIBLINGS OR CHILDREN INVOLVED IN ITS OPERATION. BUT STATISTICS SAY OTHERWISE.

According to the Family Business Institute, less than one-third of family businesses survive into the second generation, 12 percent into the third generation, and just 3 percent into the fourth generation or beyond.[1]

Why such overwhelming odds?

Common pitfalls that contribute to those numbers include:

- **No real business succession plan:** The unexpected exit of the owner due to death or illness contributes to this cause, leaving a company searching for a way to survive, when even a modicum of a succession plan would have helped. Too often family members are assumed to know how to proceed. Yet the leadership vacuum created by a lack of succession planning is quickly filled with confusion and frustration.
- **Lack of professional management and leadership structure:** A powerful owner can drive even a large organization for years. Competent fellow executives may fill necessary roles (finance, human resources, engineering), but also understand that they take back seats to the boss. In the sudden absence of The Boss, the company can crumble. All members of the C-suite must have ongoing roles in decisions that impact the future of the company.
- **Lack of outside advisors/advisory board:** Your business is successful, so you and/or your leadership team don't require outside assistance, right? Wrong. Advisors and/or a board are critical allies guiding a company, questioning an owner's decisions and helping him to make course corrections.
- **Unreasonable expectations:** This pitfall comes in two flavors — an owner having an inflated view of the value of his business, leading to reluctance to sell; or an owner who expects family members to take over, even when kin have no attachment to the company.

How do you increase the odds of survival?

Three strategies:

- **Well-crafted succession plan:** Succession planning requires a plan. Make sure it defines the prospective time of transition, objectives of the exit, and key players and activities (e.g., an exit involving an M&A would include a time for a business valuation, finding potential buyers, etc.).
- **Engaged and supportive leadership and stakeholders:** Regularly track the traits and roles necessary for the CEO and other executives to move the company toward the next generation (e.g., strategist, face of the company, industry liaison, motivator). Then identify possible successors if one or more of these leaders move on. It's not uncommon to find a role that can't be filled internally (especially that of the CEO/owner) which then informs the company's talent management efforts.
- **External, professional guidance:** Manufacturing leaders are adept at envisioning new markets and products, engaging customers and markets, guiding operations, motivating and managing a workforce, etc. But few executives have managed their own successions. You need the same level of experience and expertise you have in managing your company to deal with the unique aspects of succession (e.g., estate planning, tax liabilities, transfer contracts). Go get it.
- **Commit to the plan:** You made a succession plan, now keep it. Or, better yet, you made the plan long before you intend to leave the company, so review it annually with all necessary parties (advisors, board, leadership team, family members, etc.) and make adjustments as required.

1 "Succession Planning," Family Business Institute.

EMERGENCY SUCCESSION

Managing an emergency succession depends on the structure of the business:

Sole proprietorship:

The business essentially ceases to exist unless transfer of the company is defined by the owner, such as moving assets from the owner's estate to a new owner (e.g., family member, business partner), or until the estate or designated agent is instructed to sell the business or liquidate assets.

Corporation:

A corporation is an entity distinct from the owner and can continue to operate, even when the owner holds all the shares. As such, if the majority shareholder (owner and leader) dies or becomes incapacitated, an interim leader needs to be identified if one has not been specified in an operating or succession plan. The recipient of the deceased owner's shares may be the de facto owner and leader. Alternatively, other shareholders or outside buyers can acquire the deceased owner's shares from the estate or agent, and restructure the organization as they wish.

Any emergency succession is fraught with challenges, all of which are more difficult without a documented succession plan.

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FINDING A NEW LEADER?

LEADERSHIP SUCCESSIONS CAN SHAPE THE SUCCESS OF A BUSINESS FOR DECADES.

A company's next leader may already be on the company's leadership team, in which case it may seem that the leader has all the right attributes. But being on the leadership team is vastly different than being the leader of the team. As Abraham Lincoln said: "Nearly all men can stand adversity, but if you want to test a man's character, give him power."

Selecting a new leader from outside the company requires more work than tapping an in-house candidate, and can involve more risk and opportunity. Risk because there's no certainty that an external candidate will be a good fit; opportunity because a fresh perspective can open up new thinking and new markets. Enlisting the assistance of an executive recruiter can streamline the process and keep staff focused on selecting among good candidates, rather than simply finding good candidates.

Regardless of where high-potential candidates emerge, they should possess the following traits:

Leadership potential: Is the individual respected in the company, industry, and business community? This should be easy to gauge for an internal candidate. But like any good assessment, it requires legwork —talking with your staff, your workforce, and your peers in the industry. Is the candidate seen as a leader? Ask customers and suppliers as well. Added benefit: it's not unusual to find a leadership candidate among customers or suppliers.

Leadership skills: The next leader should be familiar with the company's business, and expert knowledge is a huge bonus (what the company does, how it operates, key technologies, understanding of customers, etc.). Another bonus is having a deep understanding of technical specifics, such as computer-engineering skills in a high-tech company. But there are leadership "technical skills" as well: an ability to define, communicate, and motivate individuals toward a strategic vision, even one that seems beyond attainment.

Intangibles: Your company's next leader must be good fit for the company. That doesn't mean mimicking the previous leader, but a successor must be comfortable with the leadership team and culture (A poor selection based on a cultural misfit can trigger an exodus of top talent). Intangibles also include a passion for the role, a willingness to learn as well as lead, and personal integrity.

In selecting high-potential candidates from within, which can boost employee morale, as others see paths for their own careers, you're likely to find and confirm necessary traits (knowledge of the business and products, integrity), but find skill gaps that require further development. A talent management strategy can begin to shape an executive for the top job. Key objectives for the talent management process are to align high-potential internal candidates with mentors/coaches, transfer knowledge required to lead the organization, and develop skills that will be tested by leadership trials (e.g., change management, alliance development, etc.).

Regardless of your age, health, or life ambitions, if you want your company to last after your departure, the time to start finding the next leader is today. After all, they have big shoes to fill.

FOR MORE INFORMATION

For more information on these and other service offerings for the manufacturing and distribution industry, please contact one of the service leaders below:

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