BEYOND BANKING: A Texas Capitalism® Series

SUCCESSION PLANNING: WHAT'S YOUR EXIT STRATEGY?

What you should know about creating a business succession plan.

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INTRODUCTION

It probably started with a great idea and a little bit of seed money. It became the source of both sleepless nights and boundless pride. There were times you wouldn't part with it for anything, and other times you thought you'd be willing to sell it and walk away for pocket change.

It's your business. It's not just a job or just a career; it's been part of your life's bedrock for years.

But eventually, the time comes to leave it behind. Perhaps you're anxious to pursue new opportunities and find new challenges. Perhaps you're ready to take a little more time for yourself and leave the business to the next generation. Whatever your circumstances, the time will come to think about succession.

EXPLORE TIPS FOR PLANNING

Click text below to jump directly to a specific section.

EXPLORE THE THREE STRATEGIES FOR SUCCESSION PLANNING

Click text below to jump directly to a specific section.

WHEN YOU'RE PLANNING

As you grew your business into a financial success, you learned that it's vital to have a sound business plan. The same holds true when you move on; to assure a successful transition, you need to have a sound succession plan.

When the time comes for you to step aside from your business, there are three primary strategies available for you to consider:

1. Sell to a strategic buyer through a merger or acquisition (M&A)
2. Sell to a financial buyer (such as a private equity firm)
3. Transfer to a family member or a business partner

We'll look at each of these strategies and what you as a business owner should know about using them in your succession plan. Obviously, every situation is unique and brings its own particular circumstances, challenges and opportunities. This is a broad road map to give you an idea of what to expect down each path. To learn more about your options and alternatives, it's a good idea to talk it through with an experienced advisor. Texas Capital Bank is adept at charting the right course through succession, and has experienced, seasoned bankers and private wealth advisors ready to lend a hand.

Whatever your circumstances, the time will come to think about succession.

It's also worth noting that these three strategies are not mutually exclusive. In fact, it's more common to combine them when planning your succession. For example, imagine you wish to retire and your business partner wants to assume full ownership but doesn't have the financial assets to purchase your share. It's possible your partner could acquire the necessary funding through a private equity concern, thus using both the private equity and transfer-to-partner avenues to assure a profitable succession.

CHOOSE THE RIGHT GUIDES

Whatever your reason for moving on from your business, ensuring a successful transition means creating and crafting a thorough plan for succession. To do this, you'll need the assistance of your own legal and financial professionals. Whether your succession plan is straightforward, such as handing the business off to a family member, or more complex, such as a private equity buyout, proper legal counsel is essential. These professionals can be welcome sounding boards right from the beginning. If you've decided you want to move on from your business but don't know how, their experience and acumen can help you map out the best possible path.

Being clear about why you want to move on from your business before you start planning will help determine the goals of your succession plan and impact most of the decisions that follow.

WHAT'S YOUR MOTIVATION?

You probably have some idea of why you want to move on from your business before you start planning, but an important step in beginning the process is to take a hard look at exactly what your motivations are and what you hope to achieve. Knowing this will determine the goals of your succession plan and impact most of the decisions that follow.

Will you step away from the business entirely or are you only interested in reducing your role? Will you move on to another enterprise or is your eye on retirement? We'll return to these questions several times because they are essential to crafting your succession plan. Knowing exactly what you want — and communicating it accurately to your legal and financial advisors — is key to making your succession a success.

KNOW YOUR TIMELINE

The longer you have to craft your succession plan, the better off you'll be. If your circumstances allow it, financial experts advise beginning your plan at least 18 to 24 months prior to the point of liquidity. The closer you are to the event, the fewer options you'll have available.

MAKE YOUR BUSINESS SHOWROOM-READY

Appearance is important. If you wanted to sell a car, you'd have it detailed first. It's not intrinsically worth any more or less, but being clean and shiny attracts a buyer's attention.

Your business should be clean and shiny too. Collect the data you need to provide a complete, organized and up-to-date financial picture of your business. Hire an independent auditor to conduct a two- to three-year audit. Take another look at your business efficiencies and monetize or eliminate any unnecessary assets. Generate a reliable financial forecast to show to potential buyers or investors.

Most importantly, remember you're selling your business, not yourself. Begin to think through how you'll pitch your business to potential buyers. Though you may be staying on in a management role of some kind, buyers are interested in your business as an ongoing viable entity. If they don't think it will be profitable without you, they're unlikely to go through with the deal. Show that your business can prosper without you at the helm.

FINANCIAL ADVICE IS KEY

A financial professional is the first place to turn if you're not sure how you wish to transition out of your business and can help you choose the best option for yourself and your business. An investment banker can help you decide if you want a strategic buyer or a financial buyer and can even help find potential buyers for your company. If you're interested in handing the business off to a partner or a family member, your banker can research means of effectively financing the buyout — and determine if it's even a possibility.

Your investment banker's first job is to learn everything about your business, to know it as well as you. They will research potential buyers, write the offering memorandum and investors' teaser (essentially an executive summary) of your business and start to gauge interest from possible investors. As the process continues, the investment banker will oversee everything from confidentiality agreements to outlining the bidding process and timeline, accepting bids and meeting with management of potential investors.

Your financial professional shouldn't have to accomplish all of this in a vacuum. The more you know, the more information you can provide, the quicker, smoother and more accurate your professional's efforts become.

Before beginning the succession process, you should be certain your financial statements are in order, know your working capital position, and have a reliable and supportable financial forecast for your business. The preferred route is to have your books and records audited by a reputable CPA firm. Don't make your financial advisors work in the dark.

LEGAL MATTERS

To ensure a successful and profitable succession, you'll also need the help of legal counsel with experience in this area.

One of the first and most important jobs of legal counsel as you prepare for succession is due diligence, on yourself and your business alike. They can uncover and identify any potential issues first, before they're brought to light by a likely investor, allowing you the opportunity to make any necessary changes or correct any issues.

If you're looking for succession through M&A or private equity investment, your attorneys will also create a "data room" — essentially a strictly organized depository of documents potential investors may request during their own due diligence and negotiation.

Your attorneys will remain a valuable resource throughout the process. They will advise you on acquiring Representation and Warranty insurance in advance of investor negotiations; they will put together your auction agreement (if applicable) and examine the offers you receive to determine which best fits your own desires for income and succession. Remember, the best offer isn't always the one that offers the best price.

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BEYOND SUCCESSION

Your business wouldn't be successful today if you didn't make a habit of planning for the future. When you begin your succession plan, you're wise to think beyond the succession itself to the impact it will have on your financial outlook and, potentially, to the estate you leave behind to your heirs.

The first goal of succession planning is the one with the longest reach — what are your plans following succession? To pursue a new opportunity? To retire in comfort? To ensure your business passes on to the next generation as seamlessly as possible? These plans usually include the future of the business itself. Will you remain on in a management role? Will you outsource the management and remain as an owner? If you wish for your children to take over the business, are they ready to do so? Or will you need to find an interim management team, a bridge between yourself and the next generation? So much of succession planning is trying to parse out and solidify these goals. Once that's done, your financial professionals can start to identify and implement the strategies you'll need to help realize them.

Remember, your succession plan doesn't end with succession. You should take the time to plan for what comes after. There are financial considerations for post-succession, of course, but there are nonfinancial matters to consider as well. Giving thought before you begin to what will come after can prepare you for the changes you're sure to encounter, and planning ahead can help eliminate the potential for regrets or second thoughts when the time for them is already past.

The list below is by no means comprehensive, but should serve as a valuable starting point to think about what comes after succession.

FINANCIAL CONSIDERATIONS

- **Financial windfall/tax consequences.** You're about to come into some money, likely in a large lump sum. Are you financially prepared for the influx of capital?
- **Upheaval in income.** This is related to the point above — your regular income is likely to change. Are you prepared for it?
- **Employment.** Unless the succession plan calls for you to stay on at the business, you're about to be unemployed. Are you ready for all that entails, from the change in routine to making certain your health care coverage is uninterrupted?

NONFINANCIAL CONSIDERATIONS

- **Emotional.** Letting go of the business you've built can be an emotional blow — for yourself and for your family.
- **Philosophical.** Does your business support a particular social issue or charity? The new owners may not share the same devotion.
- **Reputation.** As mentioned above, you're selling the business, not yourself. But depending on your community, industry or social circle, others may see the link even after it's gone.
- **Family dynamics.** Could the loss of a family business sever important ties? What message do your children receive when they no longer see you go to work each day?

CONSIDER THE TAX IMPLICATIONS

Tax implications will likely have a considerable impact on your succession plan. Tax laws change frequently, in ways both large and small. It's impossible to predict with any degree of confidence exactly which options will be available and which will be closed off just a few years from now. This is yet another instance where the input of your financial and legal professionals will be invaluable, as he or she will be abreast of any recent or impending changes in the tax laws and will know how they may impact your succession plan.

The input of your financial professional will be invaluable as he or she will know how tax laws may impact your plan.

INVESTING AFTER YOUR EXIT

A comprehensive succession plan will include one or more concrete ideas on what to do with the income generated through the succession itself. Many business owners have spent much of their professional life reinvesting extra income into the business they control, to grow it, expand it and strengthen it. Of course, you may well be able to invest money in that same business now, but if you're used to investing in yourself, putting your money into something that's no longer under your direct control can be a scary concept.

Before the succession process begins, you should generate a clear plan to guide your investments after you step aside. The options are almost unlimited — you might invest in your old business, invest in a new one, start a new venture, put your capital into more traditional investment vehicles, or beef up your life and health insurance. The important thing is to determine ahead of time which option will give you the greatest benefit and which you're most comfortable entrusting with your capital.

When the time comes for you to step aside from your business, there are three primary strategies available for you to consider. It's worth noting that these three strategies are not mutually exclusive.

STRATEGY 1

SELL TO A STRATEGIC BUYER

In today's economic climate in particular, mergers and acquisitions play a significant role in succession planning. M&A is an obvious choice if your goal is to step aside from the business completely, but even if you are planning for an internal succession by handing the business off to family or business partners, M&A can still be a valuable avenue as it is also a great strategy for growth. As the business owner, it's in your nature to do what's best for your firm, and no one has the experience to know what that is better than you.

When you divest yourself of your business through M&A, it's generally a strategic acquisition. That is, you're selling your business to another business in the same industry. They already know the ins and outs of the industry; they have the facilities and infrastructure in place to absorb your business and keep moving forward without input from you. Strategic buyers often prefer to assume direct control either immediately or on a very short timeline, unlike most financial buyers (such as private equity firms). In most cases, the acquiring institution will want prior ownership to stay on for a time in a management role to smooth the transition.

It's also worth noting that you may find yourself doing much of this work in reverse order. Most industries have at least one — usually more than one — big fish that's looking to expand by rolling up some of the smaller, more nimble competition. You may find yourself presented with an unexpected acquisition offer that's simply too good to pass up and start your due diligence on a hurried or reversed timetable.

AT A GLANCE

Here's a quick look at the most common pros and cons of using M&A as part of your succession plan.

PROS

You may be able to walk away, depending on the structure of the transaction. Strategic buyers may already have the infrastructure and management experience to run the business, so you may be able to walk away the moment you're done. If you're interested in a full and quick succession, this can be an extremely attractive option, if you negotiate a quick exit.

Immediate premium income. The long-term income from a private equity investment might be greater, but the immediate income from succession through a strategic buyer is likely to be a significantly larger initial income due to the buyer's synergies with your industry.

CONS

No interest in the business. This is the flip side of being able to walk away immediately. The business you've spent years — possibly decades — building is now out of your hands. It's too late for second thoughts — you're done.

No future income. Unlike a financial investor who may want you to remain on (at least for a limited time) in a management role, a strategic investor does not. While the initial payment or payments from succession through a strategic investor can be quite nice, once they're done, they're done. You no longer receive any manner of income from the business at all.

STRATEGY 1

CASE STUDY
SELL TO A STRATEGIC BUYER

The husband and wife owners of a translation services business had built their company up from scratch into a very successful enterprise with more than 50 employees. The idea of grooming their son to take over had been floated several times, but it was clear he had little interest in the profession. Still, it provided a good living, and they were content to continue running it — at least at the time. A few offers of buyout had come in over the years, but none of them felt adequate to the owners.

They were surprised to receive a wholly unsolicited offer from a large, multinational company in their industry, an offer they both felt was too tempting to ignore. But they found themselves without any kind of exit strategy or succession plan and were forced to work under a tight deadline to perform their necessary due diligence and data room preparation.

In this case, the buyout offer was 100% cash value, and the owners signed a contract to stay on in a consultative role for one year and signed a three-year non-compete agreement.

STRATEGY 2

SELL TO A FINANCIAL BUYER

Financial buyers (such as private equity firms) are often interested in partnering with successful businesses, providing additional capital for expansion and growth in exchange for future profits. They are also interested in acquiring full ownership of businesses they can in turn merge into or sell to other concerns.

The buyer's investment is usually financial, not strategic. Private equity firms often prefer the owners to retain some interest in the company rather than walking away completely, as the firm typically doesn't have any desire to assume operational control of a business. They often lack the experience and infrastructure to run it to its full potential and are more interested in the financial income from their investment than they are in the day-to-day operation of it. After all, you're the one who has elevated the company to its current level of financial success — so who better than you to continue making it successful?

The terms of management rollovers and existing management staying on in an operational role are an integral part of the negotiation when selling to a financial buyer. If you're interested in a quick exit from the business, it can also be one of the trickiest parts of the negotiation.

All these variables mean that finding the right buyer is key. You and the buyer will both enter negotiations with your own goals and agenda — but it's vital to make sure you're working with an investor who will accommodate your succession goals. Your financial and legal advisors, in tandem with your attorney, will be invaluable in making certain you're working with the right buyer for your needs.

AT A GLANCE

Here's a quick look at the most common pros and cons of selling to a financial buyer as part of your succession plan.

PROS

Continuity of culture. Financial buyers are investing not only in your business itself, but the in-place management infrastructure you've installed. They are less likely to lay off existing employees and make wholesale alterations to the core of your business. If you want to make sure the culture of the business you built stays intact, a financial buyer may be a better option for you than a strategic buyer.

Continue to earn. As you remain with the business in an operational or partial ownership role, you will continue to earn a regular income. If you roll shares into the company and the buyer is successful in growing the company, you may also benefit financially from that growth.

CONS

Give up (some) control but still have (some) interest. You may have been the first and last word in how to run your business. Once you take on investors, you're not. Exactly how much and what kind of control you give up will, obviously, depend upon the terms of your agreement with your buyer, but they will definitely have a say in major business decisions.

STRATEGY 2

CASE STUDY
SELL TO A FINANCIAL BUYER

Pursuing a partnership with a private equity buyer isn't always about immediately leaving your business. For some companies, it's about securing necessary financing to take the company to the next level, paving the way for a far more profitable transition further down the road.

For example, a husband and wife who owned a company that manufactured and sold a small but unique therapeutic medical device found themselves with more business than they could handle after their product was approved by the FDA. Unable to accommodate all the new opportunities ahead of them, the owners worked with their investment banker to find a new means of financing. Eventually, they settled on a private equity offer to purchase the majority of their business.

Because the private equity buyer provided them with financing to scale the business, their share of the business became even more valuable after the initial transaction. When they were eventually ready to move on from the business, they were able to set themselves up for a second financial windfall when the time came to leave the business completely.

Download our insight-based content for small to midsize business owners looking to close the valuation gap: ***Realize the True Value of Your Business.***

STRATEGY 3

TRANSFER TO FAMILY OR BUSINESS PARTNERS

After years or even decades spent building your business and nurturing its growth, it's only natural to aspire to pass it on to your children and see it continue to provide for future generations of your family. It's the true American dream. But reality is rarely as simple as a dream, and family complications can make the succession plan a bumpy road to follow.

Among the questions that must be answered before planning to exit your business by handing it off to family are:

- Do they truly want to run it?
- Can the family members accommodate the tax event that will come from assuming ownership?
- How many family members are there? Are all of them interested in running the business?
- Do they know enough to run it?
- What family dynamics do you need to consider before making this move?

If the business is not ceded to them as a gift or inheritance (see the tax question above), will they be able to finance buying you out of the business, or will they need outside financial assistance in the form of a private equity firm or other funding vehicle?

If you have only a single family member, be it a spouse or an only child, who is both interested in and capable of running the business, your path to succession may be a simple one. However, most family situations are a little more complicated and call for extensive consideration before any succession can take place. For example, consider parents who want to cede ownership of their business to their three children. They want to make sure all three are provided for equally, but only one child has any interest in running and managing the business. As time goes on, there will be countless opportunities for conflict to arise between the child running the business and those who are not. To ward off such events, it's wise to

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AT A GLANCE

Here's a quick look at the most common pros and cons of selling or passing on your business to family or business partners as part of your succession plan.

PROS

Continuity. You can feel good about handing off your business. Knowing it will stay in the hands of family or trusted partners can provide a comforting sense of continuity.

Speed. In many cases, selling your business to your family or partners can be a swifter process than selling to a third party.

Tax savings. There are tax strategies that may be available if you're selling your business to family members and that could possibly minimize the income tax impact on the sale of the business. You can also cede a portion of your business to your heirs tax-free every year. Your financial professional can provide more detailed information.

Legacy. You worked hard to build the business, and your vision can live on.

CONS

Sales price. It's unlikely that passing your business on to family or business partners will garner you the same price you'd receive if you sold it to a third party.

Future financial risk. If your family member is required to pay you back for their acquired ownership over time, is that a financial risk you want to take? Could it jeopardize your retirement?

include an exit valve for the family, a mechanism by which they can make their interest in the business liquid.

Most family-owned businesses do not survive past three generations, usually because of conflict that arises as ownership is spread out among more and more family members or through disinterest by some in continuing the enterprise. To transfer your business smoothly to the next generation and increase its likelihood of surviving and thriving, you'll need clear and frequent communication — not just from you to your family, but among the family members themselves.

If your succession plan calls for handing off your interest in the business to an existing partner, the road is a little simpler. Presumably, the partner is interested in maintaining the business and possesses the experience and acumen to continue his or her role. However, it's not common for the partner in such a scenario to possess the means to purchase your interest. In these cases, some other means of payment must be found, most often by bringing in outside investors, such as a private equity firm, to provide the necessary financing.

Despite the long-standing relationship you and your business partner presumably have, it's important to treat a transfer to your partner like you would any other transaction. Take the time to make sure all the business information is accurate and up to date. Be certain the business's financial forecasts are realistic and reliable. Work with your partner before the transition to monetize or divest any unnecessary assets held by the business.

You and your partner probably served different roles within the business, so, just as you would with any other sale, make yourself redundant. Cross-train your partner (or other employee) to do your job when you're gone.

Just as with handing your business off to family, there are personal matters to consider when transferring to an existing business partner. How will your family feel about the arrangement? Are you prepared for the inevitable change in both the business and personal relationship with your partner? Is your partner truly ready to run the business?

CASE STUDY
TRANSFER TO A FAMILY MEMBER OR A BUSINESS PARTNER

The owner of a successful piping distribution company operating across the South and Southeast was ready for retirement. His son and two sons-in-law had been part of the company for years, and he desired to pass on ownership to them. However, the value of the successful company was high enough that they couldn't finance the purchase on their own.

Looking for outside financing, the owner retained financial and legal counsel and started shopping the business as an investment vehicle for private equity firms. He entered negotiations several times, but was unable to come to agreeable terms with any of the private equity firms. Eventually, the owner decided to periodically grant his ownership to his sons and sons-in-law over a number of years. Then in exchange for the remaining interest in the company, he took out a subordinated note for the new owners to pay him interest and principal on over time. Working with their banker, the company also has the option of the bank refinancing the subordinate debt to allow the father to recoup all his money. Today, the business is still very successful after the transfer to his family.

CONCLUSION

Your succession plan, like your business itself, can succeed or fail based on decisions you make leading up to the transition. While every business, every owner, every succession is different, there are some commonalities of successful plans, and they begin with you.

1. **The business owner has clearly defined goals and a solid picture of what they want out of the transaction.** The plan should encompass financial and personal goals, such as whether to stay on in a management or consulting role or exit the business completely.

2. **The business owner's personal identity is not inextricably linked to the business itself.** A family business becomes another member of the family, and its loss can leave a void. The business owner should be able to separate himself or herself from the business.

3. **The business owner can reasonably expect to receive enough to retire or launch a new venture.**

4. **The business owner is willing to stay on in a management or consulting role after selling the business, for a period of time that typically ranges from one to three years.**

Just because you've decided to move on from your business and crafted a succession plan doesn't mean everything will work out. This is a major life event, and it's not uncommon for transition deals to fall apart, even at the last minute, for any of a number of different reasons. Just because it didn't work out one time, however, doesn't mean it won't work out the next. If your first attempt doesn't succeed, you may even find it easier to plan the next time, since you've already done so much of the groundwork.

HOW CAN TEXAS CAPITAL BANK HELP YOU?

Every business is different and every succession plan is different. Your circumstances are unique, and your plan should be tailored to match them. Having the right experts in your corner from the start can make all the difference. Texas Capital Bank offers a full suite of financial services administered by dedicated and experienced bankers who understand succession and how to craft a plan with the help of your legal counsel, financial advisors and investment bankers that will best help you meet your goals — whatever they may be.

Call us today at 214.932.6611 to get started on your plan.

