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Commercial Insights with Regions Bank

Episode 10: Planning for Succession in Unexpected Times

Covid-19 has many business owners thinking about managing unexpected twists and turns, and making sure a plan is in place for what's next when it's time to step down. In a changing business environment, what are the key factors business leaders need to keep in mind to make sure a succession plan or plan to sell is durable and realistic? And what are the implications for retirement planning?

Episode Transcript

Bryan Koepp:

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Chris Blose:

The quote you just heard comes from Bryan Koepp, SVP and Wealth Planning Executive for Regions Bank. Koepp is referring to a milestone many entrepreneurial businesses owners inevitably will face.

Sometimes that milestone comes in the form of successions — passing along the business to a family member or trusted insider. Other times it's an opportunity to sell. In either case, timing and planning are critical.

Welcome to Commercial Insights with Regions Bank. I'm your host, Chris Blose, and succession planning is our topic today. Bryan Koepp and colleague Julia Weaver, SVP and Private Wealth Strategist, are here to lend their perspectives on the key factors business leaders need to know to make sure a plan is durable, realistic and likely to succeed.

Bryan and Julia, thank you so much for joining us today. You both spend a lot of time dealing with succession planning or planning for the sale of a business. So with that in mind, I want to start with that first key decision for a business owner. When do they typically know that it's time to either plan for succession or plan for a sale?

Bryan:

I think that obviously every business owner, every entrepreneur is different in regards to that issue and making a decision. The first thing to remember is always that, you know, when you've built a business and you've taken a lot of risk in the creation of that business through good times and in bad, there may be a lot of emotion in regards to coming to that subsequent conclusion. And that's why a strategic plan is always important in arriving at when to make that call. Business owners know their business better than anybody. But one of the things that's very important is to raise the important issues regarding the marketplace, regarding economic trends and, as well, personal wealth to help them arrive at ultimately what that decision is.

Chris:

And Julia, are there often kinda key triggers for that, whether it's, you know, life events or other sort of events?

Julia:

Yes, I think oftentimes it's driven by exactly that, a life event. Business owners get very absorbed in the day-to-day challenges of their business, but sometimes an external event can cause a new focus on a potential retirement or a sale. It could be their age, it could be a macroeconomic event, such as the recent pandemic, and we've also seen a lot of business owners starting to get approached by buyers. Many who aren't even soliciting an offer are finding themselves receiving offers and that can awaken them to rethink about a sale. And that's really the point when they start coming back to their advisors for preparation for that event.

Chris:

I think you drew an interesting distinction in the first part of this discussion, too, between succession versus transfer planning or thinking about a sale too. So what are the kind of key differences there, and how might the start of the process be different, whether you're looking in-house or in-family versus looking for someone to sell to?

Julia:

Well, those certainly are very unique and different processes. So succession planning to an insider or to a family member, it really becomes more of a strategy and how they can pass the business in a tax-efficient way. Typically the entire operation is not being scrutinized because the family member or the insider is already part of it. In that event, we're looking for ways to finance the event so the owner can monetize in a way that supports their retirement. And we're very concerned about not impeding the ongoing viability of the business.

Selling to a third party is a very different process. There will be a due diligence process and preparing the business for sale. I would say overall, it really requires the owner to step into the eyes of a buyer, and they really need to look at every aspect of the business plan. They need a very involved management team. They need to scrutinize their own operations process and procedures.

Chris:

And what are the sort of questions that follow naturally once they've made the decision that it's time to move on?

Bryan:

Yeah, I think that on a basic level, it's really three key questions that come to mind, and the first would be, who? So who is the intended target in regards to the transitioning or selling your business to? And identifying potentially multiple targets gives you the opportunity for a better chance of success. When, and this is always a tough question because one of the things that we don't have control of is the capital markets.

But thinking about your life, what's important to you and really coming up with a range to say, "This is when I ultimately would like to transition my business," gives you the ability to move forward if there is an opportunity, but as well to stay back and stick with the strategic plan, if there isn't.

The third, and this is true whether you're transitioning interest to family or if you're selling outright, which is the question of how much. So in tying how much to the goals that you have, how much do I need in regards to actual cashflow in conjunction with risk to retire on the terms that I set, and how I define retirement? And as well, if I'm gonna sell my business, I really get one opportunity to do that. What does a deal need to look like to give me the best chance and probability to meet the goals and aspirations that I have?

Chris:

So we're talking about the process kind of in a general environment, but you know, a lot has changed in the past year. The business environment has been quite different for a lot of folks. How does this type of planning shift when the business environment is so volatile?

Bryan:

In regards to the volatility that we've seen, I think it really depends upon w- what your business does, because some businesses have thrived in the recent environment that we've had and some have not. I think the other key question is valuation because if you think about it, we went through an unprecedented lockdown in regards to business and our economy,and we're finally kind of beginning to inch out of that. And so to truly value a business really becomes even more so of an art than a science because, you do have a lot of asterisks and a lot of unknowns over the past year to 15 months. So in that respect there's a lot of potential questions, but also there's a lot of potential opportunity.

And I think the way that you seize the opportunity is that you really go back and engage in the fundamentals. What is my business worth? And again, why am I valuing it? And if the intention is, I would love to transition that business to my family, then we're not necessarily concerned about price, but what we are concerned about is solid defensible valuation the IRS is gonna honor. If we're looking at a sale, then in my opinion, it's really working with your commercial bank, with your investment banking partners and as well, with your wealth management team and really devising a plan that meets the crossroads of where business and personal lie, which is, how can I price the business to achieve the objectives that I have?

Julia:

Adding on to what a lot of business owners are feeling, the ones that are considering going through a sales process, the investment bankers and really the entire buyer pool right now is still assessing the impact of COVID on each business.

So I think in preparation for a third party sale, they're really considering, what are the new normals post-COVID that are impacting their business? And now more than ever, adaptability of a business is a huge consideration. So they may be looking at shifting their customer base or diversifying it or diversifying their supply chain. You know, whatever the unique impacts on their business are really front and center in their thinking.

Chris:

Sure. So I think adaptability is a key point, Julia, and, and with that in mind, you know, I'm sure businesses are revisiting their succession plans as a result of the pandemic, and maybe also their plans for if they're trying to sell their company. So what new approaches might be warranted based on the experiences of the past year?

Bryan:

You know, if I'm a seller, why am I selling? I could tell you that there are a lot of business owners that approached the altar of sale or approached the altar of transition in 2006 and seven. Those were major years in the capital markets in regards to the sale of businesses to third parties. And then 2008 happened. And there were a lot of business owners that waited. They went past the peak and subsequently, the market did what it did, and a number of them had to rebuild their businesses from the bottom up. And while 2020 was not that, when it started, it looked like that. So now you still do have the psychological effect to say, is this the time to get out?

And I think that that's a different, decision for each and every business owner regarding their personal situation. But I think it comes back to the fundamentals of, if I am gonna sell, or if I am gonna transition, do the numbers regarding the goals and aspirations that I have on the personal side of my life work? 'Cause you only get one chance to really engage in that opportunity. So it's gotta be done right. And that's where modeling of potential opportunities comes into play. It involves looking at risk in regards to investments and how that plays out over life expectancy and probability. And it also involves, you know, what do I want my legacy to be?

Chris:

That really goes into another element of this, which is retirement planning. So how does retirement planning on a personal level factor into succession planning or sales planning if a person is leaving their business?

Julia:

Well, succession planning and retirement planning are really inextricably linked. So for a business owner, the business is really sustaining their lifestyle. And when they do sell and monetize, they now have to contend with the prospect of essentially a whole new balance sheet and a whole new source of income. So it's critical that they ask and analyze, will my net proceeds continue to stay in my lifestyle in the way I wanna retire? Our team conducts something we call a gap analysis. It's a very thoughtful financial model to determine if there's a gap that exists between their net proceeds, and the amount that they need to sustain their lifestyle and their spending goals.

We also recognize that many business owners have the opportunity under the tax code to have certain living expenses, be borne by the business, and once they sell, that goes away. So a proper analysis also requires a very insightful team of advisors to dig into those questions and scenarios, and really identify, first, a thoughtful bottom line figure to the net proceeds that factors in a variety of factors the business owner may not be considering not just taxes, but deal costs and hold backs and potential escrows and earn outs.

Bryan:
I think in addition, there are a number of things in conjunction with the business or owned by the business that are very, very important in regards to the prospects of what we call a personal carry over. Retirement accounts are a big one. So new rules at the end of 2019 were passed by the federal government in the name of the Secure Act, which changed requirements on distributions to the age of 72. The rollover of 401k plans, for example, or other types of qualified plans into an IRA often come into play at deal time here because it allows for consolidation, but as well, better tax planning in regards to where retirement income comes from.

The other issue that we often see is that businesses often own a lot of life insurance. And so those policies were utilized for either buy, sell agreements or business protection. And now they're no longer necessary, and they may be able to be utilized or recast in a way to provide a personal benefit. And that may include anything from additional liquidity for estate planning purposes, for children or for charity to hedging in, in potential payment of federal state taxes at the end of life. So there are a lot of potential ancillary issues that may benefit a business owner by really looking deep into the balance sheet and seeing, what are the additional things that may cross over to the personal side of my life?

Chris:
So I think it's interesting that both of you have brought up, you know, obviously tax structure, estate planning, some of these factors that are affected by changing administrations and changing policies as well. So nothing we're talking about here exists in a vacuum. Obviously COVID has had an effect, but from a policy standpoint, are business owners looking at potential tax changes in the future or potential policy changes in general, or should they be when they're making decisions around succession planning?

Bryan :

Unfortunately, yes. In a perfect world, we would want to really look methodically at why are you selling based upon the life of the business?

The mitigating factor is always taxes. Taxes provide an emotional response. And I think that one of the things that we need to do is recognize that, and plan accordingly. There's nothing wrong with addressing that taxes are impactful, that there are reasons why you may want to engage in a transaction due to taxes, but don't let taxes just be the driving force in regards to exiting your business. Drive at balance, and I think that that's where looking at the impact of taxes through solid modeling to see what can be, or what could be, is a very important and prudent exercise to reduce the emotion, and be able then to make a decision based upon the facts at hand.

Chris:

I'm glad you actually brought up the emotional factor. I'm thinking about the emotional factor in relation to communication as well. Obviously, when you're going through a major change like this, you're gonna have a communication plan too. So can you tell me a little bit about how communication fits into succession planning for different types of stakeholders?

Julia:

First of all, that's a very astute observation and very much worthy of discussion. We know that post-COVID, we have a lot of folks out there who still have job insecurity. They were either personally touched, or they know someone who has been. So we have somewhat of an insecure workforce. So when an employer starts entertaining the notion of an outside sale, if their employees get word of that without hearing it first from the business owner and having a good plan in place, that is a pivotal time when we can see key employees start to leave the business, maybe go to competitors, or maybe even become the competition themselves. But that can be avoided with planning.

So one of the first things we do is look to those employee, key employee relationships and, and create retention strategies and a communication plan that will incentivize that employee to stay on board during the whole sales process. That's a very pivotal time for a selling business owner to not lose key employees because you can have buyers walk away from the table if that happens. They want to walk into a solid business and a solid management team. So open communication and a good retention plan is the key.

Further, it is critical for the business owner to manage communication because if word gets out in the industry that can become a time when both customers and employees even vendors can become insecure and really shift the operations of the business in a negative way. So noncompete agreements are a critical consideration, having those shored up. And I can't emphasize enough, shoring up those key employees either with stay bonuses or retention plans is really critical.

Bryan:

In regards to communication, this is why an investment banking process, especially if it's a high-profile type of company, is so vitally important, because when you begin to get into the due diligence process of, of a business sale, those communications are ultimately gonna be protected. I think the danger is, is when you're in essence kind of going it alone, and you're looking at taking offers and you begin to negotiate solo — without legal counsel, without understanding from a tax perspective in conjunction with your tax advisors, but as well, having somebody really run the merger and acquisition process — is where then you may have a leak.

So being able to have the right nondisclosure agreements in place to make sure that you've got a lockdown in regards to media disclosure until the right and stated time, I believe is vitally important to number one drive price, but as well, to ensure that that business is able to transition wholly to the new owner. That gives everybody the best chance to be successful, including the employees that are remaining in the new organization.

Chris:

So, one last question for you both. You know, we've kind of emerged from a year of COVID and we're entering a post-COVID environment. Are there any durable lessons you think that you're gonna take forward for succession planning from the past year?

Julia:

I think the key thing that business owners have walked away with is the concept of adaptability. We hear that from them on a daily basis. Many are scrutinizing their business process, making very thoughtful decisions on how to capitalize on the new normals that have emerged in their particular industry. Some have been very successful. The ones who were not adaptable have felt a business interruption. So not only are employees and families becoming more adaptable, but that particular quality has never been more important for the business owner.

Bryan:

I would tell you that innovation and the entrepreneurial spirit is alive and well. And, and that's extremely refreshing because if you think about where we were, you know, 15 months ago to where we are today, it really is incredible.

And now coming out of this, it's gonna be very exciting to see where ultimately a lot of those businesses will go and my hope is that they'll flourish, I think as well as keeping your eyes on the finish line. And so while sometimes, the line may change, you know, the race isn't linear, (laughs) it's, multidimensional. Nevertheless, keeping your eye on the finish line allows for you to focus. That focus invariably gets you to where you need to be.

Chris:

If you're a business owner, getting to where you need to be is a major consideration in succession planning. That's true whether you're passing along a family legacy or considering a sale. Your planning needs to be robust enough to ensure your own future goals are met, while leaving behind a business that's ready to flourish in new hands.

Thanks to Bryan Koepp and Julia Weaver for joining us today and offering some perspective on that planning, and thank you for listening. Get related resources for your business and listen to future episodes at regions.com/commercialpodcast. And be sure to subscribe to this podcast on your favorite podcast service.

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