September 2015

The Top Five Ownership Transition "Inflection Points"

By Dave Diehl

As you know, there are a lot of "moving parts" in the day-to-day management of a business. Between dealing with people, improving profitability, tracking inbound and outbound flows and financial reporting, you may not have much time to think about your company's ownership mix. Whether there is a single owner or multiple owners, made up of family members or not, sooner or later the topic of ownership transition may come up. When it does, it can be a stressful conversation. However, it is a conversation that is ultimately inevitable.

There are any number of reasons why business owners decide it's time to consider who the next owners of their business should be, whether the successors are family, managers, employees or a third party. All companies, however, ultimately go through an ownership transition process. The issue is whether it is planned for or an after-the-fact reaction to something. What our experience tells us is that proactive planning for ownership transition leads to outcomes that are almost always more satisfying. Time is the valuable commodity in transition planning. The more time you have the better things will be.

Ownership Transition Strategies

There are several ownership transition strategies available for business owners. Not all will work in all situations, but all might be worthy of discussion and evaluation. Here are the ones that surface most often.

1. Transition and retain ownership within the family;
2. Sell some or all of the company to key managers;
3. Sell some or all of the company to employees using an Employee Stock Ownership Plan ("ESOP") structure;
4. Sell some or all of the company to a financial buyer (such as a private equity firm)
5. Sell some or all of the company to a strategic investor or acquirer

There are two strategies that are left off of this list, because they don't apply in most cases. The first is a simple liquidation of the assets followed by a termination of the business. The second is a public offering of the company's stock in an Initial Public Offering ("IPO"). The former typically won't meet the ownership's valuation expectations since there is no reflection of the earning power of the company, and the latter IPO strategy is typically reserved for much larger firms.

Inflection Points

If ownership transition is the effect, what are the causes? For a business owner and other stakeholders, wouldn't it be helpful to see those coming? Our experience has shown some common **"inflection points"** that can (or should) trigger action. These are some things that can show signals that it may be time for the consideration of a transition plan.

1. Age of the Company's Owner(s)

This one can be easy to observe, but dealing with it can be quite delicate. The right time to exit a business is, in many cases, more a function of the state of mind of the business owner rather than chronology or health. As such, there isn't a common timeline that business owners follow, and many may exhibit a fair amount of procrastination because they are unsure about the process or the alternatives.

The age element becomes even more challenging when there are multiple owners of different ages. It is quite likely that they are not all operating on the same timeline. The tricky part that we've experienced is that it is unwise to assume that the older business owner seeks transition first. This scenario presents you with both a problem and an opportunity. The *problem* is business owners frequently believe that their only option is to sell the entire business. When there are multiple owners with varying timelines, this lack of information may stop the process in its tracks. So, it can be advantageous to be conversant on the subject and serve as the initial source of information and education for the Company's other shareholders. This can enable a frank, private discussion about ownership objectives and how they might be met by the array of attractive fractional strategies.

2. A "Hot" External Market

Business owners always seem to be aware of merger and acquisition transaction volume. At a robust market's peak, the information is almost unavoidable, but it isn't always perfect. If the market activity is strong and valuation multiples are rich, the owners may have developed thoughts about valuation. This may lead to a discussion of the topic of transition. If the marketplace is hot with business transactions, one should evaluate whether it is in its early or later stages in the cycle to manage expectations.

3. Internal Management Succession Status

Sometimes, an exit strategy is exactly what business owners want, however they haven't discussed it with others in the company. When we're talking to business owners about ownership transition, management transition is always part of the discussion. Of course, it's a good business practice whether a transition strategy is being evaluated or not. Still, management transition planning can signal preparation for an ownership transition process because it plays directly into the results.

4. Observing Career Anxiety

Our next inflection point is a little more subtle. As owners of private companies near retirement age, their associates often begin to wonder what the future holds. This preoccupation may lead to a sense of anxiety because they've witnessed elsewhere what can happen when a transition process occurs. And, in the absence of some messaging from the company's owners, they'll often fear the worst. This anxiety can impact employee behavior and also impact the desire to stay on board.

While it may not be wise to disclose details about an ownership transition plan, companies can find a way to strike a balance between confidentiality and disclosure. Sometimes, it's as simple as saying what might be excluded from consideration. For example, telling the leadership teams that a 3rd party sale to a strategic acquirer is an alternative that will not be considered. Such communication can allay concerns about whether the managers' jobs will even exist.

5. Observing "Value Protection Mode"

For many owners (and especially founders of companies) there may have been a period or two over the company's history when financial stress was encountered. As a result, some business owners don't want that history to repeat itself. Maybe you've heard the sentiment: "I don't want to go through that again!" For many, getting out of debt lifted a weight off of their shoulders, and so they are reluctant to re-lever. While this is a laudable desire, it can also result in missed opportunities as the owners protect their "nest egg". For people who have built their careers at the Company, this financial stagnation can be frustrating. It can also be costly because if one firm passes on an opportunity another will likely pursue it, which can lead to eroded market share and, ultimately, lost value.

Summary

We've outlined some of the key inflection points that can coincide with ownership transition planning. In most cases, these conditions actually precede the discussion of the subject, or at least signal that a discussion could be beneficial. Business owners should also be prepared in case others raise the issue when they spot one or more of these inflection points. When and how the conversation arises will be a function of your Company's culture, and, in almost all settings, it is nicely paired with a simultaneous discussion about management transition. Of course, the best case is for the business owner to be completely out in front of the process, and avoid finding themselves in the position of reacting to one or more of these inflection points.

For more information, contact:

Dave Diehl, CEO

Prairie Capital Advisors

ddiehl@prairiecap.com

630.413.5577