Maximize What You Have Built

Overlooked issues in family businesses

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Introduction

Family business owners have a different DNA. For them, the business is more than a livelihood – it is the love of their life and the grand plan to support their dreams. A strong desire to create opportunity for future family members is at the heart of their passion and focus. Yet too many owners overlook essential steps of quality stewardship. We explored these issues through interviewing numerous family business owners and consultants. Our results revealed that regardless of industry, all business owners have the same challenges when family is involved.

Over the years, our wealth management practice has focused on guiding successful families and family business owners. This paper shares our research and provides guidance regarding overlooked issues in multigenerational family businesses. Any family stewards desiring a road map for their families could also apply these ideas. We address the issues family business owners face today by looking at what the current challenges are, what we know is overlooked and what steps can be taken.

Macro Challenges Family Business Owners Are Facing

The successful business owners we interviewed are masters of navigating macro challenges but nonetheless are frustrated with the current environment. As each of the topics outlined below was brought up, it became apparent that they often disrupt the owner's personal goals.

Healthcare

The healthcare system and costs are a major issue for everyone in the United States, but family business owners are acutely aware of the current issues and proposed solutions. Their awareness stems from the severity of the potential impact to their business and personal decisions. We interviewed Jon Rauser of The Rauser Agency, who is a business owner and also consults with other business owners regarding healthcare. He said, "For closely held family businesses, the challenge is to offer health plans that can compete with those of larger corporations while still being affordable." Additionally, owners are faced with the administrative challenges of managing healthcare coverage when their human resources department is already taxed with strategic growth initiatives.

Tax Code and Financial Regulations

In our interviews, owners consistently spoke in heartfelt detail about the impact the uncertain tax code and financial regulations have on their business. This constant unknown makes it difficult to make decisions on business expansion or business sale. It also makes it complicated to start up a business. Banking relationships have changed dramatically, and businesses are still facing difficulties in accessing capital. Owning and managing a business in this economic environment are tough enough – adding more red tape and uncertainty is not helpful. On top of it, the appetite for risk is different than it was five years ago. We interviewed the CEO of the largest employer association in the country that serves as advisor to 3,000 business owners, Susan Fronk of MRA – The Management Association. Susan said, "Since 2008, some business owners have been focusing on shorter strategy-planning cycles and not where the business will be in the next 20 years. This may have been necessary in 2008, but can be detrimental to the long-term results of the business. A small adjustment to the steering of the ship can throw the ship off course dramatically in the long term." Some family business owners are focusing on short-term strategies not only due to change in risk appetite, but also because of the ambiguity with tax code and financial regulations.

Globalization

Perhaps the most dynamic part of our discussion surrounding macro challenges was globalization. Many businesses are finding a need to diversify revenue sources and products to keep viable. With so many mergers and acquisitions taking place, several small to mid-sized companies are finding it difficult to remain competitive with large, publicly traded companies. Yet globalization has been a positive for some industries. This is the case for John W. Miller, President and CEO of Miller-St. Nazianz Inc., manufacturer of self-propelled agricultural spray application equipment. In our interview, he stated, "International sales were 5% of the business when I first started with the company in 2006. They are now 50% of sales." This of course adds a new dynamic: managing people across cultures, accounting practices across nations, and so forth.

Other Challenges

The three primary topics we heard consistently were healthcare, tax and financial regulation, and globalization, but there was also much discussion surrounding the difficulty in hiring skilled workers and talent, compensation for family members and key employees, communication among family members, keeping employee benefits competitive with large companies, business growth initiatives and other human resources issues. There is no doubt that family business ownership can be lucrative; however, it is not without its share of challenges.

Overlooked Issues in Business Development: Succession and Transition

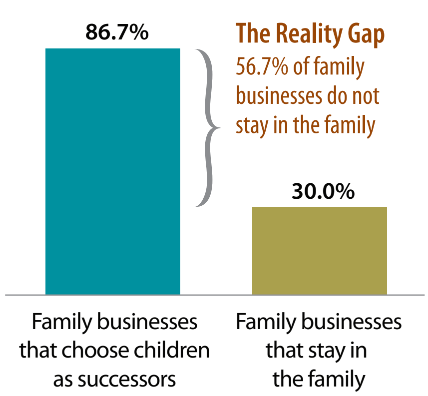
In our interviews, we heard the general business issues loud and clear. As wealth managers who have consulted with family business owners over the years, we are aware of additional issues family business owners face. In these interviews, business owners rarely mentioned – and we believe to their great detriment – the critical issues of family succession planning, preparing the business for sale and separating personal wealth from the business.

Family Succession Planning

"Of family business owners who have chosen a successor, 86.7% select one of their children to carry on the family tradition. But only 30% of family businesses are actually able to keep the business in the family" (Fowler and Masterson Edquist, 2002) (Graph 1).

GRAPH 1:

Family Business Succession



Source: Fowler and Masterson Edquist, 2002.

There are many factors why family may or may not be a good choice for succession, such as competency, interest, business style and values.

Desire vs. Reality

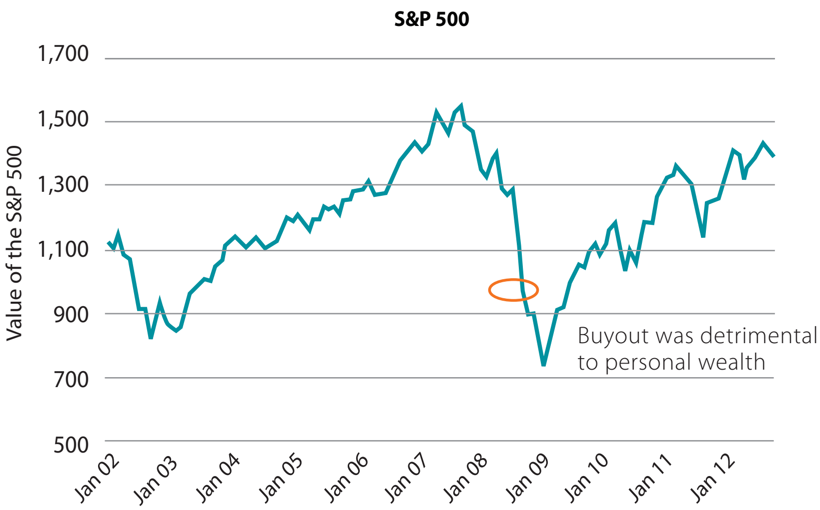
The right successor will truly have a passion for the business and been part of the succession planning process. It is important this person knows and lives by the family's values, as they will shape the future of the business. Not only does the current generation need a game plan for leadership succession, business transition and personal retirement in order to make a smooth exit, but they also need a plan for how charitable intentions and values will be transferred to the next generation. This takes time and education. Family business owners, whether first- or fifth-generation, have more to think about with their business succession planning because it is a *family* business.

Many feel succession is an awkward topic to discuss with family. I have often heard, "We all trust each other and know what our wishes are." Handshake agreements can be detrimental to the business. A prime example is a story of two brothers who co-owned a soybean farm. One passed away, and his interest transferred to the spouse. The surviving brother said he had a handshake deal with her husband that he would buy her out at book value. There was no written agreement in place, though. Therefore, the surviving brother was forced to pay his brother's widow fair market value, which was 20% higher than book value. In order to provide the needed liquidity,

the 58-year-old man had to withdraw the funds from his personal investment portfolio in
March 2008, when the Standard & Poor's 500 index was near all-time lows, which had a devastating impact on his personal portfolio.

GRAPH 2:

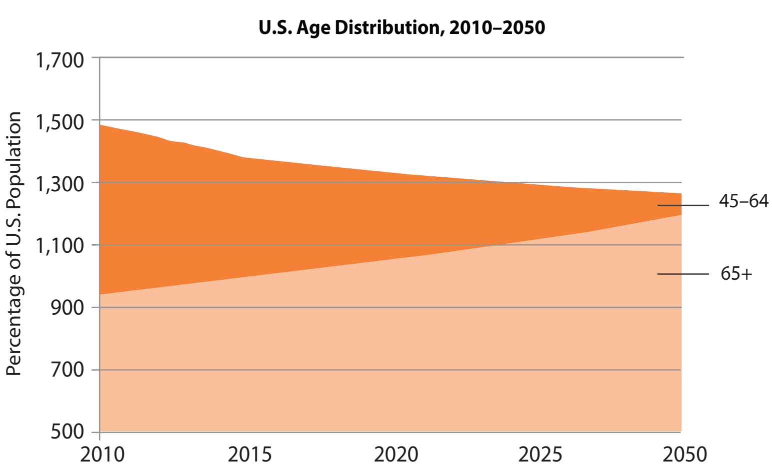
S&P 500 index, January 2002 through January 2012.



Source: ILX

GRAPH 3:

Aging Projections for the United States



Source: Population Division, U.S. Census Bureau, 2008.

This explosive growth of Americans over 65 years old may mean greater competition when selling your business, making it crucial to prepare your business for sale.

The family relationship was destroyed and the family business did not end up in the position the brothers had desired. If they had put a formal buy-sell agreement in place, coupled with life insurance, the surviving brother would have had the liquidity needed to pay the widow without affecting his personal portfolio (Graph 2).

Preparing the Business for Sale

Starting Jan. 1, 2011, every single day 10,000 Baby Boomers will reach age 65. This remarkable trend will continue for the next 19 years and make a difference to every single business owner who wants to sell (Pew Research Center, 2012) (Graph 3).

Family business owners have often expressed to us their uncertainty about the right time to sell in order to get the maximum payout. Two factors that affect the selling price of a business include the increasing number of businesses for sale on the market and inadequately audited financial statements.

As seen in Graph 3, as the percentage of the population 65 and older rapidly rises, the percentage of those 45 to 64 declines. 38% of business buyers are between ages 45 to 55 years old (All Business, 2012). With potentially more businesses for sale and fewer buyers, the market is going to be competitive. Because of this shift, it is vital to have the business prepared for sale and a proper succession plan in place.

Demographic changes are only one of many uncontrollable factors that will affect future sale price, but the numbers clearly show how procrastination could change the landscape for a family business owner looking to sell. One of the private equity consultants I interviewed, Dave Pelisek of Baird Capital Partners, said, "In the world of privately held companies, an owner will be rewarded for producing historical audited financial statements (at a minimum, reviewed statements), making necessary capital investments (computer systems, updated equipment), adding management talent alongside the owner, crafting a well-conceived strategic plan and having a succession plan for when the owner departs the business. Experienced buyers will see through the gaps where these attributes are lacking and discount their purchase price accordingly."

Take, for instance, one local couple who owned a medical device company for more than thirty years. They had their son work in the business off and on since the age of 15, thinking they were grooming him to be the successor. Their son moved on to build his own success as a senior executive at a global engineering company. The parents, now 70 years old and physically ready to retire, had always expected their son to buy them out, thus providing a nest egg so they could continue to live off a $250,000 income in retirement. The son was not part of these conversations and had no desire to take over the company. Here they sit, pondering their next steps, as the business has no audited financial statements, no action has been taken to prepare the business for sale – and not enough personal wealth has been built in order to maintain an annual income of $250,000. If they would have taken any of these three strategies, they would not be in this predicament today.

Personal Wealth Not Separated From Business

Many think of their business and personal wealth as one and the same, but in our opinion that is a risky approach to planning. A family-owned business is subject to economic and market fluctuations just as much as a stock portfolio is. Family business owners are proud of the wealth their business has created, and rightfully so. However, if an owner has aspirations of retiring, he or she needs to build his or her own personal financial security outside the business. An understanding of how the performance of his or her business correlates with his or her personal investment portfolio is also important. High correlation can result in taking on more risk than expected. Personal risk tolerance is typically different from business risk tolerance and needs to be assessed differently. Managing day-to-day business decisions requires a risk tolerance in line with the business's ability to absorb worst-case results, and the time horizon can be into perpetuity. On the other hand, personal risk tolerance is often influenced by time horizon and family dependency. One comment we heard consistently in our interviews was, "I am young and not planning for retirement right now. If something catastrophic happens to me, the business can be sold." My sad rebuttal to this comment involves a family business owner and personal friend. He was in his early forties with a stay-at-home wife and two young children, and he was a partner in his father's tool and die company. He recently passed away at the age of 41 due to brain cancer. Immediately after the diagnosis, he spent the remaining six months of his life organizing a buy-sell agreement with his father, so his wife at least received his 10% stake in the business. Had he planned earlier, establishing life insurance and building a personal financial portfolio, his widow and children could have been less financially dependent on the family business.

Four Essential Actions to a Smooth Transition

We touched on several challenges on the minds of today's family business owners. Even though every family business transitions differently, their smooth succession hinges on four essential steps:

1) **Establish a team of professionals –** The first step is to assemble a team of professionals with the appropriate skill sets. This team will provide structure surrounding wealth preservation, wealth enhancement, wealth transfer and charitable giving while acting as a resource to educate family members. Establishing the team years before retirement or business sale can help avoid costly mistakes and make the transition as smooth as possible. There are two ways to create this team. One is to interview and hire an individual accountant, estate planning attorney, business attorney, business consultant, insurance specialist and investment banker on your own time. However, this can result in a lack of coordination between professionals, resulting in critical issues being missed or conflicting advice. A better alternative is to work with a wealth manager who coordinates a team of professionals and oversees the details.

   In our experience, a good wealth manager uses a consultative process that occurs over a series of meetings and includes a team of experts. It starts with a discovery process where they find out what is most important to the family business owner. From there, using the information he or she gathered at the first meeting, they present a complete diagnostic of the current financial situation and a plan for achieving the stated investment-related goals. After the foundation is established, the wealth manager provides a comprehensive blueprint for addressing advanced-planning needs and continues to manage the progress toward achieving goals. In this way, over time, every aspect of the complete financial picture is effectively managed.

2) **Create a plan to segregate and build personal wealth** – Everyone retires, but not everyone has a plan for it. It is best to plan ahead and build wealth during working years, when family business owners have time and incoming cash flow on their side. Although an owner may sell the business at retirement, doing so would eliminate the main source of consistent income, making it difficult for the seller to keep his or her lifestyle and also leave a legacy. This is where the carefully selected team of professionals will take a holistic approach and create a customized plan that helps build wealth for both the business and the individual.

3) **Set up a succession plan –** It is important that business plans and goals line up with one's family plans and values. One interviewee, Tom Marshall, a managing partner at

Helgesen, a manufacturer of custom hydraulic tanks and reservoir systems, made a simple but often overlooked observation: "The business will be most successful when those who want to manage it the most are the ones running it." Successful families address the money and power issues. They put their succession plan in writing, review it periodically and update it as needed (Fowler and Masterson Edquist, 2002.) Start with reviewing the basics such as:

1) **Business purpose** – Why are we all in the business? *Should* we all be in the business? What is the vision for the business long-term? What are the business owner's wishes for future leadership?

2) **Roles and compensation** – Who should do what? What are each family member's competencies? What are the roles for non-family members? How should family members and non-family members be compensated?

3) **Financial and governance structures** – What is the business owner's financial wishes? Which is the best financial structure: a buy-sell agreement, key person insurance or irrevocable life insurance trust? Which is the best governance structure: outside advisory board, family council, business consultant, board of directors or a family constitution? (Brun de Pontet, Drozdow, and Emons, 2012.)

4) **Teach values and leave a legacy –** Many heirs come into wealth oblivious of how to manage it. Educate the family on why the wealth and business has been built and share with them the overall financial plan. One strategy is to have the child or children act as trustee, managing the family foundation, charitable lead trust, charitable remainder trust or any other legacy tool the family has chosen to employ. With this approach, the family business owner will have the opportunity to watch his or her charitable intent come to fruition, plus instill a value system in the rest of the family. Storytelling is another avenue to leave a legacy and keep the continuity of the business culture: "The culture of the family firm plays an important role in determining the success of the business beyond the first generation" (Adelman and Alexander, 2012). It is imperative for future generations to know what mattered to the founder, the purpose of the business and his or her vision for the future.

Conclusion

The examples and insights provided in this paper prepare family business owners with knowledge to review and improve their own financial and business succession planning. During the research process, we found that it is not uncommon to overlook or outgrow a plan for managing family success and wealth creation. Throughout our interviews, family business owners clearly expressed concerns with healthcare, tax and financial regulation, and globalization, and although these concerns were out of their control, each of them could rattle off an intricate strategy designed to deal with these concerns. On the other hand, the more controllable aspects such as family succession planning, preparing the business for sale and separating personal wealth from the business were overlooked or acknowledged but neglected. These issues tend to be difficult for individuals to discuss, perhaps because it may mean the end of an era, the need to transfer control and admitting there is an end to life. Perhaps it draws a line in the sand that they do not want to cross.

We have determined the controllable aspects can easily be addressed by engaging the right team of professionals. Like any team, their ability to work together brings a greater value than merely individual skill sets. For that reason, we recommend engaging a wealth manager who can provide an established team of experts and will act as the point person involving the appropriate experts as needed. Once the team delegates and monitors the controllable aspects, family business owners can confidently transition their business and have the ability to live a rich and full life in retirement.

ABOUT THE AUTHORS:

The Gervais Group of Baird in Mequon manages wealth for select families and family business owners, developing strategies to help clients preserve, protect, enhance and transfer wealth. The team oversees the complete financial picture for clients by employing strategies to address investment issues as well as special family, business and philanthropic interests. To learn more about our unique approach to wealth management, visit us at gervaiswealthmanagement.com or contact Lori Gervais at 262-240-3519 or lgervais@rwbaird.com.

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