TITAN FINANCIAL ASSOCIATES
EXIT PLANNING FOR BUSINESS OWNERS

Designing Your 100-Year Plan

How to Create a Sustainable Succession Plan for Your Family Business

"The most important work you will ever do"

Doug Sippel
Principal, Titan Financial Associates

TITAN FINANCIAL ASSOCIATES
5285 SW Meadows Rd., Suite 115 • Lake Oswego, OR 97035
Phone: 503-629-0810 Fax: 503-210-1426

100-Year Planning for Family Business Owners: A Parable

In the beginning there was a business….

It was a small business. The owner was determined and talented. The business grew.

Soon it was a larger business with many people working there. The owner's children were now grown and some decided to work in the business. The others did not.

Soon there were issues, disagreements over what to do with the profits. The inactive owners wanted dividends…now! The active owners saw the need to reinvest for future growth.

The founder was ready to retire. But there was little savings outside the business. The founder wanted to be conservative and protect the cash flow for himself. The sons and daughters working in the business wanted to be aggressive and grow bigger to remain competitive.

There was no way for inactive owners to sell their ownership. They wanted high dividends to make up for this lack of liquidity.

Without warning one, of the owners was killed in an accident. This owner's spouse wanted to be bought out immediately. The business had to borrow money to repurchase the shares.

The tension increased and one of the owners kept bringing it home. Soon there was a divorce. This caused a small financial emergency. Soon there was a demand for more money. A loan was made to the divorced owner.

Another owner had a gambling problem. But it was discovered too late; there were too many credit card bills. A bankruptcy was filled. More money was needed. Another loan was made.

The family members stopped talking to each other; there were too many hurt feelings and too much mistrust.

The inactive owners still wanted their dividends, now! They didn't understand. No one had explained to them the need to leave the money in the business to remain competitive in the market.

The founder had never decided who was going to take his place. It was left up to a committee when he died. The estate tax bill arrived in the mail. There had been no planning. There was no cash.

There was an auction. The assets were sold. The business is gone….

The End.

This is a sad, sad story. But unfortunately it happens…over and over again.

Please don't let this happen to your family.

Sustainable Succession Planning is the solution which would have prevented this from happening. <u>You will experience a tremendous return on the investment of time and money you make in the process of creating a vision and then implementing it with your family.</u>

But it's not easy. I call it "*planning over the curve of the earth.*" Six hundred years ago people believed the earth was flat; they only believed what they could see. In some ways we haven't changed that much. We still want to wait until the ship is on the horizon to plan for how it will be unloaded at the dock. This is a little late. Don't wait until it's too late. Use our experience and expertise to help you with the following:

Managing the fears of retirement

It's the day after you've retired and you're sitting on an airplane. The person next to you turns to you and asks, "So what do you do?" How do you answer? *"I'm a retiree"*? What's your new title? How will you define who you are and what you do to feel like a valued, productive, and respected member of your family and community?

Letting go of your business is hard. You have spent years building it into the successful enterprise that it is today. It has provided great personal satisfaction. Even if you will be involved in the business as an advisor to your children or other family members; it still means an entirely new role for you. What will you do with your time? How will you stay challenged and motivated? What is your new personal identity now that you're not the CEO?

Starting to explore and understand these new roles and the great personal satisfaction that can be gained from starting a new adventure can be very exciting. We help you visualize the new life you want to live by identifying and clarifying the new goals and objectives that will define who you want to become.

During this process we use an assessment tool to help you determine if you are psychologically prepared to close the door on this chapter of your life and begin writing another. Then we help you design a personal retirement plan that will cover the following:

- Personal Identity and Lifestyle Goals and Objectives
- Retirement Income security (especially important when the majority of net worth is tied up in the business)
- Family and business responsibilities
- Community service and charitable goals
- Health concerns
- Estate planning

Questions to ask yourself

- Have you thought about what you'd like to do when you retire?
- How much longer do you want to work in the business on a daily basis
- Imagine a point in the future when you are financially secure and you can live the perfect life. Can you describe this perfect life?
- List 3 goals you have yet to accomplish in your lifetime?
- A goal is a dream with a deadline. Are these things goals or dreams? What are the deadlines?

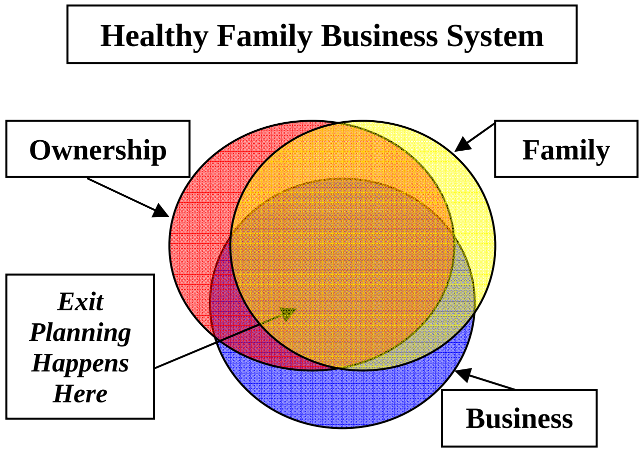
Conflicting Systems

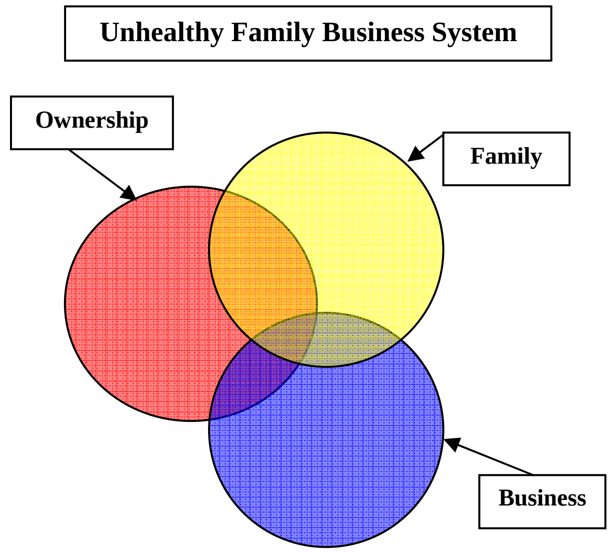
Exit planning is not a rational process.

Let's just start there. It's highly likely that thinking about the business issues, the family issues, the personal issues, and the financial issues is causing you to lose sleep at night. Thinking about how to transition your business often brings up deeply seated emotional issues around:

- Your own mortality
- Your personal identity
- Family relationships and the risks of harming them
- How to treat siblings, children, nieces, and nephews fairly versus treating them equally
- Differences in their interest in the business or business competence versus loving each the same
- The possibility that what's best for the business is not best for the harmony of family relationships
- Estate planning that makes partners out of family members when otherwise you would not choose to go into business with them

There are three conflicting values systems at work in most family owned businesses: The Business or Management system, the Family system, and the Owner system (see the diagram on page 5). In a healthy family there is a great deal of alignment in the goals and values shared between the three systems. An unhealthy system has something out of balance. For instance the family relationships may be strong, and the business is paying high dividends to all owners, yet there is disagreement about how to grow the business and conflict between two family members over their roles at work.





Most family business problems are due to poor alignment between these three values systems.

Successful Exit Planning focuses on increasing the area where all three systems overlap. The greater the alignment between all three systems the greater the success of implementing the exit plan.

Miscommunication and emotional conflict are the cause of most of the difficulties associated with Exit Planning. All three systems are equally important and must be granted equal consideration during the exit planning process.

A comparison of Family, Ownership, and Business areas of potential conflicts

	Family	Ownership	Business
Purpose	Emotional Support and Unconditional Love	Wealth creation, Cash flow, and Liquidity	Generate Profit, Grow the business,
Measure of success	Children grow into healthy, mature, responsible adults	Return on Investment	Profit, Growth, Efficiency
Based on	Cooperation and Effort, Equality among members	Financial goals being met	Conditional based on Performance
How issues are dealt with	Based on family position	Legal system, negotiation	Rational, Analytical, Practical
Succession	Based on family position or authority	Will/Trust/Beneficiary statements	Due to retirement, promotion, departure
Effect on Family Wealth	Consumption	Management	Creation
Commitment	Lifetime – intergenerational	Long term only if meeting wealth goals	Short term based on employment rewards

Understanding the Family Personality Dynamic

Family relationships are what drive the creation of family wealth. It's the relationships between the family members which will determine how financial decisions are made. The issues surrounding money and how it will be used can be some of the most intense in a family business. Emotions can flare up and cause miscommunication and broken relationships between family members.

The real issue is often not the money, but trust. Trust is what makes or breaks most families. It is imperative for a healthy family unit to be based on the family members trusting each other, understanding each other, and communicating with each other.

But how do you create and nourish these kinds of healthy trusting relationships when often times there are deep seated issues or wounds that can prevent this from happening? One of the most productive ways is to create a safe environment which allows for the unbiased discovery of each family members financial personality.

We use a process called Financial DNA which allows for this to happen in a way that brings values, communication styles and potential conflicts to the surface. The first two stages in this process are the same as would be used for an individual or couple. The third stage allows the family members to understand each other's personal <u>vision</u>, <u>passion</u>, and <u>mission</u>. These same values are then determined for the family unit as a whole to determine where the family is going and the proper plan for succession.

What's your vision?
What's your passion?
What's your mission?

Managing Capital, Cash Flow and Liquidity

Do you have a plan to prepare for liquidity events such as?

- Death or disability of a manager/shareholder
- Divorce of a shareholder
- Personal bankruptcy
- Demands for dividends
- Retirement of current owners/managers

Unfortunately many business owners procrastinate and never take the time to plan for these events which can be the cause of the destruction of the business.

Discussing sensitive issues can be difficult. Money and death are two very commonly sensitive issues. Families who plan to continue the business for generations need buy-sell agreements, stock repurchase plans, estate plans, etc. Do you have all of these in place and in writing? Do you review them on a regular basis?

Are you building a **"Sustainable Succession Plan"?** What does your family need to do to create a legacy of business regeneration? God designed and implemented a self-sustaining creation system that works when he built us. How are you going to design a system that keeps regenerating your family business? What is the cycle that businesses go through and what makes them successful at each stage of that cycle? If life follows a birth – growth – maturity – new birth – death model then how will you mimic this model in your family business? The common cycle of family businesses seems to be birth – growth – maturity – death. What's missing? The "new birth" part is what's missing.

Consider building a **"Family Business Incubator".** It is well documented that the birthing process is painful, but an essential element for survival. Studies of animals have shown that the challenge and struggle to be born and survive is what gives the new baby the strength and will to survive. In our own species the children that are raised with no discipline or rules to suffer under, often do not grow up to be successful. All too often the lack of good parenting produces spoiled children, who then grow up to be spoiled adults. Just as in raising children to be successful members of society, we need to continue to create an environment inside the family business which is made up of challenge, discipline, and some struggle. The entrepreneur is successful often times because of their ability to survive the struggle of "birthing" a new business. There are probably some members of your family who are better equipped to birth a new business than they are at being mature business managers. Identify the entrepreneurs in your family. Create a **"Personal Development Plan"** to help the family member understand the character traits they need to foster and the skills they need to develop to be an effective leader in their new business. This new business may be a division of your **"Family Mature"** business that needs to be added to help keep the "parent" healthy. But if the parent isn't growing, then the children aren't growing and the business eventually dies.

Help them write a **"Family supported →← Business structured"** business plan and do the market analysis. This means that you are building a **"Leadership Legacy"** by teaching them how to build a business with their family values wrapped in a business structure. This is how you pass on your Family's **Business DNA**. You are creating a self perpetuating structure that will not only survive, but will thrive because you planted the seeds in fertile soil.

You should consider a variety of methods to compensate the entrepreneurial family member though either direct ownership interests, phantom stock options, or other predetermined methods designed to promote the correct behavior. As an example you could capitalize this new business with 70% ownership by the Family Mature business and 30% ownership by the individual family member. The new entrepreneur's portion could be funded with a personal loan from the **"Family Empowered Bank"**. This means you have capitalized a family bank not only with money, but with the **"Family Business Character"** and values for the purpose of funding new business startups within your own family.

Loaning money to a family member from the Family Bank to finance the startup of a new business can be very powerful. This creates the most effective use of not only your family's financial capital, but also your human and intellectual capital as well. You are creating a very successful business as well as a successful person when it comes with the right mentoring and training to develop not only good business decisions, but also the right character traits that determine long term success. In addition, the interest and principle are returned to the family bank rather than leaving the family system and going to a commercial bank where the money is lost, forever!

Be sure to include education to show the other family members how this will benefit them also. By having the Family Business own 70% you will be giving the other shareholders the bulk of the profits from the success of the business, while at the same time rewarding the entrepreneur for taking the extra effort and risk for starting the new enterprise.

Let me give you an example:

The Borden family has capitalized their family bank with $1,000,000. They have trained their daughter Julia in the business for the past five years and she is now ready to assume the responsibility for starting a new division. Julia goes to the local bank to find out some information about getting a $1,000,000 loan to finance the startup of this new business venture. The bank agrees to give her the loan on one condition; her father, the president of the company, must sign a personal guarantee for the loan and it must be repaid in 10 years. The interest rate is very good, 4.5%. Julia takes the information home and sits down with her father to review their options. She points out that the interest rate from the commercial bank of 4.5% is very low and the money they have in their family bank is earning 6.5% so she decides it would make more sense to borrow the money from the local commercial bank at 4.5%. This would mean a total interest cost of $362,576 over the 10 year term of the loan, while the $1,000,000 left in their own bank earning 6.5% will grow to $1,877,137 over the same ten years so it makes sense to her to use the bank's money rather than their own.

Her father, however, points out that she is forgetting something in her calculations; the opportunity cost of not getting the interest they spent back to compound in their own bank. If they borrow the $1,000,000 from their own bank and charge themselves the same 4.5%, the payments of $136,248 back to deposit into their own bank will grow to $1,958,096 in their bank at the end of the 10 years. And if they leave the money in their family bank for 15 more years, it grows to $5,035,912. The cost recovered in the first year alone is worth more than the total interest they lost over the entire loan from the commercial bank.

This is why it is so important that family members be educated on the often competing needs between leaving capital in the business and paying it out as dividends. Educating family members, particularly those that are not actively involved in the business, about the need to be patient with their capital by capitalizing the Family Empowered bank can help them see the benefits of building a banking system, which in the long run, can generate very significant rewards for their patience. As a family you may wish to develop policies to allow family members to borrow directly from the Family Empowered Bank for personal needs, such as purchasing automobiles or even homes.

Once family members understand the long term benefits they will be much more willing to "invest" their long term capital in the family business instead of wanting to have it paid out to them in the form of dividends.

Other family members may be better at running the mature business, or will have grown into that ability over time. These family members should be groomed to manage a mature business with other family members who are also better built for this stage in the cycle.

Questions to ask yourself

- Have I had my business appraised?
- Do I know how much my estate will have to pay in taxes when I and/or my spouse both die?
- Do I have a plan to pay these taxes without my heirs having to liquidate the business?
- Do I have an investment strategy which will free me from dependence on the success of the younger generation for my income?
- Am I funding a retirement plan which can be separated from my business and will it provide adequate income during retirement or will I need additional income from another source?
- Do we have a formula for expected shareholder return?

Planning an Exit Strategy

There are many different ways to exit your business. Some of the options are:

- Work in the business until the day you die and leave the business to family members as part of your estate
- Choose a family member(s) or employee(s) as successor and train them to take over your management responsibilities while retaining your ownership
- Sell the business to a family member(s)
- Sell the business to a key employee(s)
- Sell to other owners/shareholders
- Sell to a third party
- Hire an outside manager and become a passive owner
- Liquidate the assets

What is your exit strategy?

Why is it important to have an exit plan?

- Creates peace of mind through the development of a plan which is agreed to and shared by all family members
- Eliminates conflicts and emotional decision making often times at the death or disability of a family member
- Protects the business due to lack of trained successor(s)
- Eliminates or reduces the risk of asset concentration, cash flow, and liquidity problems

- Maximizes the value of the business while at the same time reducing capital gains and estate taxes
- Creates a proper valuation for the business
- Allows for greater family wealth to transfer to future generations

Preparing a family and a business for transition involves many issues including business, personal, legal, financial, as well as tax issues and it is very important that the process and all the steps in the process be well thought out and planned for well in advance.

A family business goes through ownership transition in fairly predictable stages:

- First Generation: Owner/Manager Stage - Concentrated ownership around one or two owners/partners
- Second Generation: Sibling/Partnership Stage - Appearance of inactive ownership
- Third Generation and beyond: Cousin/Collaborative Stage - Conflicts often arise between active and inactive owners

What generation are you on in your family business?
Do you have a plan in place to make the transition from the first to the second generation or the second to the third?

Questions to ask yourself

An exit strategy really involves two things; Exiting from the management of your business, and exiting from the ownership.

- Do I have an exit plan?
- Is the plan in writing?
- Does my exit plan involve exiting from management, ownership, one or the other, or both?
- If I exit from the management without exiting from the ownership, have I chosen and trained my successor?
- What skills, talents, and experience does my successor need to gain in order for the business to thrive over the next 20 years?
- Am I willing to relinquish control so my successor can assume the responsibilities?
- Are there other family members who feel this position may be their birthright who have not had an opportunity to express their feelings?

Our Exit Planning Services are designed to cover the following four primary areas:

- **Planning for Business Continuity** – Whether you are turning over the business to children or other family members or selling to a non-family member, it is critical that the continued success of the business is planned for. A critical step is identifying who will be the visionary and how this responsibility will be transferred from the present family member. This can be particularly important if you are providing owner financing and your future income depends on the success of the business.

- **Planning for Family Continuity** – The business is often not the only asset in the family. Even if you are selling your business rather than transferring it to your children there are many other issues which can cause conflict among family members. Planning for the orderly management and ownership of all the assets is a critical step which must not be overlooked.
- **Planning for Financial Continuity** – No one wants to see the fruits of years of labor go down the drain. Planning for the continued financial success of the family members is a very important step. Many times there are family members not involved with the business. Decisions must be made that determine what is equal and what is fair. This often times is one of the hardest decisions parents have to make and understanding the family member's values, passions, and talents can be invaluable.
- **Planning for Philanthropic Continuity** – Many families will establish charitable goals and objectives as part of their mission statement. This can be the passion for some members of the family who are not as interested in running the business. Identifying those family members which have the vision and passion to manage the families "social capital" is important and can contribute greatly to the satisfaction future members will feel about the assets they inherit.

The written Exit Plan we prepare will include the following:

- Goals and Objectives – This section includes the personal and family business and financial goals as well as a contingency plan
- Business Valuation – Fair Market Value and optimal deal structure for the succession, sale, or transfer of your business
- Value Enhancement – Specific recommendations to enhance the value of the business, particularly if the business is to be sold to an outsider. This also provides a score card that ranks your business on key management and performance issues.
- Exit Options – Are you going to transfer to family members, sell to other shareholders, sell to management or a third party, or liquidate the assets? All the pros and cons of these options will discussed and analyzed to determine the best method for you and your family
- Personal Action plan for each family member – What each member of the family needs to do to personally prepare for the transition
- Business Action Plan – What do you need to do to prepare the people and the business and to enhance the value of the business? This section will list the specific steps you need to take to ensure a smooth and orderly execution of the exit plan

Questions to ask yourself

- Do we hold regular shareholder meetings for both active and inactive shareholders to educate the extended family members about the future of the business?
- Do I have inactive shareholders/owners in the business now?
- Do I have a plan to deal with the conflicts which arise between keeping capital in the business to fund future growth and paying out dividends to inactive owners?
- At these meetings do we encourage questions…especially about financial performance, return on investment and future growth plans?

A very important aspect of preparing a written exit plan is that it allows the process and decisions to be shared with all family members and the professional advisors working with the family. Verbal communication can become much distorted after it has been repeated several times. Having the plan in writing will assist all involved with accurate and effective communication.

So when should you start?

It is imperative that you allow enough time well in advance of your actual exit date to prepare the business and people for the transition. It is not uncommon for the process to take <u>three to five years</u> before the owner is ready to fully retire or exit from the business.

What is urgent is not always important and what is important is often not urgent. Please make the time to stop and reflect on what is important, and decide what you need to do today to create a plan for the successful transition of your family and your business

Next steps to implement your 100 year strategic Succession Plan

- Resolve to start exit planning at least 3-4 years before you plan to fully retire from the business.
- Begin to plan for what your retirement will look like. Dream about the things you would like to do that you've never had a chance to.
- Don't be afraid to ask for help. Realize that with help you can align the family, business, and ownership systems to create and implement a successful exit plan.
- Communicate – Hold regular family meetings to educate both active and in-active family members.
- Plan for liquidity events – Incorporate these needs into your strategic planning.
- Know who to call in case of emergency – Build your Board of Advisors as well as your Board of Directors.
- Create and fund a family-empowered bank.
- Communicate to both active and inactive owners the need for reinvestment and a future growth strategy.
- Do estate planning – Value the business periodically and know the potential tax liability.
- Managers are paid a salary; owners receive dividends – don't confuse the two. Pay a fair and market-based salary.
- Encourage questions, especially questions such as:
    - What is our total return on investment?
    - What percentage of our return needs to be reinvested to create future growth and profits?
    - How well prepared are we for potential liquidity events such as death, disability, divorce, bankruptcy, estate taxes?
- Have a formula for expected shareholder rate of return and explain it!

Are you well prepared to exit from your business? Would working with a family business exit planning specialist help? If the answer is yes then give us a call to find out how we can help you design an implement a successful exit from your business and an entrance into the next exciting phase of the rest of your life. **(503) 629-0810**

You also may want to visit our website at www.titanfa.com.