Entrepreneurs and their succession part 1: It's time to talk

Executives & Entrepreneurs

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- Current economic and market uncertainty, particularly around the path for inflation, may make entrepreneurs more worried about the next steps beyond owning and running a business.
- In this piece, the first in a three-part series, we explore how talk and communication are critical to a successful succession or business exit.
- The three ways talk can support entrepreneurs' firm, finances, and family are:

1. Open and dynamic communication can unite families and safeguard the business
2. Talk can build financial (and family) resilience
3. Talk can help founders and firms prepare for change.


Source: Getty Images

Building a business succession or exit strategy can be one of an entrepreneur's best investments.

But in practice, traditional succession approaches can be complex.

Succession and exit often depends not just on business value, but also financial wealth and its ability to support the founder's and their family's lifestyles.

Current economic and market uncertainty, particularly around the path for inflation, may make entrepreneurs more worried about their next steps.

In fact, a UBS Investor Watch survey in the second quarter of 2022 found that 37% of investors were highly concerned about the value of the assets they'd pass on to future generations.

Despite the turbulence, today may be an opportune time to begin, or revise, business succession and exit strategies so they're right for the entrepreneur's particular circumstances.

In this three-part series, we'll show how business owners and entrepreneurs can navigate the business exit and succession journey for their business, family, and financial goals.

We identify three key ingredients to succession or exit, based on experience with entrepreneurs and founders.

In this piece, we'll first explore how talk and communication are critical to success.

Communication matters because succession planning is an incomplete description. A successful business transfer involves three phases:

Succession talk. Succession planning. Succession doing.

Without the "talk" phase around sensitive topics such as transparent decision-making, intergenerational control, and the family's future beyond the founder's lifetime, even the best-laid plans may fail.

In the second part, we'll dive into the commercial and personal wealth planning decisions that drive business transitions.

And in the last part, we'll consider how business owners can execute their succession, exit, or winding up.

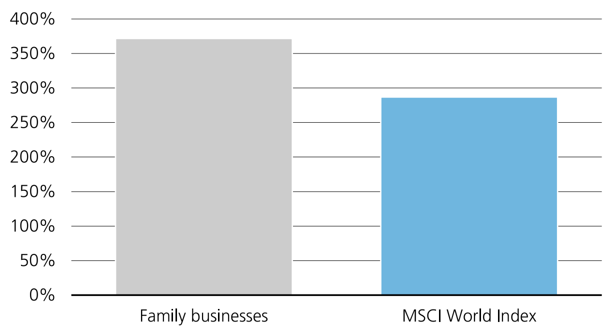
Why does talk matter, especially to family businesses?

Family involvement can be a business's biggest strength, but also its greatest weakness

Numerous studies show that family businesses tend to outperform listed peers. An analysis of the public family firms from the 500 largest public and private ones (where the family owns at least 32% of the shares and voting rights) indicates they generated consistent high-single digit excess return versus global equities between 2000 and 2021, while growing earnings 370% versus 290% growth for developed market equities (Fig.1). Potential reasons include their long-term focus on revenue growth and profitability, lower-risk funding structures, and greater investment in research and development.

Fig. 1: Family firms are outgrowing their listed peers

Growth in earnings per share in USD from 2000 to 2021, family businesses versus MSCI World index (based on current constituents), sector-neutral, equal-weighted companies



Source: 2021 EY and University of St. Gallen Family Business Index, University of St. Gallen, EY, FactSet, UBS, as of May 2022.

But the theory that families work for their collective good is not universally borne out in practice.

One study found that 85% of family businesses are not passed down to the next generation because there has been too little planning for defusing family disputes, or for preparing successors to become successful owners and managers.

What are some of the key challenges?

1) A lack of transparency around decision-making;

2) An inability of prior generations to cede control to the next generation;

3) An over reliance on formal documents like wills, trusts, and expressions of wishes whose contents may only come to light after an emotive family event such as death or incapacity.

Three ways talk can support entrepreneurs' firm, finances, and family

1) Open and dynamic communication can unite families and safeguard the business

Talking can help resolve reservations about passing a business to family members.

A 2018 UBS Investor Watch survey found that 57% of business owners were reluctant to retire and pass on their company because they were concerned family members would take the business in a different direction, or sell it outside the family (Fig. 2).

Conversations about succession are like movies, not photos.

One conversation at a specific moment in time cannot address all the operational issues confronting an ever-changing business. Nor can a single discussion account for a family's evolving financial needs or personal circumstances.

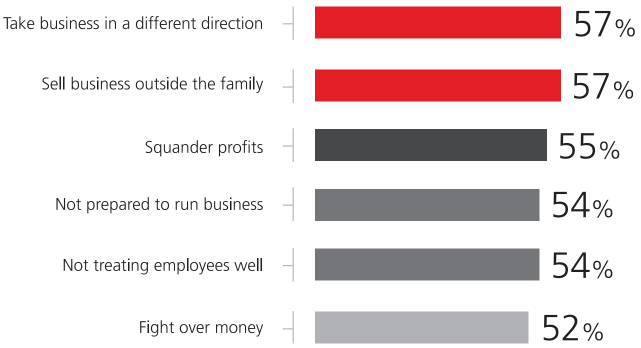
Ongoing communication also encourages the following generations to seek the counsel of family and trusted advisors (who can offer a wealth of experience and institutional knowledge) rather than look for answers elsewhere.

Tools to build effective communication include forming an independent board of directors or drawing up a formal family constitution.

Figure 2: Open communication can help business owners carry out a succession to family

Question: What is holding you back from retiring and passing the baton to the next generation?

Percentage highly worried about what family members will do



Source: UBS Investor Watch, data as of 8 February 2018

2) Talk can build financial (and family) resilience

With family, employees, and stakeholders often relying on a firm for their livelihoods, it can be vital for founders to communicate how their exit plans tie to financial resilience.

Business owners accustomed to holding most of their money in a firm they control may not have the skills or experience to become a wealth manager. Managing a concentrated stock position comes with familiar risks but may jeopardize entrepreneurs' financial wellbeing over the long term.

And challenges during a business sale or exit may show how entrepreneurs' personal and commercial finances are insufficiently protected against potential risks (whether inflation, litigation, or the loss of a key employee).

Trusted advisors can help business owners with this transition and guide on how to manage their single stock position, build financial resilience, and even devise asset protection strategies for peace of mind.

One of the most common—and potentially most destructive—challenges is how to distribute inheritance fairly.

It may seem "fair" to split a family's total wealth equally. But diluting business ownership across multiple generations, including those with no operational role, could lead to inefficient decision-making that maximizes personal gain over commercial profitability. Some family members may need more short-term liquidity than others, so an "equitable" approach—seeking to distribute resources based on each family member's needs—may be another approach to consider.

Trusted advisors have a role to play in:

1. Supporting frank conversations between families and stakeholders
2. Providing impartial valuations of business and non-business assets.
3. Helping set strategy for a family's total wealth today, in their lifetimes, and beyond, such as diversification to replace business income while managing capital for future entrepreneurial ventures or philanthropy.
4. Exploring strategic lending options, including against illiquid business equity, to give the greatest flexibility to prepare a business for sale, seed post-sale opportunities, or fund consumption during the transition period.

3) Talk can help founders and firms prepare for change

Corporate change is inevitable following a sale or succession. But business owners can prepare all parties by anticipating the extent and communicating early to minimize risks of key personnel loss or an erosion of corporate culture.

Conversations can clarify how the nature of the change will impact employees and uncover ways to keep the workforce engaged and productive after the handover.

In the event that business owners are preparing for liquidation, trusted advisors with corporate finance and wealth planning experience can discuss how to separate personal and commercial assets. This crucial step can reduce the risk of creditor claims that reach beyond the scope of the business.

And preparatory conversations with lawyers to set up a power of attorney or expression of wishes can smooth decision-making if a liquidation becomes necessary due to incapacity. Family constitutions or mission statements are also useful additional tools to empower business managers and family members with objective guidance in a potentially emotional liquidation scenario.

Conclusion

Current economic and market uncertainty, particularly around the path for inflation, may make entrepreneurs more worried about the next steps beyond owning and running a business.

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Without the "talk" phase around sensitive topics such as transparent decision-making, intergenerational control, and the family's future beyond the founder's lifetime, even the best-laid plans may fail.

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