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Entrepreneurs and their succession part 2 : What's the plan?

Executives & Entrepreneurs

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- 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 piece, the second in a three-part series, we laid out three ways that commercial and personal wealth planning decisions can drive positive results for business owners, their wealth, and their families:

1. A succession plan can help you allocate capital efficiently and dynamically
2. A succession plan can support the transition from business owner to asset owner—bringing fresh opportunities and risks
3. A succession plan can secure a firm's sustainability and help founders broaden their impact.

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.

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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.

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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 the first piece, we explored how talk and communication are critical to success.

In this second section, we'll dive into three ways that commercial and personal wealth planning decisions can drive positive results for business owners, their wealth, and their families.

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

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

1. A succession plan can help you allocate capital efficiently and dynamically

In family-owned businesses where the current owner is considering their next steps, the likelihood of one totemic family leader passing the entire concern down to another diminishes as families grow.

And as families expand, their capital needs also evolve. Building a capital allocation plan early can be a prudent investment when working closely with entrepreneur families.

The aim of this plan, drawn up alongside the entrepreneur's firm's finance function, accountants, wealth, and corporate finance partners, is to ascertain the amount, timing, and funding sources for funds that each stakeholder may need.

Examples of potential stakeholders may include:

- A holding company responsible for making dividend distributions to owners;
- Operating businesses that need capital both for working purposes and long-term capital expenditure;
- Family investment vehicles that may convert periodic payments from the business(es) to fund an investment plan—the need for careful cashflow planning becomes especially important if the family or entrepreneur invests in private markets with a regular series of capital commitments;
- Charitable foundations or endowments that may rely on periodic distributions from the business for grant making and/or to replenish the asset base from which grants are made.

Capital allocation plans can also help alleviate one of the most common—and potentially most destructive—challenges. That is, how to distribute inheritance fairly.

It may seem "fair" to split a family's total wealth equally, but in many cases this approach can actually hinder the family's long-term goals.

For example, diluting business ownership across multiple generations to include 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. However, in practice, equitable wealth transfers will often appear fair in the planning phase but become unfair later; for example, business assets may appreciate in value at a rate that is different from that of financial market assets.

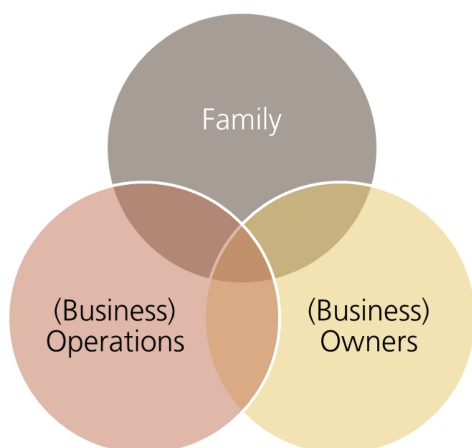
As a first step, entrepreneurs can work to understand how their stakeholder group works, including the motivations, needs, and constraints of different members.

One way to do so uses the model of "family businesses as systems" (as developed at Harvard Business School in the 1980s). It suggests mapping each key stakeholder or family member to three independent but not exclusive systems: family, ownership, and business (operations).[1]

Each group may have its own leader. One heir perhaps may be naturally suited to running operations and another to managing a family's non-business wealth (**Fig. 1**).

The model clarifies inherent tensions and sets boundaries so that family members are less likely to "stray from their lanes." And it can be easily updated as the family passes through the phases of its succession plan.

Fig. 1: An example of a family business mapping to identify different stakeholders and their (often competing) claims on capital



Source: Adapted from "Correlates of Success in Family Business Transitions," Journal of Business Venturing 12.285-501 (1997), quoted in Leibell, D.T. "Succession Planning," Trusts & Estates, March 2011. For illustrative purposes only.

A second step would be to work closely with stakeholders, especially the wealth planning and family advisory expertise, to model potential capital needs across the family's total wealth. Ideally, this identifies who needs money (e.g., the operating company for capex, an owner to support their day-to-day spending, or a family investment officer to meet a private investment capital commitment), the timing and size of the payment, and a clear plan as to how the payment might be funded (e.g., a dividend distribution from a holding company, derived from operating company profits, the sale of a financial asset, or rental income from a real estate portfolio).

Next, an entrepreneur should compare potential capital needs against available funds and decide how to set adjustable capital budgets between his or her different stakeholders.

A well-measured and dynamic capital allocation plan can allow founders and their families to meet financial goals during the lifetime of business ownership and after a succession or exit event. By setting clear boundaries on how much potential capital each stakeholder group is entitled to (or income therefrom), it can minimize the risk of family tensions over money or the risk of inefficient wealth management (like spending above the natural yield of a financial portfolio, forcing assets to be sold and reducing future potential spending power).

Lastly, entrepreneurs can build a so-called liquidity strategy to satisfy the capital allocation plan over the next 3–5 years. This strategy will likely match spending liabilities to a pool of assets including cash, bonds, selected structured investments, and borrowing capacity. Doing so can allow entrepreneurs to reduce the risk of forced selling, while earning yield and having "dry powder" available for potential future investment opportunities.

In the shorter term, expenses up to 12 months out may be best held in cash and the currency of known liabilities, in order to minimize currency, interest rate, or credit risk.

For expenses beyond the next 12 months, a portfolio of high-quality bonds can be a suitable funding source. Given the recent interest rate hikes from central banks, a bond ladder of high grade and investment grade bonds has become significantly more attractive as a tool for funding capital calls over the next 3–5 years. A well-diversified portfolio of longer-dated bonds can also be an important tool in certain circumstances.

Indeed, the average price of high-quality Eurodollar bonds in the 5–10 year tenor stands below par, at 95. If markets begin to price in more economic uncertainty, falling yields could deliver a large price increase in the bond, helping investors potentially benefit from positive convexity as bonds pull back to their par value.

While the rise in short-term rates has increased the cost of borrowing strategies, interest rates still remain very low, below the rate of inflation and the expected long-term return of most investments. Therefore, portfolio loans are likely to remain a valuable tool for funding your short- and medium-term spending needs—especially as an alternative to selling assets after a market downturn.

For more on how to manage a Liquidity strategy, please click here.

2. A succession plan can support the transition from business owner to asset owner —bringing fresh opportunities and risks

An owner's plans for life after the business will depend on a variety of financial and non-financial drivers.

The decision to liquidate a firm, for example, may be driven by a desire to reduce financial distress, minimize the risks from running a non-performing business, or begin afresh. Wealth transfer, both financial and emotional, can typically be the overarching goal for a family succession plan. And for some business owners, the shift to asset owner or wealth manager is through an explicit sale, whether selling a company in the public markets or privately to a competitor, financial investor, or family office.

Succession planning may help clarify some uncertainties arising from a transfer of business value.

Private sale paths, for example, can yield different resource mixes. There is often a trade-off between the amount (and timing) of funds raised against the amount of retained control. A strategic sale—especially to a competitor or trade buyer looking to gain market share and synergies—might yield a comparatively higher financial return in a shorter space of time than would a gradual sale to existing employees or senior managers. However, the latter route might better allow business owners to retain some operational control or cultural steer and aid in a more gradual transition away from ownership.

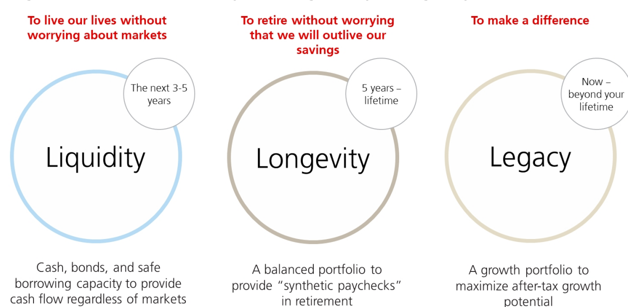
Succession plans built alongside wealth planning, financial advisors, and accountants may help to clarify the post-sale outlook for personal wealth.

As a first step, entrepreneurs will need to be diligent in managing pure financial assets, retained ownership stakes in their businesses, and potential cashflow from ongoing dividend or earnout provisions. External support on cashflow planning and wealth management may help founders make a smoother transition from entrepreneur to asset manager.

Whether thinking of selling a portion of a company, or contemplating a full exit, it is important to make sure that the founders' liquidity event and future income potential will provide them with enough resources to meet their goals.

Using the Liquidity. Longevity. Legacy. Framework (**Fig. 2**) and a comprehensive financial plan can help business owners create a purpose-built investment strategy designed around their family's unique objectives by segmenting wealth and objectives across three strategies.

Fig. 2: The Liquidity. Longevity. Legacy. framework



Source: UBS. For illustrative purposes only.

- **Liquidity strategy.** Assets and borrowing facilities needed to meet the entrepreneur's near-term spending objectives (e.g., for the next three to five years). This strategy focuses on capital preservation.

- **Longevity strategy**. Assets that the entrepreneur will utilize over the course of their lifetime. With short- and medium-term needs met by the Liquidity strategy portfolio, funds in the Longevity strategy portfolio can be invested for the purpose of long-term wealth growth. This strategy focuses on managing the risk of a business owner outliving their wealth.

- **Legacy strategy.** Assets to help improve the lives of others. These are assets in excess of what the entrepreneur expects to need to meet their own lifetime objectives and are free to be invested and disbursed to improve the lives of others. This strategy focuses on wealth maximization, and on effectively passing this wealth across generations and to charity.

UBS Wealth Way is an approach incorporating Liquidity. Longevity. Legacy. strategies that UBS Switzerland AG, UBS AG and UBS Financial Services Inc. and our advisors can use to assist clients in exploring and pursuing their wealth management needs and goals over different timeframes. This approach is not a promise or guarantee that wealth, or any financial results, can or will be achieved. All investments involve the risk of loss, including the risk of loss of the entire investment. Timeframes may vary. Strategies are subject to individual client goals, objectives and suitability.

Second, succession planning helps business owners quantify and measure their financial requirements, a crucial first step to building their investment strategy.

Based on our risk and return expectations, a couple planning to retire and fund 40 years of retirement will need to set aside somewhere between 29 and 34 years of their spending. This lump sum, along with growth and income from the investment throughout retirement, should be enough for a family to manage the risk of outliving their assets. For example, a family spending USD 150,000 per year, with USD 50,000 of pension income, would need to withdraw about USD 100,000 per year from their portfolio. Using this rule of thumb, the family would need to save somewhere around USD 3.1mn to retire safely, and any excess capital could be earmarked for the Legacy strategy and invested for growth for either inheritance or for philanthropic purposes. Naturally, every family's situation is unique, and most will be more complicated than this analysis, but this approach can be a helpful starting point for considering how much wealth the family's business interests will need to generate.

As a next step, founders can consider building a flexible financial plan well ahead of time, in order to plan and prepare for their financial goals through the pre-transfer, transfer, and post-transfer phases.

Investment diversification and choice of vehicles in particular can make a difference to financial outcomes post-transfer, such as the ability to seed a new business or move into retirement.

A particularly important planning consideration for entrepreneurs may be how they manage the risks of holding a concentrated stock position—commonly defined as an equity stake that is 10% or more of a total portfolio allocation.

But for business owners and executives with concentrated wealth that is not in publicly traded securities, we propose the following, broader definition:

A position whose return, risk, or other characteristic dominate overall portfolio performance and the investor's ability to achieve their financial goals.

As part of a financial plan, business owners would do well to consider three ways in which holding a concentrated stock position could be an inefficient way to allocate their post-sale or post-transition wealth:

1. Concentrated stock positions generate less reliable returns

If a business owner intends to use a concentrated stock position to meet future spending needs, it will be important to have the money she needs, when she needs it. Generally speaking, investors prefer the path to achieving their wealth target to be as smooth as possible. That translates into an investment strategy with the narrowest possible band of outcomes, the highest possible share of positive outcomes, and the most potential return for the lowest level of risk.

Statistically, holding a broad equity index rather than a concentrated stock position has led to a narrower range of outcomes and a greater share of positive ones.

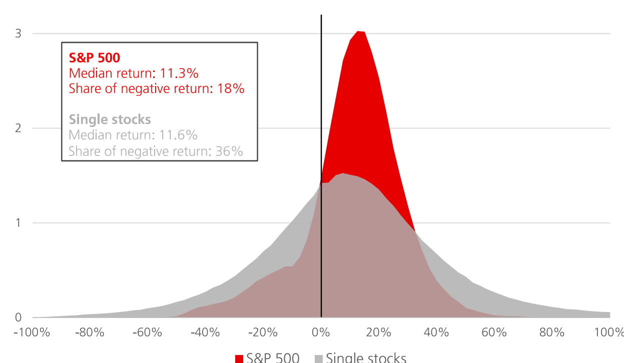
Looking at monthly rolling annual returns data for the S&P 500—the largest and most liquid stock market in the world—from 1990 to 2022, we observe that holding the whole index (**Fig. 3**) would have led to a greater number of observed annual returns around the median, with fewer outliers.

By contrast, holding a concentrated position in the median stock of the S&P 500 index would have exposed the investor to a higher chance of very large positive and negative returns. This is colloquially described as a distribution with fatter tails.

Note, too, that the share of periods where annual returns would have been negative was significantly smaller when holding the index than when holding a single stock (16% versus 37% respectively).

Fig. 3: Higher probability of negative return when investing in a concentrated stock position

Probability distribution of one-year daily rolling returns on the S&P 500 and its constituents, since 1990



Source: Bloomberg L.P., UBS, as of March 2022

Note: The figure displays histograms of the count of monthly rolling annual total return observations of the S&P 500 index and its individual constituents from 1990 to 2022. The set of S&P 500 constituents is updated on an annual basis. Bin width is 1%. 2% of constituent returns were above 100% and are not shown.

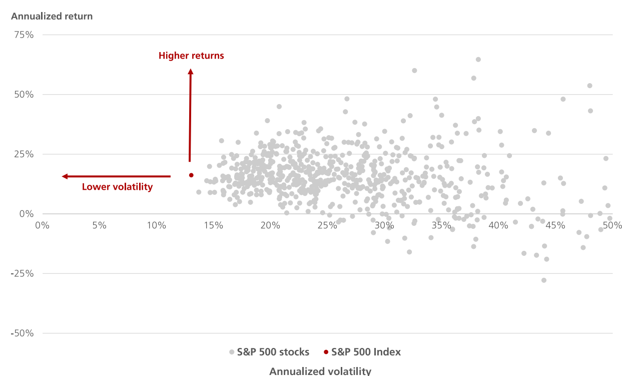
In **Fig. 4**, we further show the inefficiency of concentrated stock positions relative to the broader market.

Essentially, this short analysis shows that over the last two decades, there have been zero stocks in the largest equity market in the world with an annualized volatility lower than that of the market. In other words, there were no stocks with returns that were repeatedly more reliable than the aggregate index through a variety of market regimes.

This suggests that concentrated stockholders can increase the likelihood of meeting future spending needs by mitigating risk through portfolio diversification and not necessarily compromising on returns.

Fig. 4: Holding a diversified portfolio offers better risk-return trade off

Annualized return and volatility data for the S&P 500 and its constituents. Analysis considers data from 1990 to 2022 and contains all stocks that have been constituents of the S&P 500 since 1990.



Source: Bloomberg L.P., UBS, as of March 2022.
Note: Outliers with annualized returns below –50% or above 75%, or annualized volatility above 50%, are excluded. Note the analysis considers the last 10 years of total net return data or since inception. It contains all stocks that have been S&P 500 constituents at any point in the past 10 years.

2. Concentrated stock positions are less resilient to external shocks

If asset prices fall prior to a financial commitment, a founder may have to delay spending until markets recover or sell assets at depressed prices before they have time to recover.

In simple terms, individual stocks are generally more liable to extreme price falls than broad equity indexes. This is because holding a single security exposes investors to company-specific risks from external shocks. Examples include the loss of a key supplier, reputational and litigation damage from an environmental disaster, or a shift in government regulation that suddenly undermines a business model.

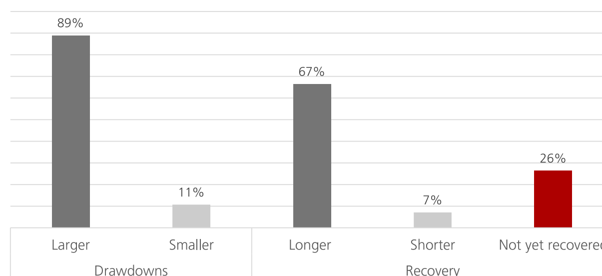
In **Fig. 5**, we use the same S&P 500 index data set from before to show that nearly nine in 10 single stock positions experienced steeper drawdowns (peak-to-trough losses) than the overall index.

A business owner with an appetite and capacity for risk may care less about drawdowns and more about the time needed to recoup losses as a measure of the risk of missing spending targets.

Yet, here too, the data speaks against concentrated stock positions. According to our analysis, single stocks typically require longer to recover from their maximum drawdown. Only 7% of constituent stocks in the S&P 500 recovered more rapidly from their troughs than the index over the last two decades.

Fig. 5: Single stocks with higher drawdowns and longer time to recovery

Comparison of the maximum drawdowns of the S&P 500 and its current constituents. The maximum drawdown is measured over the past ten years using monthly total net return data.



Source: Bloomberg L.P., UBS, as of March 2022
Note: Time to recovery does not sum up to 100, as not all stocks have fully recovered from their maximum drawdown. However, this does not necessarily mean that the time to recovery is longer.

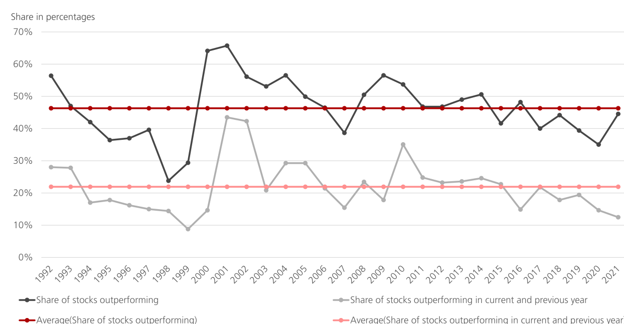
3. Concentrated stock positions may deliver less repeatable results

Concentrated stockholders may have enjoyed strong absolute and relative performance in the past. This experience has perhaps persuaded them that holding the bulk of their wealth in a single position can deliver outperformance year after year. However, data on the broader risk and return of single stocks and the market suggest this is unlikely to the case.

In **Fig. 6**, we use the same S&P 500 data set to show that outperformance typically does not persist. Over the last two decades, an average 46% of stocks have outperformed the S&P 500 in a given year. There have been some periods—such as the early 2000s—when this share has been higher. However, the share of stocks that have outperformed the S&P 500 in two consecutive years falls to only 22% on average. The share of stocks outperforming over two years has not exceeded 50% over the last 20 years.

Fig. 6: Outperformance typically does not persist

Share of stocks outperforming the S&P 500 in a given year and share of stocks outperforming the S&P 500 in two consecutive years using total net return data.



Source: Bloomberg L.P., UBS, as of March 2022.

For more on how to plan and manage a concentrated equity position, please click here.

3. A succession plan can secure a firm's sustainability and help founders broaden their impact

If business owners care about environmental, social, and corporate governance factors as levers of commercial performance, they can use succession planning as a way to ensure ESG passes down to the next generation of company leaders. This may make particular sense if a business's sustainability goals make objective commercial sense.

Well-constructed sustainability policies can play an important part in a business owner's succession planning process. We note that external buyers (whether trade, strategic, or private equity) increasingly demand sustainability data alongside administrative and financial information when appraising a potential target. A growing number of businesses will use the sustainability profile of a business as a criterion for assessing the ease of assimilation in the parent company, any estimates of future profitability and, by extension, the appropriate offer price.

By contrast, business owners that task their business with tackling the sustainability problems they most care about—though they may be less relevant to operating performance—risk seeing their efforts undone after an external sale. Even in the event of a family succession, future generations may reappraise the company's purpose and decide to pivot to more material sustainability issues.

Business owners may also use succession plans that cover their total wealth to understand how they might be able to support different sustainability goals over different time horizons using different tools.

For many business owners, their largest pool of capital—and their greatest potential for delivering social and environmental impact—lies with their operating business. This may be the part of an owner's total wealth where they can seek both commercial and societal returns.

Sustainable and impact investing approaches increasingly allow business owners to use their longer-term capital—whether for their lifetimes or beyond—to address environmental and social challenges through market mechanisms. UBS CIO has designed a sustainability scoring methodology that allows investors to use their investments to tackle the causes they most care about in six fields: pollution and waste, climate change, water, people, products and services, and governance.

Some sustainability challenges cannot yet be solved commercially or through capital markets alone. Nevertheless, business owners whose succession plans reveal excess funds after a sale or liquidity might want to consider impact philanthropy, social finance, or catalytic capital approaches to address deep-seated sustainability challenges.

These approaches go beyond traditional giving approaches by tying donations to objectively measured outcomes or by funding the necessary investments to unlock private-market investment (through derisking projects or lowering financial barriers to entry).

For more detail on how to align interests, investments, and impact, please see "The New Continuum," a paper from UBS's Family Advisory and Philanthropy Services and Family Office Services Group.

Business owners can use their money to support their personal sustainability passions. But we believe they are most likely to make the biggest difference—in meeting both their financial and sustainability goals—if they carefully consider sustainability as part of their succession plan and align their total wealth with their values.

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.

In this piece, the second in a three-part series, we laid out three ways that commercial and personal wealth planning decisions can drive positive results for business owners, their wealth, and their families:

1. A succession plan can help you allocate capital efficiently and dynamically
2. A succession plan can support the transition from business owner to asset owner—bringing fresh opportunities and risks
3. A succession plan can secure a firm's sustainability and help founders broaden their impact

[1] Kelin E. Gersick, John A. Davis, Marion McCollum Hampton and Ivan Lansberg, *Generation To Generation, Life Cycles of the Family Business*, Harvard Business School, quoted in Leibell (2011), op.cit.

Appendix

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