Success through succession planning

Helping New Zealand small businesses prepare for the coming wave of retirement

Executive Summary

A recent Xero survey found that almost 10% of business owners would like to retire in the next year. Statistics New Zealand numbers suggest, up to a quarter could leave their business within 10 years. Hardly any of those business owners have a succession plan, which means:

- they're unlikely to get the best sale price for their business
- their standard of living in retirement may suffer as a result
- the buyer may have a harder time making the business succeed

Stepping away from a business is a massive life event. Owners can be overwhelmed by emotion, leading to procrastination and poor decision-making.

Small business advisors, brokers, and policy-makers have created this report to help New Zealand business through this transition. Its recommendations include:

- increased promotion of and education about succession planning
- research to better understand the implications of ageing owners in New Zealand's small business sector

> "We've got this massive retirement tidal wave coming at us and we aren't prepared to provide small businesses with guidance and care.
>
> GLEN WILLIAMS

* Unless otherwise stated, numbers in this report come courtesy of Statistics New Zealand

Background

Professionals who serve small businesses agree that most owners don't have a succession plan. This potentially undermines the price they'll receive when selling their business, and the quality of retirement that follows. It also diminishes the quality of the handover to the new owner.

As many business owners are now approaching retirement age, Xero has recognised that succession planning is a major issue and has convened a working group of industry leaders to explore how succession planning could be improved.

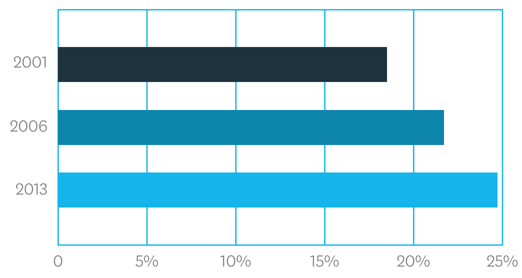


Figure 1, Percentage of New Zealand business owners aged 55-64. Almost a quarter were over 55 by 2013.

A mass exit is coming

More than 90,000 businesses are owned by people aged 55 and over. Most of them will exit from their business within 10 to 15 years. A recent Xero survey found 8% of all business owners are hoping to retire in the next year alone.

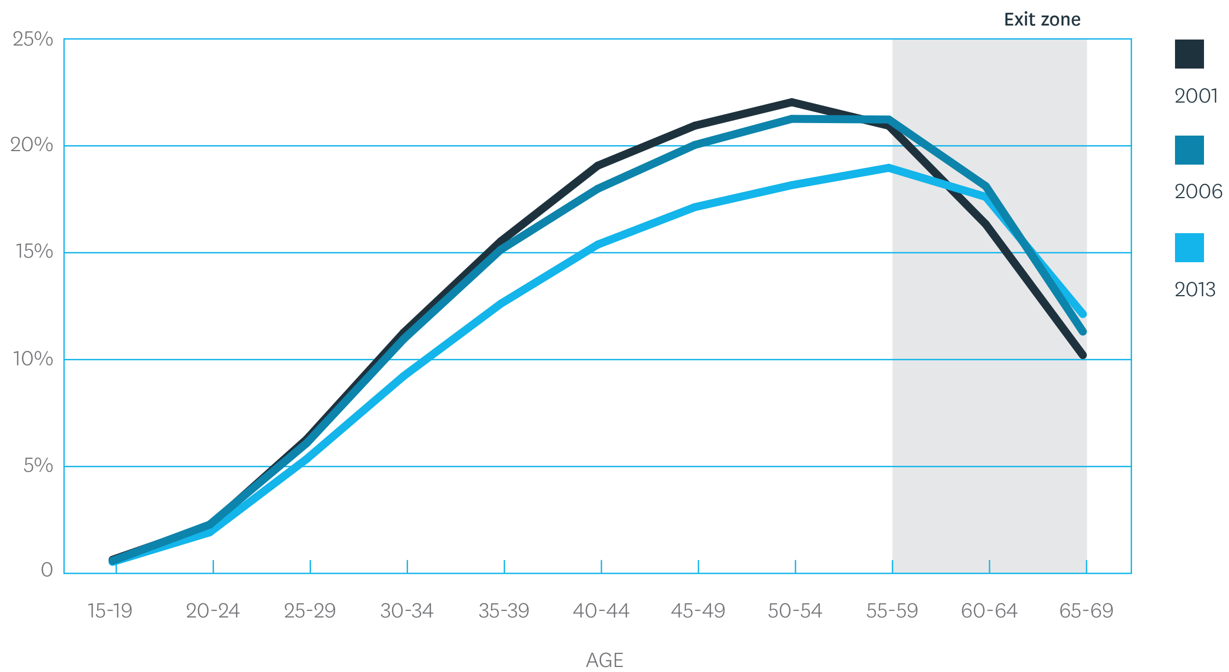


Figure 2, Percentage of people who own a business in each age group. The exit zone (grey) shows that people start leaving businesses in their 60s.

Retirements at stake
The retirements of those outgoing business owners could hinge on:

- whether or not they find a buyer
- what price they can get for the business

Business and economic risks
Businesses without a succession plan are less likely to thrive under new ownership. A quarter of New Zealand small businesses are about to experience this vulnerability, which could have knock-on effects for the wider New Zealand economy.

Figure 3, Importance of small business to the economy. Businesses of 50 or fewer employees contribute hugely to New Zealand's gross domestic product and employment.

> “A lack of succession planning can lower the price owners get for their business, and diminish the standard of retirement that follows.

Where succession planning goes wrong

The small business advisors, brokers, and policymakers who attended our workshop were asked where succession planning typically breaks down. They identified several areas.

Forming an exit strategy
Owners don't understand the importance of succession planning. They haven't thought about whether they'll sell to family, staff or the highest bidder. And when the time comes to move on, they find the emotions difficult to deal with.

Getting ready for sale
Owners don't realise how long it takes to get a business ready for sale. As with selling a house, there's a lot to prepare before the sale process even begins. They don't know what their business is worth, or what they could do to boost its value. Many don't keep enough financial records for buyers to judge the business on its merits. And they're poor delegators, which can mean the business will struggle without them.

Making the business sale
Owners don't know how to put together a pitch that summarises the opportunity to prospective buyers. They don't know when to get a broker involved, or how negotiations play out. And they don't realise that sometimes they might get more for their business by breaking it into its component parts.

How can we fix this?

1. **Get small businesses to think about succession planning**
   Most businesses overlook succession planning because they're preoccupied with day-to-day operations and medium-term goals. We need to help them prioritise succession planning by:
   - encouraging advisors to bring it up with their clients
   - running a wider campaign to reach businesses who don't have an advisor

2. **Help people come up with a succession plan**
   Succession planning is a big topic, and it's hard to know where to start. Business owners and their advisors need a playbook to help them plan effectively. Xero's working group has started producing this educational material.

3. **Make New Zealand businesses more efficient**
   Efficient, well-run businesses are attractive acquisitions. They require less effort to manage and expenses are well controlled. Business owners should be encouraged to introduce formal systems and automated processes to help make their business more marketable.

4. **Learn more about New Zealand's ageing business sector**
   The average age of New Zealand business owners is climbing and is increasingly dominated by people aged over 45. We don't fully understand the causes or effects.

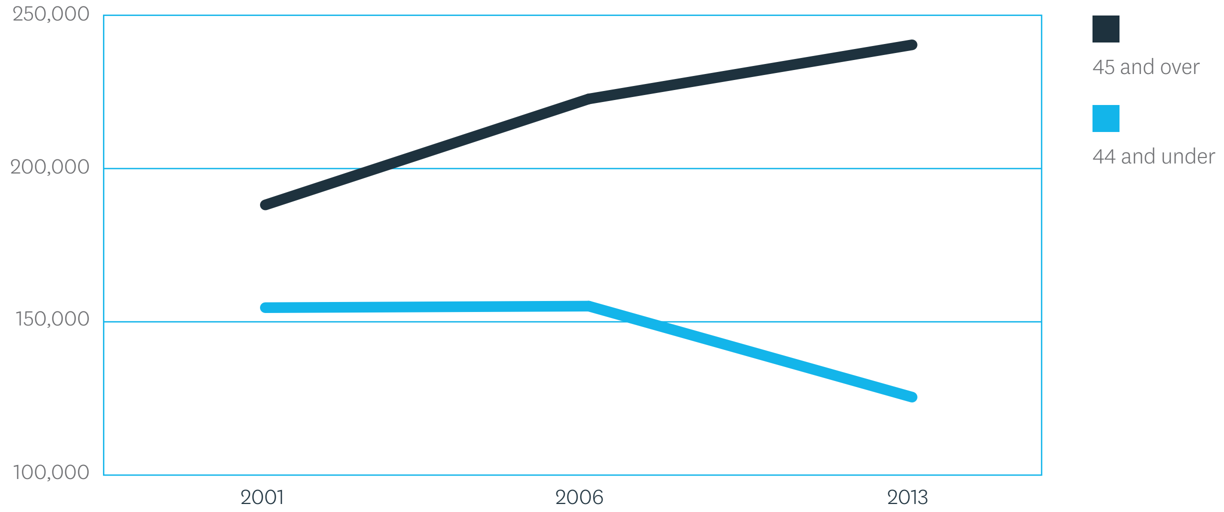


Figure 4, Number of business owners under and over 45. Business ownership is growing among older groups and shrinking in younger groups.

To help investigate and manage this phenomenon, we need research asking:

- **How much money are retirees leaving on the table?**
  While we know that inadequate succession planning leads to poorer outcomes, the evidence is anecdotal. Quantitative data would help establish the true scope of the issue.
- **What happens to businesses after they're sold?**
  Poor succession planning also affects the buyer, but we're not sure how much. The relationship between succession planning and post-sale success needs to be measured.
- **Why are fewer young people entering business?**
  Our ageing business ownership reflects a lack of young entrants. What's holding them back? Is the small business sector at risk of shrinking?

Conclusions from the working group

Most small business owners leave their business by their late 60s. Professionals who serve the sector say hardly any of them have a succession plan. This diminishes the sale price they receive at exit and could limit the long-term prospects of the business itself.

A quarter of New Zealand business owners will reach their late 60s in the next 10 years, meaning there'll be up to 90,000 exits in that time. How many of those owners will leave money on the table?

Our working group recommends further research into succession planning and issues related to New Zealand's ageing small business sector. In the meantime, the industry needs to work hard to improve succession planning for the sake of outgoing owners and the businesses they've built. This should start with a publicity campaign to get a dialogue going with small business owners.

What a business sale should look like

EMT Services

- Internal demolition/strip-out specialists.
- Founded 2002.
- Sold 2017.

Terry and Janet Kendrick were more nervous about selling their business than they'd been about starting it. "We expected it to be a drawn-out process for our little business, and no one would be interested," Terry said.

ABC Business Sales broker, Gerard Dunne, was more confident. "Owners often focus on the things they think aren't so great about their business," he said. "But Terry and Janet had a good operation – and they were committed and open vendors."

"A lot of owners start out feeling intimidated. They worry they'll have to open up their books to a stranger in a suit who'll want to pry into information they've traditionally held close. In this case, we built trust very quickly. They were very helpful in assembling the information to explain the business coherently."

The business sold inside 10 weeks, for six times more than the Kendricks expected.

Gerard says it helps that the business was sale-ready. The Kendricks maintained clean accounts and good processes – and they knew what was going on.

"They were able to explain everything. What was driving revenue. Who their big customers were. Why the gross margin and expenses looked the way they did.

"It was a business that could be transferred to someone reasonably easily. And that was proven because we sold it to someone who had no background in construction."

It was a textbook sale:

- a solid business
- committed and open vendors with accurate records
- computerised systems to support operations
- a clear explanation of how the the business worked
- enough homework had been done to satisfy buyer scrutiny

> “We’d have been over the moon if we got a sixth of what we did.

TERRY AND JANET KENDRICK


FOR SALE

Improving succession planning in New Zealand business: a guide for advisors

How accountants and bookkeepers can support small business as baby boomers leave the sector.

It’s up to us

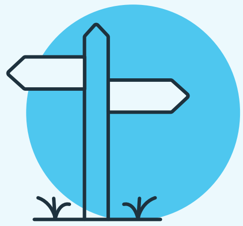
Transitioning owners out of a business involves accounting, counselling, valuation, negotiation and contract law. No single professional can handle it all. But business owners need someone they can trust and rely on throughout the process.

As the primary advisors to small business, accountants and bookkeepers can play a role at each stage, including:

- forming an exit strategy
- getting the business ready for sale
- selling the business

Phase 1: Forming an exit strategy

It can take two to three years to prepare a business for a successful change of hands. It's a complex process with many decision points. Advisors need to focus their clients on exiting the business long before they're ready to go. And they also need to help clients think rationally in spite of all the emotions associated with moving on.



1.

Start planning now
Most owners don't think about leaving their business until illness or some other life event forces their hand. This results in a hasty exit strategy and, ultimately, a lower sale price than they might have achieved. Lack of preparation by the seller can adversely affect the incoming owner too. Business owners may overlook exit planning because they're:

- too distracted by day-to-day tasks
- daunted by all the unknowns
- reluctant to think about life after business

Advisors can help them think ahead. You can begin the conversation by asking how they want to exit the business – you don't have to talk about when. Identify the risks of rushing a sale and use that as a reason to start preparation now.

2.

Who will the the business go to?
Find out if your client intends to transfer ownership to family, staff members, or a buyer on the open market. Their preference will shape your succession planning advice.

- *If selling to family,* the plan will need to stress fairness to everyone involved. This is especially so if two or more children enter a partnership to buy the business. Blended families (which involve children from past relationships) pose even more challenges. Allow sufficient time in your planning to settle on a fair and equitable outcome for all family members
- *If selling to an employee,* there's more likely to be a staggered sale. The new owner may only be able to afford a deposit and wish to pay the rest from business income.
- *If selling on the open market,* record-keeping becomes crucial. Someone who isn't already familiar with the business will need clean financial reports, and documents explaining how the business operates.
- *If selling to an immigrant*, it could take a little longer. Many migrants come to New Zealand on entrepreneurial or investor visas, and want to buy a local business. They'll often seek help and advice from their co-ethnic community. You could position your business to appeal to these economic migrants. Be aware that this type of sale may take longer, as your potential buyer works through familiarity with New Zealand business laws and conditions.

3.

Will it be a clean break or a slow transition?
Some people like to stay involved in their business after they've relinquished ownership. (This is more common when the enterprise is transferred to family.) Your client's preference will shape the succession plan. If they want to act as an advisor or consultant, they may be best to remain as a shareholder or director. That will give them an opportunity to collect dividends and directors' fees through retirement.

The seller's capital requirements may also affect this decision. If the seller wants or needs all their capital released immediately, then an external sale may be the only way to go. If the seller can leave money in the business to help finance the new owner, they may want to have a closer involvement to protect that investment.

4.

Don't ignore the emotions
Owners dedicate extraordinary hours of effort to their small business, going through many highs and lows along the way. This creates an emotional attachment that can be hard to break. These feelings play an even larger role when it's a family business. Unchecked emotions can cause tension, interfere with communication, and affect decision making. Try to remove this volatility from the process.

- **Be more than a numbers person**
  Help clients recognise when emotions are running high. If they're really struggling, consider involving a professional counsellor.
- **Encourage rational thinking**
  There'll be times when clients avoid tough decisions or succumb to biases – for example, by over inflating the value of their business. Ground them when you can.
- **Be sensitive to family issues**
  Selling a family business can be especially fraught. Emotions can run very deep. Do what you can to make the process transparent and fair to all family members.

5.

Take away the fear of the unknown
You'll do a huge service to your clients simply by telling them what's involved in succession planning and selling a business. Without that knowledge, the process will seem daunting and unachievable. It's important to set expectations around timeframes. Make it clear just how long it could take to get the business in ideal shape for a sale.

Phase 2: Getting the business ready for sale

Most businesses can improve profitability and boost their asking price. Advisors can lead this work, helping owners clean up their accounts and optimise their operation. These are important steps, even if the business is being sold to family.

1. **Play the long game**
   Advisors should begin preparing a business for sale long before a broker is involved. Starting two to three years out, help your client get their accounts in order, find ways to improve profitability, formalise internal systems, and automate processes where possible. Besides lifting the sale price, taking these steps will improve business performance during your client's final years as owner.

2. **Invite other experts**
   Invite advice from other professionals to help prepare the business for sale. An advisory board could include a lawyer, an additional accountant, a marketer, a trusted business mentor, or any other experts you might need. An advisory board can be particularly useful in providing an independent voice when families are involved.

3. **Allow plenty of time**
   You know it takes years to improve business processes and enhance value-drivers. But it takes even longer for those gains to show on the books. Most buyers will look at two years' worth of financial data, so build that into your timeline. That's why it's important to get your client's business sale-ready, even if they don't imagine selling it for years.

4. **Teach the business to survive without its owner**
   No one wants to buy a business that relies too heavily on its owner. Your client needs to make themself replaceable. Suggest they start by cutting back to four days a week. If they're not able to, it's a warning that their business isn't sale-ready.

> “It is not unusual for business owners to form an opinion of what their business is worth based on information from family, friends, and of course by trying to interpret all sorts of information on the internet. I have seen instances where initial expectations are wide of the mark by a factor of two or even three.
>
> GERARD DUNNE, ABC BUSINESS SALES

5. Make the business more valuable

Help your clients identify the value drivers in their business. Make a note of things like product differentiation, market share, customer loyalty, intellectual property, and experienced staff. Equally, look for things that would worry prospective buyers.

Make a plan to fix the weaknesses and consolidate the strengths. This will require discipline so get clients to commit to a timeline. Find a business mentor – maybe it’s you – to hold them accountable. Otherwise it won’t get done.

6. Get all the records into good shape

Accurate and up-to-date financials are a must. If you’re fixing up a history of poor accounting in the business, your client will need to wait until the clean data flows through. Most buyers will want to see two years of reliable records.

Many small businesses optimise their tax planning by legitimately classifying some discretionary private expenditure as business expenses. Removing these expenses from the business can positively impact the sale price, so start as early as you can.

And remember to make sure that employee history is well documented and up-to-date.

7. Document systems and processes

Ensure business procedures are written down so new owners can use them as an instruction manual when they step in and start running the business. Xero research into accounting businesses has found that those with documented systems and processes are easier to sell – and sell for a premium price of up to 100% more. If accountants prefer to buy well-prepared businesses, so will smart business people.

8. Seek advice on a realistic sale price

Some owners will find information about industry multipliers and cobble together their own valuation of the business. These are often inaccurate, and generally high. Suggest your client obtains an expert guideline valuation so they have a better idea of where their business sits.

Phase 3: Selling the business

Selling a business is a once-in-a-lifetime event for most owners. There are a lot of unknowns, which creates anxiety. There'll be other professionals, such as brokers and lawyers, to manage this process, but advisors can be a trusted voice in the room.

1. **Assess prospects for the business**
Before formally valuing the business, there'll be a broader assessment of how it's doing. Financial and non-financial assets will be identified, and drawbacks flagged. There may be tough decisions to make. For example the business may not sell as a going concern. It might need to be broken up into separate assets.

2. **Develop a sales pitch**
Owners need a compelling story to tell about their business. It should explain why and how they started, and summarise the journey so far. The narrative should be positive and point toward a bright future – but it needs to be grounded in fact. Use metrics to support the story.

3. **Get an independent valuation**
There'll come a time when a value is put on the business. A specialist appraisal will provide this but it's only a guide. Don't let your client become completely anchored by the valuation. If they sell on the open market, the business is worth whatever someone will pay. If it's sold to family or an employee, the valuation will need to be agreed upon. And in that case, tax advisors usually come in to advise on tax planning and shareholder options.

4. **Look for buyers**
If your client is selling on the open market, they'll need a broker to connect them with buyers. Some deals are done through the broker networks, without openly advertising the business for sale, but your client shouldn't count on that. They'll probably need a budget to market the business.

5. **Do a deal**
A business broker will usually act as facilitator in the negotiation phase – helping buyer and seller agree on a value. To the owner, this can seem like the finish line, but there are many steps still to go. Help keep them grounded through these final steps:

- Drawing up a contract
- Usually a small team of experts, including lawyers, will take care of this.
- Carrying out final due diligence
- Buyers will run some final checks and can still pull out if something worries them.
- Transacting the business sale and purchase
- There might be a staggered sale or an outright transfer of ownership.

Stepping up for New Zealand small businesses

A quarter of small businesses are likely to be sold in the coming decade. Tens of thousands of retirements could hinge on the outcomes.

Small business advisors are uniquely placed to influence this transition. It's a big responsibility but also a massive opportunity.

Use these guidelines to talk about succession planning with your clients. And where you lack knowledge, link with fellow advisors to fill in the gaps. Small business is the backbone of the economy. Let's keep it that way.

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