

SUCCESSION PLANNING

RISK MANAGEMENT

Plan B: Prepare for the worst

ANTHONY DAVIES

SUCCESSION planning isn't just about having a plan for exiting your business in an orderly fashion, it's also about having a back-up plan if the unexpected occurs.

And the unexpected happens far more frequently than business owners count on. For example, a business owner has a 13% (one in eight) chance of dying before the age of 60, and a one in three chance of being incapacitated by illness or accident for at least six months.

Hayes Knight director Aaron Wallace says risk management is a vital but often overlooked part of succession planning.

"Even if you're not looking to sell your business in the short to medium term, to command top dollar or even to be in a position to actually have a business to sell, you must be prepared for:

- A sudden illness, term disability or death;
- A planned management buyout (MBO) falling apart and no longer being an option;
- A problem with a generational succession plan (maybe because of intractiveness, better options, illness, etc.);
- A competitor or strategic partner making an offer to buy you out as they seek growth. Could you demand a premium?
- A sudden change in plans by one of your co-investors/shareholders.

Risk management is a vital but often overlooked part of succession planning.

Business owners/senior management should be constantly looking to identify and reduce business risk, forming strategic growth plans, passing an annual "warrant of fitness" and removing dependence on owners (including reliance on their personal networks).

It comes down to not being a forced seller, says Kensington Swan senior associate Chris Parke.

"Failure to properly address succession planning issues at an early stage can severely damage the saleability of a business, and in doing so limit stockholders' exit options," Parke says.

"Where exit options are limited, then price inevitably gets squeezed, as stakeholders look to implement an exit plan over a short period of time. If a planned approach to succession is implemented, stakeholders are likely



Hayes Knight
director Aaron
Wallace.

to have much greater options available to them, creating a cleaner, more orderly exit at optimal value."

It's an area in which Cecilia Farrow specialises. Farrow is the managing director of Tri-plejunn, a

nationwide franchise specialising in personal and business risk for small and medium enterprises (SMEs). Her job is getting business owners to think about the unthinkable.

"When the owner of a business dies the shares or ownership of the business may become part of the deceased's estate. Assuming a valid will is in place and it is given probate, the ownership will pass to whomever the deceased has bequeathed. Most commonly this is the surviving spouse or life partner," she says.

"This may create significant problems for the remaining business partners. The spouse may not have appropriate skills to make a contribution to the business but may have an ongoing need for income in the form of dividends or profit share and be therefore reluctant to sell. As a shareholder they may therefore be entitled to income despite making no contribution to the success of the business.

"Alternatively the spouse may not want future involvement in the business and may want to sell the shares to the highest bidder. This may give rise to substantial costs in legal and accounting fees as a fair and equitable settlement is sought."

The solution, she says, is not just to have a shareholders' agreement in place from day one, but also appropriate insurance cover so it can be implemented because buying out an incapacitated or deceased business partner will require the kind of capital which the surviving/remaining partners may not be able to source at short notice.

"The death or serious disablement of any one of the owners may cause revenue to decline and costs to increase, especially if the person's skills need to be replaced. Obtaining loans at a time when profit is at risk can be difficult, especially if other business or personal borrowings exist."

This issue can be addressed by the business buying life insurance cover for each shareholder with the sums assured being at least to the pre-

such as accountants, lawyers, banks, business consultants/coaches, insurance and business brokers seem to have the answer, or at least that's what they're portraying in their marketing material.

"In fairness, each of these advisers does have something to contribute in a successful handover, however if used collectively the outcome can provide a special result.

"Using them all sounds expensive, but it doesn't need to be. You should choose one as your trusted adviser, the big picture thinker, and allow them to assist you to 'conduct' an exit plan."

Getting the books in order is an



DEATH AND DISABILITY STATISTICS FOR BUSINESS

For a partnership with four people, the following are probabilities of:			
Average age of partners	Probability of at least one dying before age 65	Probability of none dying before age 65, but at least one becoming disabled for six months or longer	Probability of all four surviving and not becoming disabled
35	51%	20%	29%
45	48%	19%	33%
55	38%	16%	46%
For a partnership with three people:			
35	41%	20%	39%
45	39%	18%	43%
55	30%	14%	56%
For a partnership with two people:			
35	30%	16%	54%
45	27%	15%	58%
55	21%	11%	68%

Source: Mortality: NZ Life tables Disability: Davies Financial and Actuarial (2004)

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agreed value of their shares. She adds this should be linked with a buy/sell agreement stating that upon the death or disablement of any shareholder, his or her shares will be sold to the remaining shareholders.

While most business constitutions allow for pre-emptive shareholder rights to buy out a deceased, disabled or retiring shareholder, Farrow argues these don't provide enough certainty.

"Surviving shareholders have the option not to buy and the estate has the option not to sell."

In other words, the remaining owners could end up being in business with their former partner's spouse or children who know nothing about the business.

In its business insurance guide, life insurer American International Assurance also outlines other potential losses/liabilities a company can address through key person insurance:

- Lost profits otherwise generated by the key person;
- The additional costs incurred in securing and integrating a suitable

replacement into the business.

- Customers and/or valuable contracts that may be lost or unable to be completed;
- Loss of market share as competitors take advantage of the situation;
- The personal liability of directors if they have allowed the company to trade recklessly (for example, if the directors "cause or allow the business of the company to be carried on in a manner likely to create a substantial risk of serious loss to the company's creditors.") (s135 of the Companies Act 1993).

Selling your business – there's no time to lose

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"Seek proper advice, and seek it now. Many owners are attending seminars, reading books and articles or seeking lazy advice – that is, they're looking for professional advice but they're not willing to pay for it, therefore they're getting mixed or incomplete messages.

"The old New Zealand ego and No 8 fencing wire mentality is prominent and disadvantaging vendors," he says.

He adds that no one profession has a monopoly on good advice, so it pays to get advice from a range of sources. "Advisers from many industries

obvious place to start. This includes getting any family members on virtual securities off the payroll and getting personal assets off the balance sheet. The aim is to be able to present the potential buyer with a "clean" set of accounts requiring as few adjustments as possible.

Business broker Max Heron, of Corporate Link, outlines issues vendors need to address in his article, "Tips when valuing a business."

"Many of our business owners will not have any quans about adding the home insurance to the business accounts, or taking the partner on that overseas business trip and travelling business class as well, all

to save 33% tax.

"A sound business with history and a good set of financial accounts can command between 3.5 and 4.5 times the pre-tax earnings, or between four and seven times the after-tax management earnings. So what is the point of pinching, say \$10,000 out of the business, when by so doing, \$40,000 to \$50,000 is lost in the business's total value? It's a high price to pay merely to reduce tax."

In other words, the key to getting top dollar is to maximise the value of the business in advance, which may mean not being too aggressive on tax planning.

Deloitte corporate finance &

growth solutions associate director Audrey Williamson says getting the financials sorted is just part of it. Every aspect of a business needs to be worked through.

For example, if a business's location is a major selling point, how long does the lease have to run? How robust are staff employment contracts, contracts with clients/suppliers or any intellectual property or licences?

"Get the skeletons out of the cupboard and try to anticipate any problems," she says.

■ Anthony Davies is managing editor of financialart.