Spring Street Financial

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HOW WILL YOUR BUSINESS ENDURE WITHOUT YOU?

Five straightforward business succession planning steps to help your business gain a tactical advantage today — and in the future

Planning for your business's future without you can reap tactical advantages today while providing the foundation for your business to prosper long after your tenure. Here's how to get the process started.

It's been said, "It's not personal; it's business."

But you know this idiom couldn't be further from the truth. As a business owner, you've sacrificed time with friends and family, taken some risks and had more than a few sleepless nights. You leaned on your instincts and know-how to push through those critical first few years to build something that, today, supports your family, your employees, customers, and your community. Business, to the contrary, is highly personal. Indeed, 84 percent of business owners said in a recent survey by Northwestern Mutual that they have a strong emotional attachment to their business.

That's why it may be difficult to ask yourself a critical question: "How will my business survive without me?"

It's not hypothetical. At some point, whether it's a few years or a few decades from today, there will come a day when you will leave your business. And while it's never easy to think about, it's possible something unexpected may happen to you or a key member of your staff. What would happen to your business in that situation? You're not alone if this question keeps you up at night: 65 percent of business owners are worried that, without them, their business may falter. Yet our research found that only 34 percent of business owners have taken steps to build a full succession plan. Now is the time to build your plan, and we can help.

ONLY
34%
of business owners have a fully formed succession plan

Why now?

A succession plan charts a future course for your business, but there are also tangible benefits you'll reap while you're still at the helm. For starters, you may sleep better at night. Identifying and nurturing key employees can be a powerful talent retention tool. What's more, customers and suppliers often prefer working with businesses that have a strong succession plan in place to ensure stability. And a full succession plan will protect your business if something unexpected should happen. In other words, holding off on planning for tomorrow could cost your business today.

We're here to help you take control and build your plan — it's easier and less time-consuming than you might expect. We'll take you through some of the findings from our survey to show you where other business owners are in this process and provide concrete steps you can take to build a succession plan with your advisory team. We want to help you exit your business on your terms while providing a firm foundation for the next generation.

ABOUT THE STUDY: Northwestern Mutual teamed up with Forbes Insights to survey 222 business owners with at least $1 million in net worth to learn the condition of business succession planning and how business owners feel about their plans in 2021. The data in this paper is from the survey unless otherwise noted.

STEP 1: START WITH YOUR GOALS

A good business succession plan begins at the end. It's important to think through a few key questions, as the answers will help determine the best path forward. Building a succession plan isn't a one-size-fits-all strategy — every business is a little different. Instead, view these questions as thought starters to get some ideas flowing. Your advisory team can be a big help here, as they'll be able to match their expertise with your unique aspirations for the business you built.

74%

of business owners want to take steps to ensure their business lives on long after they're no longer running it

When do you want to leave?

How much longer do you plan to be in control of the business? Are you planning to leave at a certain age or valuation or another milestone? Will you step down immediately, or are you planning for a more gradual transition from the business?

What's next for you?

Are you interested in starting another business, or will it be time to enjoy the fruits of your labor and fully relinquish the duties and stress of leading an enterprise? Are you planning to retire? Or would you want to stay on as a part-time consultant after you sold your business interest? This is often the case when an owner sells the business; they stay on as a regular "employee" at reduced 1099 wages to help the new owner get up to speed.

Who will take over the business?

Do you want a co-owner to buy you out? Do you want someone in your family to take over? Will you transfer ownership to a talented employee, or will you sell to a third party?

What's your business worth?

Businesses have a range in value, and understanding that range in business value is critically important in selecting various buyout options when selling your business. When you're selling to third parties, it's important to get an accurate valuation of your business and get the best price the market allows. However, if you're gifting the business, you'll want to consider strategies to minimize its value for tax purposes. Your advisory team can help you strategically value your business based on your goals.

How much do you need from the business?

How much money do you need from the business to reach your personal financial goals? How much of a financial burden are you comfortable passing on to your successor? An advisor will help you consider the tax implications of every option. Your advisor can also connect succession planning to your personal financial plan to ensure that you're meeting both your business and your personal goals.

These are just a few basic questions you'll want to address, but they should lead to a rich discussion with you and your advisory team as you work together to craft a succession plan that's tailored to you.

TOP 5 SUCCESSION PLANNING CHALLENGES CITED BY BUSINESS OWNERS

1. Setting a succession strategy grounded in data and performance metrics, not gut instinct
2. Finding candidates who understand the business and its customers
3. Transferring critical knowledge to the next leader
4. Finding successors with deep industry knowledge
5. Finding candidates with the right commitment, disposition, and energy to run the business

STEP 2: BUILD YOUR PLAN

Who?

Three of the top five succession plan challenges center on who takes the reins when you leave. The decision may be easy if you're planning to pass the business on to a member of your family. Our survey found 44 percent of business owners plan to do that. And of business owners who have a chosen successor, 65 percent say that person is a member of the family. There's no right decision here, but there are some strengths and weaknesses of every approach. Here are a few things to consider when answering the "who" question:

FAMILY MEMBERS

PROS

- Keeps the business in the family
- Helps support family members
- Family members likely understand your vision
- You may stay involved on a limited basis

CONS

- Family members may not want to run the business
- Family members may not be capable of buying or running the business
- It may be difficult to divide the business among all family members
- Some family members may feel treatment is unequal

CO-OWNERS

PROS

- Co-owners are committed to the business
- They understand the business
- Transfer to co-owners provides continuity with employees, vendors, and customers

CONS

- Limited market may reduce negotiating leverage and sales price
- Co-owners may lack liquidity for purchase

EMPLOYEES

PROS

- Key employees may be groomed on the job
- Incentives can align employee compensation with business goals

CONS

- Limited market may reduce negotiating leverage and sales price
- Employees may not be ready to run the business
- Employees may leave the business before transition
- Employee succession may upset family dynamics

THIRD PARTIES

PROS	CONS
• Possibly higher sale price from a third party • Avoids difficult discussions regarding favored employees or family members	• Difficult to find a buyer in some industries • Creates uncertainty for employees and customers • Surrenders family succession

NOBODY (LIQUIDATE)

PROS	CONS
• No need to choose successors • No need to arrange for financing	• Elimination of family business • Employees lose jobs • Customers must go elsewhere • Loss of intangibles, such as goodwill • Generally results in lowest value for the business

How?

Once you know whom you want to transition the business to, work with your business succession team to consider strategies that suit your desired level of engagement, etc. The following chart lists common strategies that could work in your situation:

DEFERRED COMPENSATION

The business agrees to provide a future benefit to an employee. The benefit paid to the employee can be timed to coincide with the business sale and used by the employee as a down payment for the purchase price.

PROS	CONS
• Provides incentive to the employee to stay with the business • Employee is taxed only when the benefit is paid • Most owners surveyed by NM keep businesses in their families	• The business gets an income tax deduction only when the benefit is paid (in the future)

EMPLOYEE STOCK OWNERSHIP PLAN (ESOP)

An ESOP is a qualified retirement plan that invests primarily in company stock. The company may make contributions of stock or cash to the ESOP. Roughly 70 percent of business owners surveyed by Northwestern Mutual are considering this approach.

PROS	CONS
• Provides a buyer for stock when a shareholder wants to leave • Contributions are tax deductible	• ESOPs are complicated, expensive and require the help of experts • As a qualified plan, it must be available to all employees • Dilutes the remaining shareholders' ownership rights

GIFT

All or part of the business is transferred by gift, either all at once or over time. According to Northwestern Mutual's survey, 76 percent of business owners plan to gift their business as part of a succession plan. This strategy is commonly used when you plan to keep the business in the family. Discuss valuation strategies with your advisory team to minimize gift tax liability, as well as options to retain varying degrees of control if you are interested.

PROS

- No need for recipients to borrow money or make payments
- You transfer the business on your terms

CONS

- Subject to gift taxes and may use a large portion of your lifetime gift exemption amount to cover the gift tax
- May cause family discord if gifts are not equal or partly go to non-family inside employees
- You receive no sales proceeds

INSTALLMENT NOTE

The buyer promises to make installment payments of principal and interest over time.

PROS

- You recognize capital gain over time, spreading out the income tax impact
- Buyer doesn't have to pay the entire purchase price upfront

CONS

- Risk that the buyer will not make future payments
- Recourse may be limited if buyer defaults

INSTALLMENT SALE TO GRANTOR TRUST

You sell all or part of the business to an irrevocable grantor trust in exchange for an installment note. This strategy typically works when you are transferring the business to family.

PROS

- Seller recognizes no gain on the sale to the grantor trust
- Any business income and appreciation after the sale that exceeds the interest paid on the note is outside the owner's estate
- After the installment note is paid (and no gift tax was paid), and all the value and future growth of the transferred business interest is outside the seller/grantor's estate

CONS

- Requires initial gift to fund the trust
- The outstanding installment note balance, if any, at the seller/grantor's death remains in the seller's estate subject to estate tax
- More complexity and administration to set up and operate

SUPPLEMENTAL EXECUTIVE RETIREMENT PLAN (SERP) COMBO

In addition to receiving proceeds from the business sale, you may also receive payments directly from the business through a supplemental executive retirement plan. The amount of these payments and period over which they will be paid, as well as the frequency of payments, can vary.

PROS

- Seller receives a desired amount through a combination of sale proceeds and SERP payments
- Reduces overall taxes for both seller and buyer, and gives the buyer a tax deduction on the SERP payments, which offsets buyer's income tax on net taxable income used to make the SERP payments
- May lower the value of the business to facilitate a smoother succession plan
- Allows the buyer to spread payments, via the SERP, over many years as their business has earnings over multiple years

CONS

- SERP payments are subject to ordinary income tax rates (not capital gains rates) for the seller
- Company needs adequate time to establish a SERP plan to build funds to later make SERP payments

SINKING FUND

The prospective buyer systematically accumulates funds to purchase the business in the future.

PROS
- The buyer can accumulate all or part of purchase price over time
- Accumulation vehicle may offer tax-deferred growth

CONS
- May not be sufficient time or resources to accumulate adequate cash
- Typically involves an installment note for the remaining buyout value

THIRD-PARTY FINANCING

The buyer obtains third-party financing, such as a bank loan, for all or part of the purchase price.

PROS
- You receive all or most of the purchase price at once
- You bear no risk that the buyer will default on future installment payments

CONS
- May be hard for the buyer to obtain favorable financing
- Buyer pays income tax on earnings used to make the installment payments to the lender
- Installment or loan payments to lender are not deductible

STEP 3: MANAGE YOUR RISK

Life is unpredictable, and everything can change on a dime (as the pandemic showed us). A strong succession plan accounts for risks that could derail the plan — both known and unknown. Here are a few common succession planning risks that you can account for:

What if a key employee leaves and joins a competitor?

If your succession plan depends on a single key employee, you can hedge this risk by giving them ample reasons to stay. Some key incentives include deferred compensation, a bonus plan, a DI wage continuation plan, long-term care plan, or other benefits.

What if a key employee becomes disabled or dies?

Key person disability insurance and life insurance can provide cash to cover expenses or lost revenue resulting from the death or disability of a key employee. In addition, you could use the money to recruit a replacement to help keep your business and your succession plan on track.

What if you or a co-owner becomes disabled or dies?

In such an event, buy-sell agreements funded with a vehicle such as life or disability insurance can spell out what will happen with your business. The insurance can provide the funding necessary to carry out your wishes.

STEP 4: VALUE YOUR BUSINESS

Most business owners are confident that the sale of the business will generate sufficient income for their retirement and associated plans; however, it's important to quantify exactly what you need to identify any gaps and how to address them. Knowing what your business is worth is key to any business succession plan. Northwestern Mutual advisors have access to proprietary technology that uses proprietary, patented algorithms and that can help you and your advisory team take the guesswork out of business valuation.

Depending on whether you have chosen to maximize or minimize the buyout value and what strategy will best meet your goals, when it comes time to implement your plan, it's likely you will need a more formal valuation. A variety of methods can determine the value of your business. In addition to software-driven tools, some common valuation methods include the following:

- **Book value** is based on assets minus liabilities. This method is useful for asset-based businesses.
- **Multiple of earnings** estimates value based on a multiple of net earnings. This method is commonly used by businesses to begin the planning process.
- As your transition nears, a valuation expert can provide a **formal business appraisal** based on a variety of factors, including business operations, the economic outlook, and sales of similar businesses.

ONLY

57%

of business owners surveyed are very confident they've been relying on data rather than their gut in their succession planning process

Again, it all comes back to your advisory team, as they will work closely with you to ensure the documentation, valuation, and funding are coordinated with your goals.

Managing a payout

Are you counting on using the cash from the sale of your business to fund your retirement or begin a new business? Whether received in a lump sum or over time, the cash produced from your business should be integrated into a comprehensive plan that accomplishes your personal, retirement, and estate planning goals.

Your financial advisor can coordinate your team of advisors to design strategies that will meet your current needs as well as your retirement and estate planning wishes.

STEP 5: REVIEW YOUR PLAN

The only constant in life is change, which means your business succession plan should be a "living" plan of sorts. Factors inside the business and extraneous factors (a global pandemic, industry disruption, or the loss of a key employee, for example) may require an update to your succession plan. Make a point to review your succession plan annually to ensure it is a fit for your goals. Some things to consider:

- **Changes in your goals –** If you decide you want to continue running the business longer or start reducing your hours earlier than you had intended, revisit your plan and agreements.
- **Changes in your family situation –** Anything from the birth of a child or grandchild to a divorce or sudden death could impact your succession planning.
- **Changes in management or employees –** If a partner or key employee leaves or an employee or a family member steps up and shows exceptional interest and initiative, you may need to rethink elements of your plan.
- **Changes in value –** Major new client contracts, product innovation, or changes among competitors are just a few examples of how your business value or demands of the industry may warrant a revision to your succession plan. Four in five business owners surveyed by Northwestern Mutual indicated the pandemic significantly impacted their business — either positively or negatively.

Your advisors can assist in your review process and can help you adjust your plan based on any changes in your situation.

Start the process today

Whatever stage your business is in — whether you are planning to leave your business soon or years from now — start thinking about business succession planning with these five key steps in mind.

Talk to a financial advisor who can coordinate your team and help you create a comprehensive plan that will take into consideration both your business and personal goals. You'll sleep better at night knowing that your business succession plan is in place.

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