Principal®

BUSINESS INSIGHTS

What is your business succession plan?

Business owners make important decisions every day. Some are focused on just-in-time needs, while others are longer term—like planning a building expansion or mapping out a five-year strategy. Another key decision business owners need to make is determining their succession plan.

There are many aspects of succession planning, both short-term and long-term, and a key starting point is answering these three questions:

1. When do I want to hand the reins over to someone else?
2. Who do I want to take an ownership or leadership role?
3. What is the value of my business?

As you answer these questions and begin developing your plan, you'll also want to consider unplanned events that can negatively impact your plan and how you can minimize the impact. Some examples include death, disability, loss of a key person, and financial issues.

To get started, let's take a look at some of the common succession planning options owners like you often consider.

> Succession planning is one of business owners' top priorities according to research from Principal.[1]

1 | Maintain ownership

You can continue as an owner and maintain control but turn the management over to one or more of your key employees. If you take this approach, consider a few key questions: Are the people you selected ready to take on a management role? Have you designed a compensation and incentive plan to meet your objectives and keep them engaged and focused on growing your company? Are their plans in place to allow distribution of company profits, based on your ownership percentage, as you wind down your involvement in business operations?

[1] 2023 Principal Financial Group® Business Owner Insights, conducted by Dynata.

2 | Sell the business

A key component to many succession plans is a properly funded buy-sell agreement. If you already have a buy-sell agreement, it's a good practice to review your agreement every couple of years to make sure the terms of the agreement still meet your needs. Here are some considerations:

- **Co-owner(s).** When you have a co-owner(s), you may already have a built-in buyer. Having the conversation about whether each of you would like to continue the business if the other owner(s) leaves is a critical component to your plan. In some situations, one owner may want to take on more ownership while others don't. It's also important to understand each owner's objectives and future goals, as well as the options they have to finance a buy-out.
- **Family members.** If your business is family-owned, you may have a child or other family member to whom you would like to turn it over. A key question is whether the family member is ready. If not, what steps can you take to help position them for success? If there are other children who aren't involved in the business, or won't be after the transition, it's important to discuss your decision with all your children. These can be tough conversations, but it's better to have them up-front rather than later, particularly if an unforeseen event occurs.
- **Key employees.** In many instances, owners want the business to go to a key employee. The common challenge is the key employee doesn't have the financial means to buy the business outright, so you'll generally need to work with them to find financial terms that work for you and for them. There are a number of financing strategies that can address your needs and make it possible for a key person to acquire a business, particularly when there is plenty of time to prepare in advance.
- **Use of an ESOP.** An employee stock ownership plan (ESOP) can help address retirement needs for employees and provide a business owner succession plan. An ESOP invests primarily in employer stock, creating a buyer for the business. It provides liquidity for owners and encourages employee engagement and loyalty by making employees beneficial owners of the business.
- **Outside third party.** An outside buyer could be a competitor, investor group, or a business looking to expand its offerings by growing through an acquisition. Typically, when an investor group purchases a business, the arrangement involves the current owner staying for several years to continue to run the business—with an incentive for additional buy-out dollars if the business continues to grow. Other buyers may or may not want the current owner to stay.

3 | Transfer to children through gifting

Another popular option that comes up in initial discussions on transferring a family business is that the parents want to transfer the business to one of their children at no cost or at a minimal cost. For this to work, you must consider your financial needs when you're no longer benefitting from income from the business. For many business owners, the business is their biggest asset and one they need to monetize into an income stream in retirement. Let's take a quick look at a hypothetical example.

Julie has worked in the family business for many years and is expected to run the business. Steve and Amy are her siblings who have not been involved in the business, but they want to benefit from the value of the business. A common approach is to split the business equally between the three children.

This approach typically doesn't work well, because Julie's interest in putting money back in the business to keep it growing isn't consistent with her siblings' desire to pull money out of the business. This can be especially problematic if they have equal decision-making power. In this example, Julie could consistently be in the minority

even though she has the expertise needed to make the business successful. A better way to address this may be to "equalize" the inheritance for Steve and Amy by giving them other assets or using life insurance to reach a fair and equitable distribution while allowing Julie full or majority control of the business.

The right approach depends on your situation.

Think about your goals, objectives, and financial situation. Consider whether a family member, key person, or ESOP makes sense for you, or if an outside buyer will work the best. Start by determining the value of your business, who you want to sell or transfer it to, and when you want it to happen. It's also important to consider both planned (perhaps retirement or another owner decreasing their involvement in the daily operations of the business), as well as unplanned events (such as a death or disability) that could negatively impact your overall plan and timing.

> Answering these three key questions while working with your professional advisors will help get you started on a plan that will work for you.

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Patti Bell specializes in key employee and owner benefit plans, business succession, business protection, and estate planning. She works with business owners and financial professionals to implement comprehensive solutions that help meet employee, business, and personal needs. A Loras College graduate and member of the American Institute of Certified Public Accountants, Patti is a frequent speaker on business planning, executive benefits, estate planning, and related topics.

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