Succession Planning for Family-Owned Businesses

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Family-owned businesses - from Main Street to Wall Street - are the heart and soul of America. According to Forbes, family businesses account for 50 percent of the gross domestic product in the U.S., and 35 percent of Fortune 500 companies are controlled by families, either privately or publicly ("5 Steps To Create A Viable Succession Plan For Your Family Business" Forbes, August 2013). Despite their success, Forbes cited that only one-third of family businesses successfully transition from the first generation to the second.

Family businesses must have a succession plan and process in place. It is not safe to assume that the founder's children will automatically take over the role of leader. Perhaps the kids have no interest in taking over the company or they are not equipped with the education or leadership skills necessary for ensuring the long-term stability of the company. Succession planning is designed to solve the dilemma of who will take over and gives peace of mind to the family business founders.

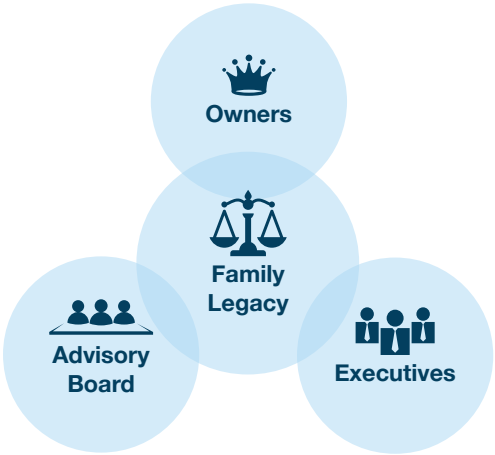
It is never too early to create a succession plan; developing a road map for the future of the company will alleviate any arguments about succession and will ensure the intended successor is ready for the job. Some family business founders insist on maintaining family control, while others seek executives from outside of the family to take over. The conversation about successors is a difficult one to have, particularly for founders who fear retirement.

Three facets must be considered during succession planning; choose and develop the next generation of company owners, executives, and advisory board to preserve the founder's legacy. Be sure to include a balance of family members among the three facets. Don't be forced to go out of business or sell due to a lack of succession planning.

"Research by Ernst & Young, the Family Business Network, Credit Suisse, and others shows that large, long-standing, publicly traded family businesses grow faster than non-family companies, are more resilient, and outperform market returns by several percentage points."

Leadership Lessons from Great Family Businesses

Harvard Business Review
April 2015



Facets of Succession Planning

The succession plan for a family-owned business consists of developing three integral facets: Owners, Executives, and the Advisory Board. Each facet asks tough questions of the current business leadership and will encourage the family to develop a solid plan to encourage continued growth generation after generation.

OWNERS:

Who will own the business? The owners can be likened to the "conquerors", according to the Harvard Business Review, where the conqueror is a strong leader with extraordinary vision. This person is absolutely entrenched in ensuring the success of the family business through their entrepreneurial drive ("Family Businesses Need One Person to Conquer and Another to Rule" Harvard Business Review, December 2014). In a typical family business structure, the owner is the parent, usually to those in executive positions. Some succession plans encourage a 'bump up' in stature; as one set of parent owners leaves, another (their children) take their place, and so on down the line. Be sure to clarify the owner's compensation, outline their role within the business, and determine how owners will interact with executives. Developing this outline and skill set needed for an owner will set up the business to continue to perform well.

EXECUTIVES:

Who is going to manage and lead the business? The executives are in charge of managing the family business and managing key stakeholders, i.e. the family. Harvard Business Review calls these types of executives the "rulers" of the organization. They are the governors who make the detailed decisions that strive to enact the long-term goals and strategy developed by the "conqueror" or owner ("Family Businesses Need One Person to Conquer and Another to Rule" Harvard Business Review, December 2014). Executives have a fine line to balance, as they work to engage and smooth out disagreements among stakeholders both within and outside of the family.

ADVISORY BOARD:

Will the advisory board be mainly comprised of family members? How will they interact with the executive teams? Determine the common values that the company was built upon and then assign the advisory board the task of ensuring those values are carried out. Some family-owned businesses also design the advisory board as a family philanthropy arm of the company, which gives other family members the opportunity to participate in the family business at this level of engagement, versus actually running the company or working for it in another capacity.

Further Reading

Family Businesses Need One Person to Conquer and Another to Rule

Harvard Business Review
December 2014

Four Dimensions of Succession Planning - EY compilation

Points of Failure

Once the facets of the business are ironed out, next look at points of failure. Like any type of strategy or goal planning, succession planning could crumble if the points of failure are not addressed. Consider the following and implement them into the succession plan.

POINTS OF FAILURE #1: *EXECUTIVES*

Owners must be cautious when inserting the younger generation into executive positions; they should not be driven by simply ensuring the company is in the hands of family members. Many family businesses run into trouble when they insert relatives in executive positions due to a lack of skills and training deficits, as well as a lack of definition around the role itself. For example, make it a rule that any family member who is seeking an executive position must earn a college degree. Some family-owned businesses also require the next generation to gain employment outside of the family business for a period of time to learn valuable professional skills that they can eventually bring back to the family table. Once a family member is in an executive position, treat them like any other employee. This means ensuring they are adhering to a growth plan and working to engage with staff via meeting and reporting structures. Succession plans can be formed at any time, so if there is a next-generation employee on staff who expresses an interest in an eventual executive position, begin creating a growth plan for them now to be sure they have the capability to achieve the tools they need to earn their spot 10 years down the line.

POINTS OF FAILURE #2: *OWNERSHIP*

Clearly define what is expected of an owner. The owners will be responsible for balancing financial returns and working within tax code constraints. This is especially true when planning for the owner's death; tax and probate delays could occur at this time which could have a negative impact on the business. Also determine how an owner will be paid and compare that to executive compensation. Family discord can arise when a non-participating owner is paid the same as a CEO or COO sibling. Determine the compensation package based on the role performed, not level of ownership.

POINTS OF FAILURE #3: *FAMILY DISCORD*

Family discord is common in family-owned businesses, particularly as the business stretches among more than one generation. Think about it: Businesses are supposed to take risks, tackle challenges, and push to the next level. By contrast, families seek stability, security, and harmony. The advisory board and executives will assist in ensuring disputes are quickly resolved, and a process must be developed to properly handle any disagreements. Many family businesses create a "family constitution" or rules of engagement to make sure each family member is on the same page and offers ways for outlying family members to get involved in the business, i.e. attending the Annual Meeting or becoming a part of strategic planning. Also, consider how the next generation feels about the family business. The second generation is typically driven by different things than the founding generation; while the founders (parents) are driven to leave a legacy, the children who grew up in the business may feel differently about its direction.

POINTS OF FAILURE #4: *WEALTH TRANSITION*

This could be a big point of contention in a family business. Determine where the company's wealth will go when ownership changes hands. Keep in mind that the company could get so successful that it's literally impossible for the younger generation to buy out the owners during a transitional takeover - what once was a $10M business is now a $100M business. Also, consider the beneficiaries; will family members earn a fair share based on the work they put into the business, or will they be given an equal share no matter what their role? Consider tax and legal consequences as well, including how much of the company's wealth should be earmarked for the current generation. Finally, revisit the wealth transition plan each year; a lot can happen between acquisitions and tax law changes that could impact the plan.

CEO Selection

For family businesses that are embarking on their first succession planning journey, an obvious place to begin is selecting a CEO. It's likely that a family business considering their succession planning options are at a stage where the founders are still running the company, but are nearing retirement. While the balance between owners, executives, and the advisory board are essential to consider throughout the succession planning process, this is an in-depth look at the first priority: CEO selection.

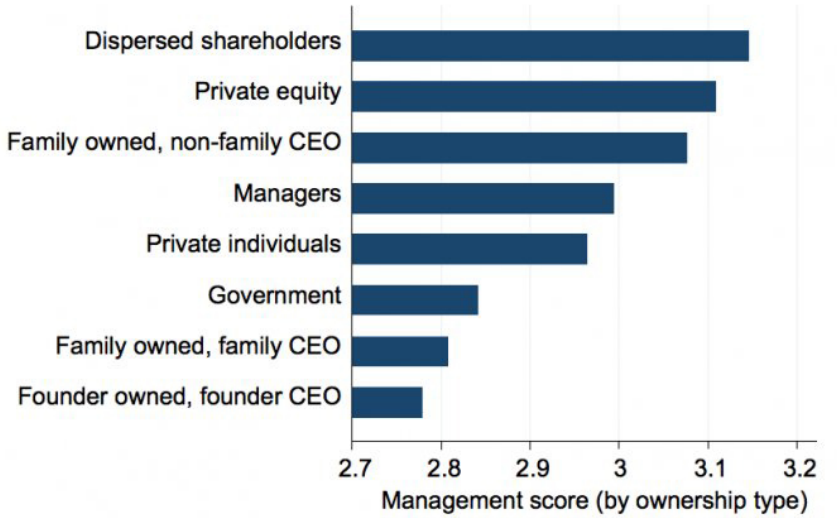
OPTION #1: *PRIMOGENITURE*

The successor to the current CEO/owner will be a family member. According to the Harvard Business Review, this is a great option for many family-owned businesses due to the trust built among the family and the institutional knowledge the second generation has about the company. However, this option grossly narrows down the talent pool to perhaps a handful of qualified family members. Be cautious in this approach; some family members may assume they will be given the CEO position one day, making them less likely to work hard to earn the spot. A primogeniture model of succession could be detrimental to non-family member executives, who may feel they are working hard for little advancement opportunities ("Family Firms Need Professional Management" Harvard Business Review, March 2011).

OPTION #2: *FORMAL SELECTION PROCESS*

Choosing an outside person to take over the CEO role is not considered a failure or lack of trust in the second generation. In fact, this option demonstrates the founder's commitment to the company's longevity. Conduct a professional and disciplined search to identify potential CEO candidates and choose one using a strategic process that aligns with the company's long-term strategy and goals. This process includes developing an ideal CEO profile that will be confirmed through the recruitment process with interviews and research on the candidate's references. A solid strategy is to conduct a formal selection process by looking toward family first, then internal non-family executives, then finally external candidates.

Figure 7. Family- and Founder-Owned and -Managed Firms (in Manufacturing and Retail) Typically Have the Worst Management



Management scores after controlling for country, industry, and number of employees. Data from 9,085 manufacturers and 658 retailers. "Founder owned , founder CEO" firms are those still owned and managed by their founders. "Family firms" are those owned by descendents of the founder. "Dispersed shareholder" firms are those with no shareholder with more than 25% of equity, such as widely held public firms.

This graph demonstrates the average management quality broken down by type of ownership. Teams from Harvard, Stanford, and LSE surveyed thousands of medium sized firms in 20 countries to quantify their management practices. They combined 18 questions to create a management quality index from 1-5 highly correlated with firm performance as measured by productivity, profitability, sales growth, and survival.

Bottom Line

Start succession planning now – before you need it. Just like creating a will, succession planning will outline what to do in the untimely death, divorce, or incapacitation. Unexpected issues aside, succession planning ensures the family-owned business founders are satisfied that the company they worked so hard for will be in good hands after their retirement. In fact, according to the Family Business Institute, a mere 30 percent of family-owned businesses last into a second generation; 12 percent reach the third; and three percent get to the fourth generation or beyond ("Leadership Lessons from Great Family Businesses" Harvard Business Review, April 2015).

Above all, be sure the succession plan adheres to the values of the founders. Family-owned businesses are staples of the American economy because of their dedication to their values. Be sure to leave a legacy that serves the family, its stakeholders, and the community.

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