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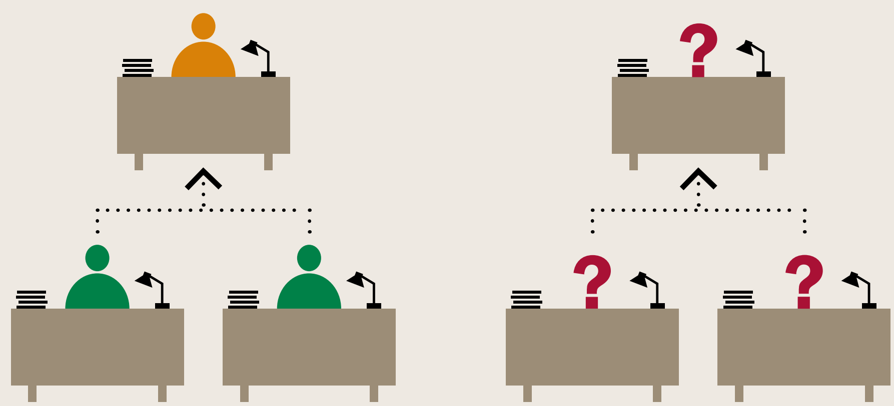
Selling a Business to Retire: Wrong Sequence

Leaving succession decisions for the next owner avoids tough choices but adds risk for the next owner.

by Mark Working

Management succession is a reality and a necessity unless the business ends when the key manager/owner retires or is unable or unwilling to continue. It is very unusual to find a business in which no other human is able to take the reins, although transitions can be more or less difficult depending on the business. Avoiding the challenge of putting in place a succession plan may seem easier and is often justified as being a decision that the next owner should make. Although a buyer of a business will certainly develop an opinion of who and how the business should be led and may not concur with the choices made by a founder, the uncertainty of an impending change of leadership creates a risk that drives away a significant portion of the market of buyers and creates a risk value discount.

The Value Difference: One company has a well-functioning management team with a succession plan in place and the other has no succession plan and a lot of question marks about the team.



LINKAGES

Owners who lead their companies depend on a cadre of people who play important roles in support of the business mission and are often a form of family. The personal and professional linkages among team members create the strength of the organization to fulfill its mission and are redefined when the leader is changed. Whether it is as a result of one of the other team members or a new person from the outside moving into the senior leader role, this can lead to dissatisfaction among team members who do not share in the wisdom of the choice and, at the least, a period of learning and adapting to new styles as the linkages are reestablished. An owner who has not gone through such a process can find this daunting and difficult. The potential fallout of choices not embraced by the team and the resulting energy required to repair broken linkages creates paralysis in even the most dynamic leader. Emerging from procrastination is a justification that such a major decision as leading the company should be left up to the next owner. When a sale process occurs, the owner willingly agrees to "stay on and help with transitioning the new leader."

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PERCEPTION OF RISK

The buyer perceives this situation as a huge risk because the leader of the business will no longer sit in that chair. Buyers are well aware of the potential turmoil in changing leadership and decision making, the loss of tribal knowledge, and the fragility of the entire leadership team. At best, a new leader will coalesce the team around a goal and will build strong linkages so that the business can move forward. At worst, the team can disintegrate before their eyes. Rarely do businesses make these transitions without missing a beat. Buyers implicitly take all of these risks and convert them to costs that affect their view of value – creating a risk value discount. The amount of this discount is hard to quantify but any experienced investment banker will attest that there will be a difference between two equal companies – one with a well-functioning management team and one with a team that must be reimagined.

What to do? The only choice is to create and execute a succession plan substantially in advance of sale or retirement of the founder. Succession planning is anathema to entrepreneurs and the best plan will be much more than choosing a person to take the founder's position. Nevertheless, owners should not put off decisions that will eventually need to be made. The presumption should be that the best value will be achieved in a sale if the business comes with an experienced successful group of managers at the helm with a lot of gas in the tank. Experience needs to be over several revenue cycles (two or three years), long enough to measure the impact and effective-

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(continued p. 2)

ness of the team's decisions. Effectively, this means a transition process should be started at least three years before a sale or the retirement of the founder.

ACCOMPLISHING THE OBJECTIVE

How to do it? Books have been written on this subject and there are many firms that specialize in human capital planning that work with company owners to develop and execute plans designed to accomplish the desired objective with the least fallout. We do not hold ourselves out as having special expertise in this area, but have observed enough successful and unsuccessful succession plans to recognize some basic principles that should be remembered.

- The best next leader is not necessarily a clone of the previous leader. Businesses evolve and what they need in a leader changes.
- Don't underestimate the fragile nature of a management team. Pulling out a member and replacing them with another causes ripple effects throughout the organization. Employees who have options can use their feet and they will do so when least convenient. It is not like everyone gets a vote, but effectively they do.
- Leaders have their own unique styles. No matter how well accepted the person for the position, it will take time for the organization to learn to read and react to the style of the new leader.
- Outside assistance from a board or consulting firm can help assure an objective process that considers the environment in which the leader will operate.

The greatest risk comes when both the ownership and leadership change occurs at the same time such that the least knowledgeable parties are forced to make decisions.

The best succession plans we have seen were in cases where leaders were developed internally and impending changes were known far in advance such that training and experience developed the leaders. When the change eventually happened, it was a fait accompli. There were no surprises and the organization adjusted over time, thereby allowing everyone to keep pulling on the oars to preserve momentum.

The critical message for business owners to understand is that careers and investments have different horizons and, in fact, investment returns are best achieved when they are staggered. The greatest risk comes when both the ownership and leadership change occurs at the same time such that the least knowledgeable parties are forced to make decisions. Better to get some help to transition leadership such that the business can be sold with all systems humming. **ZS**

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ABOUT ZACHARY SCOTT

Since 1991, Zachary Scott has assisted owners of privately-held businesses in the greater Pacific Northwest to plan and execute major business or ownership transitions by offering sell-side M&A and acquisition and investment advice. For more information on Zachary Scott, go to **ZacharyScott.com.**

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