From downturn to upside

New thinking on business succession for today's economy

Today's business conditions may be challenging,

but they could represent

the business succession opportunity of a lifetime.

A white paper from RBC Wealth Management Services.

From downturn to upside

With economies worldwide still struggling through a recovery, business owners are understandably focused on survival and growth for today rather than their succession plans for the future.

Whether the business is worth $1 million or $100 million, owners who are able to plan now for the inevitable succession of their business can find unconventional opportunities in these unconventional times.

Two opportunities in particular are becoming apparent:

- **Hire a future owner.** With recent business downsizings and turmoil in the labour market, the pool of available talent has never been greater. Business owners who are open to selling their business to management or employees may be able to find the ideal future owner of their business from this rich talent pool. This could also be an excellent opportunity for employees who think they would like to have an ownership stake in a business one day.
- **Expand through acquisition.** It may seem counter-intuitive to buy another business as part of implementing a succession plan. But valuations are lower now than they were a few years ago, and buying an attractively priced business today could be an effective way to consolidate market share or expand the business. It could also help attract a higher valuation and more bidders when the economy recovers.

At a time when many business owners are waiting until conditions improve before planning their next move, those who plan beyond the current economic climate may well create their own business succession and ownership planning opportunities. And with so many owners looking to sell in the near future as the baby boomer bulge retires, the opportunities created today could prove invaluable years down the road.

THE SUCCESSION PLANNING IMPERATIVE

Staying a step ahead of the competition is fundamental to business success. But many owners don't consider how succession planning can put them a step ahead too, by helping them to maximize the value of their business.

In fact, many business owners don't plan their business succession at all. According to a study by RBC®, one in four small- to medium-sized-business owners in Canada over the age of 50 plan to exit their business in the next five years.[1] However, 77% of owners have made little or no progress putting a succession plan in place. Owners of businesses with revenue of more than $5 million annually are somewhat further ahead than the average, though 50% still say they have made little or no progress.

A well-thought-out business succession plan can not only help position a business today for ongoing success by looking at ways to maximize its value, it can help ensure that the owner achieves his or her business and retirement objectives when the transition eventually occurs.

OPPORTUNITY: HIRE YOUR FUTURE BUSINESS BUYER – TODAY

The current economic climate provides a particularly attractive and sizable pool of skilled businesspeople and professionals from which to choose one or more potential successors. Even if the planned transition out of a business is many years away, early planning will enable these individuals to fully develop their skills, helping to ensure a smooth and successful transition.

1) Quantitative Study of the Business Succession Market in Canada, RBC Royal Bank, 2007.

It can be critical to build and nurture the capability of potential future owners well in advance of succession to ensure their success after the sale. Experience demonstrates that management buyouts have a greater success rate than third-party purchases.

When it comes to developing internal talent, it may be necessary for everyone to learn new leadership skills and gain the flexibility to adapt to changing trends. These skills should include not just operational and management skills, but also the ability to conduct financial analysis and strategic planning. Though time-consuming, this should be viewed as an investment in the company's future success.

This "grooming for success" approach can also represent a critical advantage to the departing owner if the proceeds of sale are being paid out over a period of years. It helps to ensure that the new owner has the ability and desire to maintain the financial integrity of the business so that payments to the departing owner can continue.

If an internal successor has been identified, it's imperative to discuss the succession plan with him or her well in advance of the transition date. A potential successor needs not only to agree to the proposition but also to be aware of expectations in terms of how the business will be continued and to have an opportunity to develop any necessary competencies. Early planning also gives the potential successor an opportunity to explore financing structures to facilitate the transfer.

It's easier to sell a business that already contains a strong base of talented employees than one in which significant talent gaps exist. So whether a new hire ends up as a business successor or just improves the talent base, business owners who upgrade their team of skilled employees can reap the rewards when they decide to step down.

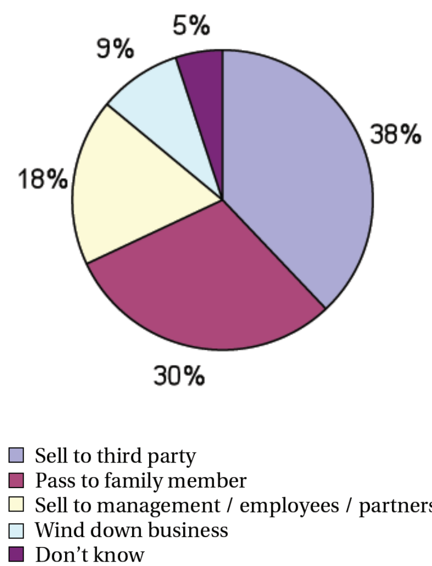
OPPORTUNITY: BUY BEFORE YOU SELL

The relatively low valuations of many businesses in the current economic environment could represent a largely

INSIGHT

HOW BUSINESS OWNERS PLAN TO EXIT

In a study by RBC of small- and medium-sized-business owners in Canada over the age of 50, selling to a third-party was the number one exit strategy (38%) followed by passing to a family member (30%). Five percent had no exit strategy.



Source: RBC Quantitative Study of the Business Succession Market in Canada (March 2007); based on private companies with annual revenue greater than $250,000.

ADVICE

Selling to management or employees avoids the disruption of potential third-party buyers touring the facilities, reviewing records and examining confidential information.

ADVICE

It's important to get a professional valuation. Emotion, history and lack of access to relevant information can cause owners to overestimate or underestimate the value of their business.

INSIGHT

BUILD THE RIGHT ADVISORY TEAM

Having the right partners at the table can make the business ownership planning process both easier and more effective. It's important to have a team with experience in succession planning. The following individuals may prove useful at different stages of the succession planning process:

- Accountant
- Lawyer
- Family members
- Management team
- Business broker
- Business mentor
- Business valuator
- Family business facilitator
- Commercial banking account manager
- Personal financial advisor

unrecognized buying opportunity that may not last for long. Businesses that acquire a competitor or complementary business at a bargain price may, in fact, be able to use the downturn to their advantage. While there will be a cost to such a move over the short term, the potential increase in business value over the medium to longer term could be substantial as the economy recovers and the business finds itself in an expanded or more dominant market position. A strategic acquisition can position the business to be first out of the gate when the economy fully recovers.

In the past 12 to 18 months, a number of business owners have delayed their plans to sell because of economic and market conditions. When the economy recovers, there could be a significant increase in the number of businesses available for sale, increasing the competition. An acquisition that brings with it an increased talent pool of employees and management can help increase the value of the company in a third-party sale. Alternatively, the acquired company's management team could be in a position to participate in a management buy-out in the future.

In determining whether an acquisition is an appropriate way to build long-term value, business owners need to revisit the fundamentals. A competitive-advantage analysis will help identify the best areas for future investment. This could include a review of their business plans, their market strengths and weaknesses, the areas in which the business is functioning effectively and the areas that require work to retain or improve market share.

In terms of the nature of the acquisition, the company accountant, an external financial advisor or a mergers-and-acquisition professional on the owner's advisory team should be able to advise on the elements of a competitor's business that could be valuable – such as a company's equipment, its intellectual property or its clients – and provide a detailed financial analysis. There needs to be a clear demonstration of how the target company will add value. The business owner's advisory team can also assist with a process of thorough due diligence.

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TAX STRATEGIES FOR CONVERTING BUSINESS ASSETS TO PERSONAL INVESTMENTS

A layer of complexity is created as the value of business assets transitions into personal investments. Tax laws and regulations are complex, requiring advice from a qualified tax advisor. Tax strategies to discuss with a tax advisor when transitioning a business include the following:

1. Establish an estate freeze

In an estate freeze, typically the owner's new shares in the business have voting control and a fixed value, while family members initially receive shares with a nominal value but which benefit from all future growth. This offers a variety of tax-saving strategies, such as income splitting and multiple use of the personal lifetime capital gains exemption of $750,000 on the sale of qualifying small-business shares. Owners should be careful not to freeze too much or too soon and the tax advice should be tailored to their own circumstances and objectives.

2. Set up a holding company

A holding company between the business owner and the operating company can distribute ownership interest, facilitate an estate freeze, potentially provide a degree of creditor protection by holding excess cash, investments, insurance or land, allow for income-splitting tax-saving strategies and potentially enable the use of the capital gains exemption, and allow more flexibility in succession and estate planning.

3. Set up a family trust

A family trust that has an ownership stake in the family business allows a family to minimize overall taxes because income earned in the trust can be taxed to children or grandchildren through various income splitting strategies. It also allows family members to have indirect ownership in the business with a trustee in control.

4. Implement an Individual Pension Plan (IPP) or a Retirement Compensation Arrangement (RCA)

An IPP is a defined benefit registered pension plan established for the benefit of a single employee, most often the business owner or key employees. It typically has a higher contribution limit for tax-advantaged savings than an RSP. An RCA is a special type of trust that provides an enhanced retirement benefit for a key employee. Even though the trust itself does not benefit from any special tax concessions, it creates several planning opportunities that can provide the key employee with long-term benefits in retirement.

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STRUCTURING THE PURCHASE

The financing structure for any business transition often represents a complex balance between the interests of the buyer and the interests of the seller. The ultimate structure may include some or all of the following:

- **Bank financing.** This is typically the most affordable and easily accessed type of financing. Structured to support the needs of the business, it may take the form of an operating loan or a term loan.
- **Mezzanine debt.** This type of subordinated debt tends to be used by highly leveraged businesses that require more than bank financing alone. It may require giving up some ownership interest.
- **Equity investment,** where third-party investors provide equity through ownership interest in the business.
- **Vendor take-back loan,** where the seller supports the acquisition in the form of a loan or becomes an investor in the business.
- **Buyer's equity,** using the buyer's own personal assets to finance the purchase.

FINANCING CONSIDERATIONS

Determining how a change in ownership will be funded is a crucial component of the transition process. The amount and type of financing needed will depend on a number of factors, including:

- the tax implications for both parties;
- what the owner's future involvement in the business will be, if any;
- whether the owner needs ongoing income from the business.

There is no "one size fits all" approach to the financing of a business purchase and there are many different ways to structure a deal. For example, many management buyouts are structured to occur over a period of years. This allows for the gradual release of funds to the retiring owner while new ownership assumes control and responsibility in the same time frame. It can also help ensure a smooth transition, particularly if the original owner receives payments for successfully achieving certain targets.

This kind of "staged exit" may be particularly desirable when the business represents a large portion of the owner's individual net worth. The business owner may be able to spread the receipts — and their attached taxable capital gains — over a maximum period of five years.

A lawyer, accountant, a commercial banking account manager, financial advisor or other professionals on a succession advisory team can help ensure that the financing structure agreed upon works to meet the financial and tax-planning goals of both the buyer and seller. The accompanying box outlines the most frequently used structures.

MAXIMIZING SALE VALUE

The process of positioning a business for maximum value needs to start many years in advance of a sale, with a strong management team in place to develop and execute a solid business plan.

Buyers will pay more for an acquisition when they understand its opportunities and risks. Above all, they want to know that the company can generate earnings. But gathering this information and presenting it effectively to potential buyers can be a challenge. To get the highest price for the business, the seller will need to demonstrate transparency by providing disciplined reporting and audited financial statements going back several years.

Potential purchasers also want to see a clear growth strategy and a track record of successfully delivering on that strategy. The owner should have a formal business plan that addresses the company's competitive advantages, customer base, market size, competition, operations, past financials, forward projections, industry outlook and growth plans.

For companies in the early stages of planning, a team of advisors with expertise in corporate finance can help analyze how the company can maximize its value and put together a plan to do so. The process may very well identify ways to increase value before a sale, such as making a strategic acquisition, divesting non-performing assets or diversifying the customer or supplier base.

Ultimately, the most attractive companies can demonstrate a history of profitable earnings and a strong position in a growing market. Regardless of the size of the business, a disciplined process and a team of advisors can help the business owner take the right steps to maximize value. (See sidebar for specific factors that can increase a business's sale value.)

PLANNING MAKES PERFECT

Whether business owners are able to take advantage of the "upside of the downturn" opportunities discussed in this paper, or pursue other succession strategies, the key to business transition success is advance planning. The case studies that follow highlight the many benefits that such planning can bring.

RBC works with business owners and their advisors to plan their succession, both from a business perspective and a personal financial and tax planning perspective to achieve personal objectives and maximize wealth. Our specialized financial advice for businesses and business owners includes succession planning, business financing advice, raising acquisition capital, wealth management, tax planning, personal retirement, philanthropy, insurance and estate planning. Business owners can contact their RBC commercial account manager or their RBC financial advisor for more information. For more information on succession planning, visit www.rbcroyalbank.com/succession.

INSIGHT

KEY FEATURES THAT CREATE VALUE

Here are some of the key factors that can add value to a business in the eyes of a potential buyer:

- History of profitable earnings
- Solid cash flow
- Strong balance sheet
- Proprietary products, technical capabilities, patents or intellectual property
- Diverse customer base
- Diverse suppliers
- Dominant market position
- Significant competitive advantages
- Strong and committed management
- Expanding markets for key products

Case Study A: **Buy-out by a key employee**

Barbara, a very successful owner and operator of a hotel on the coast of Nova Scotia, incorporated her business 28 years ago. About 10 years ago, as part of an estate freeze, she sold 49% of the ownership of her shares to her husband, Donald, on the advice of their accountant.

Since that time, the region has been inundated with foreign as well as Canadian visitors and as a result the hotel has increased substantially in value. Today, it is worth approximately $4,000,000 according to a recent valuation performed by a local Chartered Business Valuator (CBV).

Barbara and Donald talked to their accountant, lawyer, personal financial advisor, management team and their commercial account manager five years ago about the possibility of selling their hotel and retiring this year.

They mentioned their plans to their long-time general manager, Sarif, and he expressed interest in buying the hotel. However, he could not buy it all at once and would need assistance with the financing. Both Barbara and Donald are thrilled at the prospect of Sarif taking over ownership, as he has always treated the staff well and is loved by the hotel guests. They agreed on a plan for Sarif to buy the hotel over a period of three years incorporating vendor-take back financing for a portion of the purchase price to augment bank financing. This "staged exit" gives Sarif more flexibility with financing and reduces the tax burden for Barbara and Donald.

Barbara and Donald have always contributed the maximum to their RSPs every year. On the advice of their accountant, their company also set up an Individual Pension Plan (IPP) for them, to defer even more of their substantial annual income from tax. In addition, they recently updated their powers of attorney, Wills, and insurance coverage to ensure that if one of them becomes unexpectedly ill or dies, the other will be able to continue to operate the hotel or sell it without undue legal complexities or tax burden.

What did Barbara and Donald do right?

- Initiated discussions with experienced advisors several years in advance of selling and engaged financial experts.
- Had powers of attorney, Wills and insurance coverage to deal with life's unexpected events while they were working out their plan.
- Had a suitable successor in mind and actively engaged him in the succession planning process.
- Incorporated the business, saving taxes on active business income as well as creating the potential to claim the capital gains tax exemption on the disposition of their shares of a Canadian-Controlled Private Corporation. Since they are both owners, they may each be able to receive up to $750,000 of capital gains tax-free.
- Set up an IPP, which allowed for additional tax sheltering of retirement savings beyond that provided by their RSPs.
- Had the business properly valued by a CBV so everyone felt the purchase price was fair.

Because they initiated succession planning several years before leaving their business, Barbara and Donald are pleased with the outcome: Sarif will continue to run the business and they are well positioned for a very enjoyable lifestyle in retirement.

ADVICE

With careful early tax planning, it may be possible for the business owner and various family members to each make use of the personal lifetime capital gains exemption of $750,000 on the sale of qualifying small-business shares.

Case Study B: **Transfer to children**

Phil, 66, owns and operates a successful construction business in southeastern Ontario that has grown significantly in the past decade and is still in growth mode. He had the company professionally valued recently and discovered it is worth approximately $30 million. Over the next seven years, Phil wants to scale back his hours and eventually retire. He recognizes that he needs an exit plan but has been so busy with day-to-day operations that he hasn't yet planned how he will transition his business. Phil has one son and one daughter involved in the business, and he wants to pass the company to them. His second daughter is a doctor and has no interest in the business.

Phil's concerns are three-fold: he wants to ensure the company is positioned for continued success to support both his retirement and the ongoing needs of the next generation; he wants to minimize the tax payable when the business is ultimately transferred to his children; and he wants to ensure all three children are treated fairly.

Phil starts his business succession planning by putting together his team of advisors, including his long-time accountant. Based on their recommendations, Phil does the following:

- After sitting down with his children, Phil confirms that both his son and his daughter want to continue their careers with the business for the long term.
- Phil decides to complete an estate freeze for his business. On a tax-deferred rollover basis he exchanges his common shares for preferred shares that pay regular dividends while preserving his voting control over his business. New common shares with a nominal value are issued directly to a newly created discretionary family trust in which Phil, his wife and their three children are named as beneficiaries. The trustees named are Phil, his wife and his accountant. This will ensure Phil receives an income stream from the preferred share ownership and potentially income distributions from the trust.
- Having the growth shares in the discretionary family trust allows for flexibility in the future for the trustees to make decisions on both capital and income distributions. The family trust means that each beneficiary may be able to use the personal lifetime capital gains exemption of $750,000 on the sale of qualified shares to the extent they haven't previously used it.
- The family holds a meeting and agrees that the children who work in the business will gradually be able to receive distributions of company shares from the trust and over time have outright ownership of the common shares of the company.
- Phil buys a life insurance policy naming his daughter who is a doctor as the beneficiary, ensuring that his estate treats all his children fairly. While the other two children receive shares in the business, she will receive the proceeds of the policy.
- Phil buys corporate life insurance to cover a portion of the capital gains taxes payable on the preferred shares upon his death.
- The company also buys key-person life insurance for the son and the daughter who work in the business, since they are only in their 30s and it's much cheaper to buy it now.
- Phil will continue to be a consultant to the company and draw a reasonable salary.

By working closely with his family and his advisors over a number of years, Phil has ensured he can live the retirement lifestyle he wants, arranged an orderly transfer of his business to his children, planned for the fair treatment of his heirs and saved a significant amount of taxes.

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