



WHITE PAPER:

KEY ISSUES IN SMALL BUSINESS SUCCESSION PLANNING

Introduction: As baby boomer business owners approach retirement, succession planning for small, privately-owned businesses has become a pressing issue. Without a solid succession plan, businesses risk disruption, loss of value or even closure, affecting local economies and community stability. Effective succession planning ensures a smooth transition that preserves business value and secures the legacy of the owner. Failure to plan sufficiently in advance is a key reason why only 25-30% of small businesses have a successful sale and the rest result in liquidation.

1. The Importance of Early Preparation (5–10 years in advance): Succession planning is not a last-minute task; it requires foresight and strategic preparation, ideally starting 5 to 10 years before the intended transition. Early preparation allows business owners to gradually address potential challenges, strengthen the business's market position and groom potential successors. Early action provides time for financial restructuring, talent development and the improvement of operational efficiencies, which enhance the business's appeal to buyers or successors.

2. Building a Strong Support Team: A successful succession plan relies on a collaborative team of experts who can navigate the complex landscape of business transfer. Key members of this team should include:

- **CPA:** Provides a clear picture of the business's financial health, ensures accurate financial records and advises on financial preparation for a sale or transfer.
- **Tax Advisor:** Offers guidance on the tax implications of different succession options, helping to minimize liabilities and maximize returns.
- **Business Attorney:** Plays a crucial role in drafting and reviewing legal documents, ensuring compliance with relevant laws and protecting the owner's interests during the sale or transfer process. An experienced attorney helps mitigate legal risks and streamlines negotiations.

- **Business Appraiser:** Establishes fair market value for the business, giving owners a realistic expectation of the potential sale price and aiding in negotiations.
- **Estate Planner:** Assists with personal financial planning to determine retirement asset needs, protect the owner's assets post-sale and plan for future generational wealth transfer.
- **Business Broker:** Facilitates connections with potential buyers and advises on marketing the business effectively. Alternatively, owners may engage with a **Small Business Development Center (SBDC)**, which offers guidance and support for business transitions often for free.

3. Types of Succession Options: Business owners have several strategic options for succession. The choice depends on the business' nature, the owner's goals and market conditions. Key succession types include:

- **Strategic Sale/Partnership:** Selling to a company that sees value in acquiring complementary capabilities. This often brings synergy benefits and can lead to a higher valuation.
- **Private Equity Purchase:** Private equity firms buy businesses with the intent of scaling them or adding them to a portfolio. This option often provides upfront financial benefit to the owner while the firm may involve the seller in transitional management.
- **Sale to a Competitor:** Competitors might be interested in acquiring the business to eliminate competition or expand their market share. While potentially lucrative, owners should be prepared for rigorous due diligence.
- **Sale to a Supplier:** Suppliers may be interested in purchasing a business to vertically integrate operations, gaining greater control over the supply chain. This option can be mutually beneficial if it aligns strategically with the supplier's objectives.
- **Transfer to Employee Ownership:** Transitioning a business to employee ownership can ensure continuity, preserve company culture and incentivize long-term business success. There are three primary options for structuring employee ownership:
 - **Employee Stock Ownership Plan (ESOP):** An ESOP allows employees to acquire shares in the company through a trust, often funded by the business itself. This option provides tax benefits to both the seller and the

company and can be a powerful tool for employee retention and motivation. ESOPs require careful structuring and administration to comply with federal regulations but offer a proven model for transferring ownership while maintaining operational stability. Businesses with less than 20-25 employees will find this legally/administratively challenging for the reward produced.

- **Worker Cooperatives:** In a worker cooperative, employees collectively own and democratically control the business. Each employee has an equal vote in company decisions, fostering an inclusive and participatory work environment. Worker cooperatives can be an attractive option for smaller businesses or those in industries where employee engagement is critical to success. This model requires significant cultural alignment and preparation to ensure employees are ready for shared decision-making and ownership responsibilities.
- **Employee Ownership Trust (EOT):** An EOT involves transferring ownership to a perpetual trust on behalf of the employees. Unlike an ESOP, an EOT does not require employees to buy shares directly; instead, profits are shared among employees, creating a stable ownership model that secures the company's long-term independence. EOTs simplify the transition process and can align well with owners seeking a legacy-focused transition that benefits employees without the complexities of share purchases.

4. The Challenge of Finding a Buyer: One of the most significant challenges for small business owners is finding a suitable buyer. In the Quad Cities and nearby regions, there is a notable lack of a pipeline of ready buyers or entrepreneurs interested in acquiring businesses. Factors contributing to this issue include:

- **Demographic Shifts:** Many potential buyers are in the same age group as the retiring owners, reducing the number of active entrepreneurs.
- **Economic Constraints:** Younger generations may face financial barriers that prevent them from purchasing businesses, including student debt and difficulty accessing business acquisition loans.
- **Entrepreneurship Gaps:** There is a need for more initiatives and programs that encourage entrepreneurship and prepare younger individuals, specifically from the millennial generation, to step into ownership roles.

5. Key Take-Away Points:

- **Emotional and Personal Barriers:** Emotional readiness often outweighs financial preparation when it comes to selling a business. For many owners, their business represents their life's work, a significant portion of their financial security and even their social circle and identity for themselves and their families. Selling the business is not just a professional decision, it's a major life transition that many owners are not prepared for or do not take the time to fully consider.
- **Financial Readiness:** Owners must prepare for the impact of taxes; ensure business financials are optimized and that the valuation reflects the true worth of the business. Working with experienced advisors helps navigate these complexities.
- **Training Successors:** Whether transferring to family, employees, or a new management team, having a strong mentorship program ensures that the successor is prepared for their new role. Owners should allocate time to transfer knowledge and leadership capabilities and this is often accomplished by having the seller as an advisor or employee for up to 3 years.
- **Communication and Transparency:** Keeping key stakeholders informed and engaged in the succession process is essential for a smooth transition. Clear communication minimizes resistance and aligns everyone's expectations. This is easier said than done because of the strong desire to keep plans quiet.

Conclusion: Effective succession planning is essential for the long-term success of businesses and the economic stability of the Quad Cities region. As a community, we can strengthen the economic vitality of the Quad Cities by planning early, building a support network and finding succession plans that work best for your companies to attract the right buyer – thus continuing your legacy and providing strength to our community.