THINKING ABOUT BUSINESS SUCCESSION

BEGIN AT THE END

In *Alice in Wonderland*, during the trial over the Queen of Hearts' stolen tarts, the White Rabbit is asked to read a set of verses into evidence. Thereupon, "[t]he White Rabbit put on his spectacles. 'Where shall I begin, please your Majesty?' he asked. 'Begin at the beginning,' the King said gravely, 'and go on till you come to the end: then stop.'"[1] Starting at the beginning is the way to accomplish most things in life. However, with respect to business succession planning, it is better to *begin at the end*.

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When thinking about business succession planning, most business owners start by considering how much their business is worth, how to transition the business, and to whom the business should be transferred. The focus is on the mechanical transition whether by gift or part-gift, part-sale to family members, by sale to management, or by sale to an outsider, such as a strategic third party or private equity fund. Although it may seem strange, when thinking about leaving your business, you should begin at the end, by planning for your and your family's life after the transition and how leaving your business will impact your and your family's financial success.

Profound Regret

According to the Exit Planning Institute's Readiness Survey, 75% of business owners "profoundly regretted" selling their business 12 months after finalizing the deal.[2] For the owner who has sold a business, once their involvement has ended, there are many different reasons that can cause feelings of regret. Some reasons involve lack of purpose, loss of status, or simply boredom. Frequently, regret comes from the lack of personal financial planning before the transition and the former owner receiving less from the transaction than is necessary to maintain a desired lifestyle.

While family, careers, material well-being, friends and health are all top sources of meaning, they vary in importance across publics surveyed.

Ranked choice among 17 topics coded as part of what gives people meaning in life.

	1st choice	2nd	3rd	4th	5th
Australia	Family	Occupation	Friends	Material well-being	Society
New Zealand	Family	Occupation	Friends	Material well-being	Society
Sweden	Family	Occupation	Friends	Material well-being/Health	
France	Family	Occupation	Health	Material well-being	Friends
Greece	Family	Occupation	Health	Friends	Hobbies
Germany	Family	Occupation/Health		Material well-being/General Positive	
Canada	Family	Occupation	Material well-being	Friends	Society
Singapore	Family	Occupation	Society	Material well-being	Friends
Italy	Family/Occupation		Material well-being	Health	Friends
Netherlands	Family	Material well-being	Health	Friends	Occupation
Belgium	Family	Material well-being	Occupation	Health	Friends
Japan	Family	Material well-being	Occupation/Health		Hobbies
UK	Family	Friends	Hobbies	Occupation	Health
U.S.	Family	Friends	Material well-being	Occupation	Faith
Spain	Health	Material well-being	Occupation	Family	Society
South Korea	Material well-being	Health	Family	General Positive	Society/Freedom
Taiwan	Society	Material well-being	Family	Freedom	Hobbies

Source: Spring 2021 Global Attitudes Survey. Q36.
"What Makes Life Meaningful? Views From 17 Advanced Economies"

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In the United States, material well-being ranks third after family and friends as a factor that makes life meaningful.[3] Even though the amount of U.S. respondents citing this as a factor has declined from a similar survey in 2017,[4] material well-being still ranks in the top three factors that provide life with meaning.

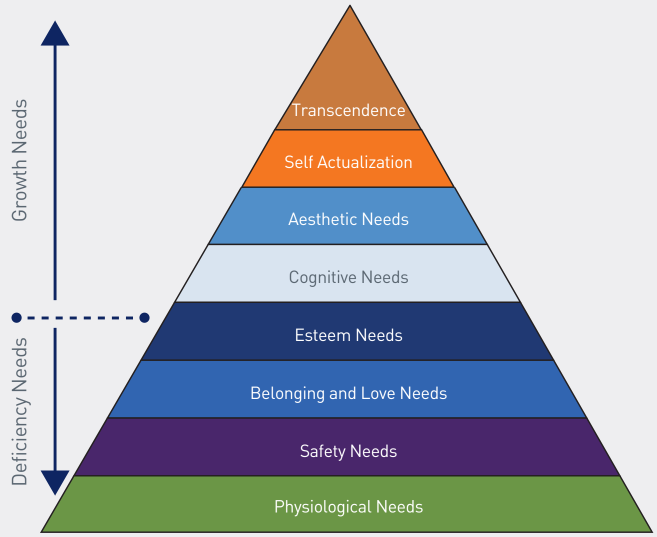
"According to most financial advisors, an owner's business wealth is usually 80-90% of their overall net worth."[5] Imagine the profound regret a former business owner would feel if the proceeds from selling (or transitioning away from) their business would not provide sufficient resources to support the desired lifestyle for the former owner and their family. Stated another way, given the amount of the business owner's wealth tied up in the business, failure to convert that wealth prior to or upon the owner's exit to personal financial resources that will support the owner and owner's family's desired lifestyle, would be heartbreaking.

Financial Needs and Desires

Each family is different, as are the things that each family desires. There are basic needs, like shelter, food and clothing (and other physical things needed to simply survive). Until those basic needs are met, other needs do not come into play (although this all or nothing approach has been softened so that when one level of needs is "more or less satisfied" a person's activities will seek to satisfy the next level of needs).[6] However, as each level of needs is met, other things become needs, and the individual will strive to satisfy them. Following is a diagram showing an updated hierarchy of needs.

Most Americans can satisfy their basic needs. However, "[w]hen describing their sense of

Chart 1
Maslow's Motivation Model



Source: McLeod, S.A., (Updated, January 24, 2024). Maslow's hierarchy of needs. Retrieved from https://www.simplypsychology.org/maslow.html (last accessed November 1, 2024).

meaning and fulfillment in life, many in . . . advanced economies mention their material well-being, stability or quality of life – including whether they have enough money to live comfortably, their ability to afford necessities, their standard of living and whether they feel safe and secure."[7]

Know What You Need to Live Your Life

Before making any major change, it is prudent to evaluate its impact on your life. When evaluating any major financial change, such as selling your business, it is critical to understand how your life will materially change (for better or worse) after the transaction. Envision your life after leaving your business. Think about today: What do you enjoy doing in your spare time? What activities do you wish you had more time to pursue? What causes are you passionate about? Then, *pretend it's Wednesday afternoon, six months following the sale of the business, your perfect day in "retirement": Where are you? What are you doing? Who are you with? What does it cost to do what you imagine you are doing?*

If you are like most business owners, you spend a lot of time and energy managing your business. To a large degree, you are able to control the direction of the business, its operations and its risk profile. As a business owner, you have a tremendous amount of control over how your credit capacity and capital are used in the business. In fact, although it sometimes does not feel like it, you are able to manage your business, and therefore, your investment risk. You can project your cash flow year to year and probably know how to plan your life based on anticipated income from your business operations. In addition to cash compensation (and other cash distributions from the business) many of the niceties of modern life may be provided by your business, perhaps a car, a cell phone, business travel to nice places (that might include some time off, too) and other things that make life pleasant. Therefore, when contemplating the potential future sale of your business, it is important to determine how you will replace the income and perquisites that the business currently provides (and perhaps to decide which of the perks you will do without).

The only way to know how the sale of your business will impact your and your family's lifestyle is to prepare a comprehensive financial analysis that illustrates the cost of your lifestyle today and the sources of revenue used to fund those costs (your baseline) and additional financial illustrations that project the cost of future (and possibly other) lifestyles and the sources of revenue available to fund them.

For example, engaging in comprehensive financial planning well in advance of an ownership transition could lead you to rethink your business working capital strategy, causing you to potentially relocate some business assets (such as, profits) from the company's balance sheet to your personal balance sheet over time. Having assets on your personal balance sheet can provide you with flexibility when the time comes to negotiate the selling price or terms of your exit from the business.

A comprehensive financial plan can project the financial impact of life's beautiful things like annual ski vacations, owning a home near the beach and a long and healthy life. However, although it may be difficult to think about, a comprehensive financial plan can also project the financial impact of life's difficulties, such as illness requiring long-term care, children who need financial support deep into adulthood, as well as premature death. We can't know what the future holds but understanding the potential financial impact of life's ups and downs can help you be prepared, no matter what comes.

Because each family's financial goals and objectives are different, it is not possible to state here what your family would need to live life as you would wish (only you can do that). However, it is axiomatic that without a complete and accurate financial plan it is not possible to really know whether the price you expect to receive from the sale of your business will support your and your family's lifestyle after the sale, and provide for other desired financial goals, such as a family legacy or charitable giving plan.

You can find the time necessary to do this important work long before you desire to exit your business. As a business owner, you are busy. It probably seems that there is no end to the tasks that you must do to keep your business running smoothly. Of course, many of those tasks involve planning for the future. So why not apply those same planning skills to your personal finances? Consider regularly reallocating some of the time and energy you now use managing the business to developing and periodically updating a personal financial plan that explores the impact of exiting the business and leaving behind resources derived from the business necessary for you and your family to accomplish your personal financial goals and objectives.

What Do You Need to Live Your Life?

The sale of your business may generate a significant amount of cash, but will that amount be enough? By completing a comprehensive financial plan, you can determine the amount of income necessary to maintain your and your family's desired lifestyle. That is, the amount you would you need to invest in a portfolio of securities to generate the cash flow necessary to support that lifestyle.

Below is a chart indicating how much you would need to invest at various rates of return to support different lifestyle costs. This illustration shows a fixed return on investment (a linear analysis) and does not consider market fluctuation or inflation.[8]

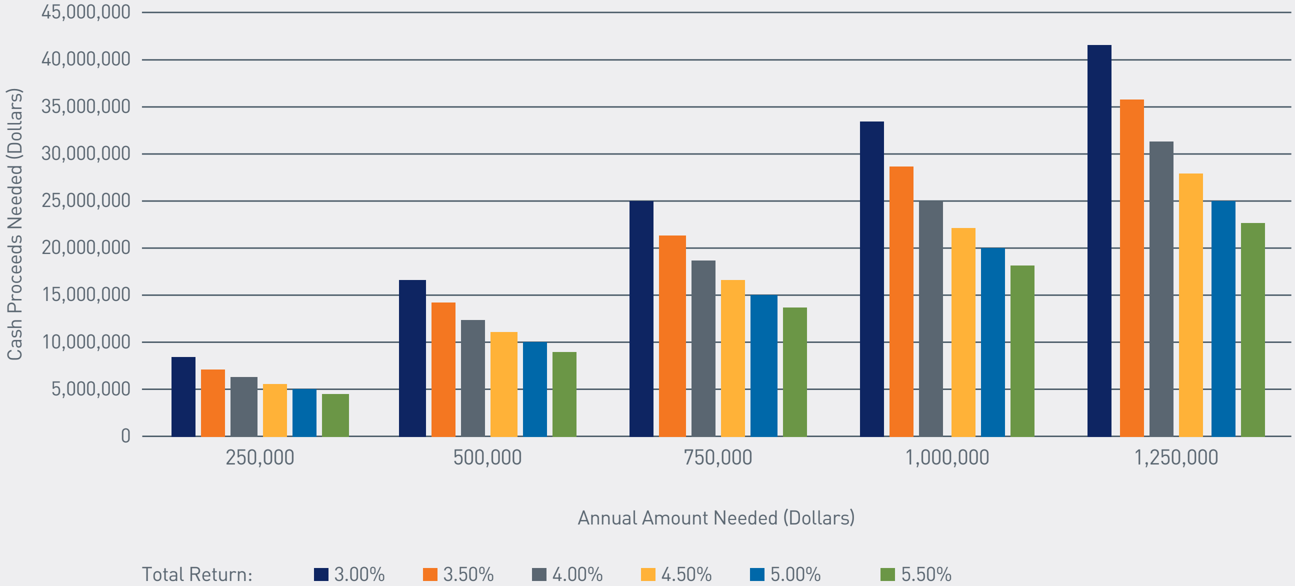
In the end, you must answer this question: How much must you to receive from the sale of your business that, when added to your non-business financial resources, will be sufficient to support your and your family's lifestyle, now and in the future, while also providing for other financial goals and objectives?

Plan Now, Plan Again, Keep Planning

President Dwight D. Eisenhower is credited with this paradoxical statement about being prepared: "Plans are worthless, but planning is everything."[9] In our experience, many business owners decide to exit their business after receiving what is considered to be a good offer, selling for that price. It is only later that they find out that the amount received after taxes was not enough. Other times, the business owner decides to retire and completes a comprehensive financial plan shortly before offering the business for sale. While this provides the marginally better result of no surprises, and the ability to avoid a financial misstep, the owner is forced to consider whether to stay on beyond the anticipated retirement date and build the business to the necessary value, or consider other options, such as scaling back lifestyle or finding additional sources of income following the sale of the business.

Setting a financial plan in place before an ownership transition is important to your financial well-being, yet, without more, producing a single, static, plan may yield unsatisfactory results. Ideally, planning should be dynamic and ongoing. The knowledge gained during the planning process, through the exploration of a wide variety of options and contingencies, is critical to selecting optimal actions as future events unfold. Once again, as President Eisenhower put it: "Plans are worthless, but planning is everything."[10]

Chart 2
How Much Do You Need?



Source: PNC Private Bank

Investment returns are hypothetical and may not reflect actual market returns. Your return on investment is dependent upon the assets that you own. For purposes of this illustration, all taxes are included in the Lifestyle cost amount. Your tax liabilities are dependent upon many factors, none of which are illustrated. PNC does not provide legal, accounting or tax advice. Consult your attorney, accountant or other tax advisors for tax advice.

Plan now. It is never too early to plan. Good business planning begins early and never ends; and a very important part of business planning is planning for your exit from the business. Then, when the plan is done, plan again.

No matter how old you are or how long you have been in business, you should always know the amount of cash flow that you need to support your lifestyle were you to exit the business at any particular moment. Approximately, "50% of all business exits are involuntary and are forced on the business owner by external factors."[11] It makes sense, therefore, to know what you need today should you exit the business unexpectedly. Knowing what you need today and projecting what you will need in the future, allows you to take steps to grow and develop your business now, prudently and patiently over time, so that, whatever your exit plan, the amount that you receive when you exit will support your desired lifestyle, now and in the future. Keep planning, until you are ready to execute. And once the business is sold, continue planning for whatever your future brings.

Seek Assistance – Don't Do It Alone

Successful people have support networks, groups of professionals, friends, business associates and others with whom they can discuss ideas, plans and goals. Business succession planning is no different. If you are a business owner, whether you are thinking about transitioning your business, haven't thought about it, or even if you don't know where to start, we know one thing is certain — whether voluntarily or involuntarily — every business will transition someday. By beginning at the end and continuously planning for your present and future financial goals and objectives, after you transition out of your business, you will be more likely to relish than regret your business succession decision. PNC's Corporate Advisory Center, Business Owner Solutions Group, Wealth Strategists, and Institute for Family Success® are resources that you can use to help you think about this important, yet often forgotten, topic.

To access these or any other of PNC's resources, contact any member of your PNC team.

Endnotes

[1] Carroll, Lewis, Alice's Adventures in Wonderland, The Millennium Fulcrum Edition 3.0, Project Gutenberg, Chapter XII, https://www.gutenberg.org/files/11/11-h/11-h.htm (last accessed November 1, 2024). This work is in the public domain.

[2] Exit Planning Institute, *The State of Owner Readiness Survey 2013 National Survey Final Report* (2013), updated 2016. Also, Exit Planning Institute, *Walking You Through the Perfect Exit*, p. 5.

[3] Silver, L., Van Kessel, P., Huang, C., Clancy, L. and Gubbala, S., *What Makes Life Meaningful? Views From 17 Advanced Economies*, Pew Research Center, November 18, 2021, https://www.pewresearch.org/global/2021/11/18/what-makes-life-meaningful-views-from-17-advanced-economies/ (last accessed November 1, 2024).

[4] "The share of U.S. adults who bring up their material well-being – including references to feeling safe, secure, able to cover the basics, living comfortably or being well-off – has dropped from 29% to 18% over the past four years. This decline has been concentrated among two groups in particular: married adults and White Americans. In 2017, both groups were among the most likely to point to material well-being as a source of meaning." Van Kessel, P. and Silver, L., *Where Americans find meaning in life has changed over the past four years*, Pew Research Center, November 18, 2021, https://www.pewresearch.org/fact-tank/2021/11/18/where-americans-find-meaning-in-life-has-changed-over-the-past-four-years/ (last accessed November 1, 2024).

[5] Exit Planning Institute, *Walking You Through the Perfect Exit*, p. 6.

[6] McLeod, S.A., (Updated January 24, 2024). Maslow's hierarchy of needs. Retrieved from https://www.simplypsychology.org/maslow.html (last accessed November 1, 2024).

[7] Silver, L., Van Kessel, P., Huang, C, Clancy, L. and Gubbala, S, *The Conditions that enable meaning*, Pew Research Center, November 18, 2021, https://www.pewresearch.org/global/2021/11/18/the-conditions-that-enable-meaning/ (last accessed November 1, 2024).

[8] To model the potential impact of random variables upon an investment portfolio, including market fluctuation (dynamic investment returns and volatility) and inflation, your financial plan should include a so-called Monte Carlo analysis, also known as a multiple probability simulation.

[9] Eisenhower, Dwight D., *Remarks at the National Defense Executive Reserve Conference, November 14, 1957*, Public Papers of the Presidents of the United States, Dwight D. Eisenhower, Federal Register Division, National Archives and Records Service, General Services Administration, 1958, p. 818.

[10] *Id.*

[11] Exit Planning Institute, *The 5 D's*, 2020. The 5 Ds refer to certain external factors that can force the transition of a business. The 5 Ds are, Death, Disability, Divorce, Disagreement (among various contingencies), and Distress (in the business).

For more information, please contact your PNC Private Bank Hawthorn advisor.

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