



BRIEFING PAPER

*Successful succession:
Options for passing on your business*

SPRING 2014

Introduction

Succession is inevitable and with only 13% of family businesses making it to the third generation, planning for change is critical to success. Where family business succession just happens without proper planning, the result could be unsatisfactory and may be detrimental to the family, the business or both. As well as preparing for the transition of share ownership, family business owners also need to consider who will lead and manage the business, if it stays within the family.

Sometimes these succession decisions are obvious and the hand over easy, but more often than not, where there are family and business considerations to balance, the boundaries can become blurred. Business decisions can be influenced by family emotions and involvement, which can often lead to ineffective results.

On the converse, decisions may be made without sufficient consideration of family concerns, which is also not a recipe for success. This complexity is exacerbated by the fact that the leadership and ownership of a family business may transition at different times.

Every family business is unique and so the way they approach their succession will be unique. That is often why families benefit from some guidance through the planning process. At Coutts, we often hear challenges like:

There is no 'one size fits all' response to any of the challenges that come with succession, but starting early to resolve issues and being inclusive in the process, will help to ensure you make the right decisions and that your family are properly prepared for the transition when it occurs. Succession is a gradual process, not a one-off event – plenty of time and consideration needs to be given to planning and implementation.

There are many different ownership and leadership models available as the business moves from the entrepreneurial stage through to subsequent generations. Deciding on the best options will depend on factors, such as:

- the values and vision of the family
- personal objectives for retirement
- individual and family financial needs
- whether the business has an obvious successor
- the tax implications
- the health of the business
- the market situation now and in the future

'I believe passing down a business is more tax efficient than passing down wealth, but I can't get my children to take an interest in the business'

'All my children are involved, which is great, but how am I ever going to be able to choose between them as to who will lead the business?'

'Should I split the business so each of my kids can run their own areas?'

'With 15 cousins as future owners, it is going to be much more complicated than it was when just my siblings and I were involved'

'The business needs significant investment to take it to the next stage. Is now the right time to sell or bring in external management?'

'My staff have been so loyal and will play a key role when I step back. How can I incentivise them if I don't want shares to pass outside the family?'

'Working in the business is an opportunity not a birthright and I want my children to really prove themselves if they want to join'

'My dad wants me to take over the business but that is not where I see my life or career heading'

For many families, the long term vision is to keep the business in the family and for each generation to act as stewards of the business for the younger generation. The business often represents, not only a key part of a family's financial wealth, but amazing career opportunities and an important contributor to the family's tradition, legacy and pride.

Below are five different options to consider, where the aim is to 'keep the business in the family', which we will explore in greater detail in this paper:

1. Doing nothing
2. Passing on leadership to family
3. Bringing in a non-family leader
4. Private equity investment
5. Reverse succession

Each section of this paper outlines the benefits and challenges of the approach and some 'things to think about' if you are considering that route. There are also case studies to illustrate how others have approached succession and the impact of these decisions.

However, it should be remembered that this is not an exhaustive list and your decision should be the end point of the planning process. The discussions can be lengthy, and should involve family and key management throughout, but it will be a valuable process. Opening up family communication and sharing long term expectations and aspirations are core to reaching the right decision. More importantly, involving everyone in the process will help to achieve long term buy-in and ensure that your decisions are likely to be broadly acceptable to all.

All this preparation may sound onerous, but planning ahead means that your family will be ready and willing to take over ownership and prepare for the challenges ahead.

If you would like more information about how to plan and communicate effectively through the succession process, please contact the Coutts Institute team (see page 22).

1. Doing nothing

What does it mean?

Despite the advantages of planning for succession, in our experience, the most popular option for many family businesses is to do nothing and to ignore the fact that succession will one day be upon them.

The resistance to succession planning is often due to complex emotional, psychological or financial reasons. The current generation may fear the implications of retirement, such as not having enough to do, letting go of control and power or losing their identity. There may also be worries about how to choose a successor from the younger generation without causing conflict, particularly if there is rivalry in the family or concerns about feelings of entitlement. Ultimately, planning succession means discussing subjects which may feel uncomfortable for some families and so the easiest option is to avoid them altogether.

However, this is usually the worst option as it doesn't give the family time to properly prepare themselves and ensure that the transition is gradual and smooth with minimal impact on the business and family.

What are the benefits?

- Planning ahead avoids the need to confront uncomfortable issues such as death and finances or the need to make difficult decisions such as choosing a successor amongst family
- Avoids changing the status quo

What are the challenges?

- The current generation are not planning for retirement and therefore are unprepared, emotionally and financially
- The younger generation are unclear on expectations and unprepared for the responsibilities that ownership and leadership bring
- Family gossip and conflict can result from trying to resolve decisions informally
- The family and the business are left to deal with the results of a badly planned and executed succession

Things to think about

- Take small steps – simply starting to think about your personal objectives and reading around the topic begins the journey
- Talk to other family businesses about their experiences so you can learn from their successes and challenges
- Start to involve your family and try to understand what they want and what their vision is for the future
- Remember that avoiding issues does not mean they will disappear. Even if discussions are likely to be difficult it is always better to let each family member express their views

2. Passing on leadership to family

What does it mean?

The vision of some families will be to retain the leadership of the business within the family. They see it as a way to keep the family involved and in control whilst also providing career opportunities that couldn't be accessed elsewhere.

The first requirement for this approach would be having someone in the family who has experience in the business, is well regarded and has the capability and willingness to take on this role. The challenge becomes more complex if there are several family members progressing in the business. Managing the expectations and the emotions of the wider family can be a challenge.

Ultimately this decision should be based on ability and merit not based on family position, expectation or any other emotion-led criteria. There will need to be timely discussions with the board and the family about how the next leader will be selected and who and what should be involved in that process. Having an objective and transparent process in place, based on merit, can help to make these decisions fairer and can lead to more acceptance of the outcome.

But selection isn't the end of the process.

Too many family successions have failed because no consideration had been given to what will be needed once a new generation starts to take over. The new leader will need to be given authority but also support and development in order to grow into the new role.

It should also not be assumed that this will be a job for life. Family leaders will need to be fully accountable and have regular reviews in the same way that non-family would. This will ensure they remain best for the business, with full support from the board and the family.

What are the benefits?

- Being involved as owners and managers enables the family to remain in control
- It is easier to ensure the family values and vision remain embedded in the company
- The business continues to provide job opportunities and career progression for family members
- A family ambassador will remain in place, which is particularly important if the family name is above the door

What are the challenges?

- There may not be a suitable family member to take over
- The success of the business is on the younger generation's shoulders, which may be a difficult responsibility to bear
- Family rivalry may surface, especially if selecting a leader means having to choose between family members
- Supporting and developing the younger generation to grow into a leadership role takes time, money and effort

Things to think about

- Start preparing the younger generation as early as possible for the responsibilities of ownership and leadership. Consider putting in place development plans including opportunities to work outside the family business
- Clearly define rules regarding employment and succession, including remuneration, share options, holiday, accountability and exit. This may not have been standard practice for family members in the past but will be a key part of managing expectations and avoiding assumptions being made going forward
- Employees may not hold the new leader in the same regard as the current generation. Having a strong track record and being selected as part of a robust process can help to build credibility
- Separate any money received from working in the business from any money received by virtue of being a family member or shareholder
- Objective feedback mechanisms, as any other manager would have, should be put into place for family members
- If family members are not quite ready to take on the leadership role, then consider whether non-family professionals can help bridge the gap and strengthen the team

CASE STUDY: JULIAN WALKER, MANAGING DIRECTOR, A.B. WALKER & SON LTD

A.B. Walker & Son Ltd, independent funeral directors and monumental masons for 180 years, is now in its fifth generation and is considering how the next generation might join the business.

At the last generational transition, there was no process in place to manage family members entering the business or any objective way to manage their performance. What resulted was an individual taking a position that was not right for them. Once forced to move on, the negotiation regarding the terms of the settlement was a prolonged and destructive experience which permanently strained relationships within the family.

All shares are now owned 50/50 by brothers Julian and Matthew Walker. To avoid repeat issues, they have an updated shareholder agreement and a new family agreement (the equivalent of an employment contract). “These documents cover sticky subjects like death, divorce and the decision to continue,” says Julian. “And we have engaged with our spouses to understand their expectations. We have also looked at how the next generation will enter the business. Our intention is that we will pay for them to get experience elsewhere first.”

In the future, Julian would like to review the rule that only the working family can own shares. “I would like to grow the capacity for wealth creation, so that if someone is working in the family business they can be rewarded, while still allowing for rewards for ownership if they are working outside the family business.” The family also plans to set up a family council to give the retired members of the family a chance to give their opinion. It will also be an opportunity for the next generation to become involved before they decide whether to join the business.

Julian says the family has worked hard to get the right people in place to govern the business and has gained a lot from taking advice from external professionals and talking to other family business owners. “When my father and uncle ran the business the culture was that ‘nobody does it as well as the family’. But now we have grown non-family managers internally and brought in a non-family, non-executive director which helps strengthen our board and provide direction for the future.”

3. Bring in a non-family leader

What does it mean?

If family members are not willing or able to run the family business successfully then the best option may be to appoint a non-family leader. This decision should be reached by the board, in discussion with the family. It's often at the point where they can see that professionalising the business, and strengthening the board with outside expertise, is important for future growth and success.

When bringing non-family leaders in, or promoting them through the ranks, having the right selection process in place is crucial for success. It is important to select someone, not only with suitable experience, skills and track record, but who also understands the culture and values of the family and what the business stands for. A formal and objective recruitment process is advisable, which both the family and the business could be part of.

Taking this route however may be hard for the family to accept, particularly if a family member feels the leadership position should rightfully be theirs or where they fear the impact of the change that professional management might make within the business.

Where conflict arises, it is important for the family to establish and articulate their vision and agree some core principles. Is the business run as a meritocracy? Is the vision of the family to grow and enhance the business for future generations? If the answer to both questions is yes, then succession will be clearer. Selecting the strongest leader, be they family or non-family, will allow the business to flourish, which is ultimately in everyone's best interests.

What are the benefits?

- It can bridge a gap if there are no family members to take on the role
- As well as new skills and attributes, non-family leaders can give a family business a more outward looking perspective, bring external experience and help develop a balanced board
- It avoids the success of the business being over-reliant on the family's skills
- It moves the business away from a 'family first' approach which can help attract stronger non-family employees
- It is an opportunity to bring someone in who has prior experience of growing a similar business to the next level

What are the challenges?

- The family will be less involved on a day-to-day basis and will need to create governance and accountability to ensure the business is being run in their best interest
- Family members may feel overlooked in favour of the non-family member leading to negative emotions and conflict
- The compensation demands and expectations of outstanding executives can be challenging and a big change for the family
- The family must invest in the recruitment process to ensure the correct candidate is selected

Things to think about

- Look for someone who has experience of working with other family businesses so they understand the unique dynamics of this type of organisation
- Consider carefully how to incentivise non-family management, particularly if you don't want shares to pass outside the family. If shares are passed outside the family, ensure agreements are in place to return the shares if the employee leaves the company

- The family will need to articulate their vision for the family business and give a clear mandate to the board, whilst giving them the freedom to lead
- The family need to be prepared to embrace the change that the new leader may bring
- Family governance mechanisms need to be developed to ensure clear and effective communication between the family and the board and to ensure the board remains fully accountable to the shareholders

4. External investment

What does it mean?

Bringing in external investors can work particularly well in certain circumstances. For example, if the business needs funding to grow, if the family needs to create liquidity for the older generation to take a step back or if one generation, or branch of a family, wants to buy out the other.

Bringing in external investment can help to plug both financial and management holes. It can provide working capital to help with expansion, product development, or restructuring of the operations, management, or ownership. It may also help professionalise the business and bring in outside expertise and contacts.

Family businesses have traditionally avoided this route, either because they fear losing control or they believe that the only way out of such a deal is ultimately through an exit from the business. Neither of these need be the case and many family businesses have

found outside investment to be a strong way of taking the business forward and addressing their succession challenge.

An investment will generally be made by a private equity firm or an angel investor in return for a stake in a private company. The type of investor to consider will depend on the needs of your business and the approach of the investor.

There are some barriers to securing external investment. For example, some private equity firms can have negative views of family businesses, because of the family's involvement and preference for long term ownership. Equally, some families have concerns about the intentions of external investors and their ultimate aim of exiting the business. On that basis, partners need to be carefully selected and any agreement needs to be entered into cautiously, to ensure that all parties have the same vision and objectives and that everyone clearly understands how the relationship will work.

What are the benefits?

- Investment can give the business a solid foundation to help grow, improve or diversify
- It can create liquidity to help fund the retirement of the older generation or facilitate exits by family members or branches of the family
- External investors can bring an independent viewpoint and new ideas to the business
- If the family's ultimate goal is to exit, the investor can work with a family in grooming the business for sale in order to maximise the returns

What are the challenges?

- Family ownership and control is diluted
- The external investors may get involved with the ongoing management of the business, which risks upsetting the family and non-family employees
- It can be challenging to secure the right investment for your business and make the partnership work

Things to think about

- It is important to identify the investor who has the best fit with your business and has worked with family businesses before and understands and appreciates their nuances
- Spend time with the investor to build relationships and clarify expectations on both sides. For example, what does the investor want out of this and what is the family's agenda?
- Talk to others who have experienced external investment but remember that each situation will have unique characteristics and needs
- Clarify timescales and how long the investors want to remain involved. Agree a clear exit strategy up front so everyone understands how things will work when the time comes

For more information on Venture Capital you can request from your Private Banker a copy of the Coutts publication 'The Price for Growth - The Venture Capital Mindset: What you Need to Know to Secure and Succeed with Venture Capital'.

5. Reverse succession

What does it mean?

Some family businesses believe that the younger generation should prove themselves before they are given the opportunity to enter the business. Reverse succession is one way of doing this and involves the younger generation successfully setting up their own business before bringing it back to be part of the main family enterprise.

Giving the younger generation this opportunity has many benefits. It encourages them to develop business acumen as well as their confidence, credibility and skills. Proving their worth and ability in an external environment can be hugely valuable in the long term to the family business. The family businesses can then come together, with the younger generation continuing to run their enterprise as part of the main family business or moving into a new role within the core family business.

However, reverse succession is not without its challenges and the rules and boundaries around funding, resources, support and buy-back must be made very clear from the outset. There are also risks if their business fails, and the impact this may have on their credibility and confidence. The family will need to plan carefully how the younger generation will be mentored and supported before, as they develop their new venture and how this approach fits into the long term overall succession plan.

What are the benefits?

- The younger generation gain confidence and valuable experience of setting up and running a business
- It encourages entrepreneurialism in the younger generation
- It may lead to more respect from non-family work colleagues when they return to the family business
- It is a diversification and, potentially an additional source of income for the family

What are the challenges?

- Incentivising the younger generation to come back to the family business can be a challenge, particularly if their business is a great success and they are enjoying the freedom of running it
- It can be seen by others as nepotism and giving family members a 'leg up', particularly if people don't understand the arrangement
- If the new venture is funded by the business or the family, it can create challenges unless the family are clear around details in advance, for example who owns the new business, whether it is a success or failure
- It can create rivalry between family members, particularly if one is more entrepreneurial than the other and ultimately more successful

Things to think about

- Establish clear ground rules from the start. Agreements, ideally legal, need to be put into place around areas such as the type of investment, repayment terms and exit
- Work with the younger generation to provide them with the support they may need in their venture and ensure the greatest chance of success. Agree in advance what access to company support/resource they should have i.e. IT, HR, Finance
- The current generation can use it as an opportunity to work closely with their children and act as a mentor for them

CASE STUDY: WILL ASHWORTH, MANAGING DIRECTOR, WATERGATE BAY HOTEL LTD

John and Mary Ashworth are part of a large family of hoteliers and in 1967 they acquired a hotel in Watergate Bay. When the couple faced a declining market in the 90s, they decided to retain the hotel with the vision that their three sons would eventually want to come on board, bringing new ideas to drive the business forward.

However, before joining, they encouraged sons, Will and Henry, to gain training and external experience in the hospitality industry. They wanted to ensure they had the skills and credibility to develop the business and wanted to give them the freedom to learn and grow.

Henry decided to set up a 'beach lifestyle' business ('Extreme Academy') next to their parent's hotel, with Will as an investor.

"We wanted to prove to our parents that there was a viable year round, 21st Century proposition to replace the traditional 'bucket and spade' holiday," says Will. "We did not want to take on a business without believing it had a bright future."

They borrowed substantially to acquire and convert suitable buildings into the Extreme Academy and, within five years, they had achieved turnover of around £1.5million, and gained significant local recognition for helping transform the experience and image of the traditional Cornish holiday.

Will feels the experience of building the Extreme Academy independently from the family business was positive. Their parents believed in the vision and were always available for support and guidance. And although the investment was raised through the same bank, the Extreme Academy's finances and operations were kept independent of the Hotel, meaning the Academy's outcomes and successes were clear. This whole experience helped Will and Henry gain their parents' confidence and reshape the future of their family business.

Will says there are many benefits to approaching succession in this gradual way. "It gave us the ability to cut our teeth on something new that was our project, while also allowing us to experiment with the market and a product which would eventually influence the family business" he says. But Will admits there were also downsides, namely the stress of working in the same location as family.

In 2005, at 33, Will became Managing Director of the Hotel and fully incorporated the Extreme Academy. Following the merger, the team built a sophisticated brand and turnover grew. The family has since diversified into holiday homes and has brought a branch of Jamie Oliver's Fifteen to Watergate Bay. They are now looking at their governance and keeping the Watergate Bay Hotel in family hands for the next generation.

6. Conclusions

Family business succession can be a unique and special opportunity. It is a chance to pass your legacy onto the next generation and beyond. It is an opportunity to bring new skills and approaches to reflect the changing nature of the business and its clients. It can also be a tax efficient way to pass your wealth down.

However, there are challenges to be overcome along the way. Family perceptions, assumptions and emotions can prevent the right decisions being made or lead to conflict. There are also personal reasons for avoiding discussions about succession, such as fear of what the future may hold, resistance to handing over power and control or avoidance of making difficult decisions. For the younger generation, there may be concerns about the future of the family business being their responsibility and whether this is a career and lifestyle they want to take on.

A good starting point is to begin talking to individual family members about their goals and aspirations, both personally and for the business. This can help create a plan that will be broadly acceptable to all and can be openly discussed. An external facilitator can often add value here, to bring experience, create a neutral environment and ensure everyone is able to contribute fully to the family discussions.

A few general top tips for planning and managing succession are:

- Don't be scared of change – it can bring opportunity
- Talk openly as a family to understand everyone's vision and aspirations and then plan the best way forward
- Don't put pressure on family members to remain involved if they don't want to be
- Speak to other family businesses about their experiences and lessons learned
- Take your time – succession is a process not an event
- But start as early as possible, so you have plenty of time for discussions, planning and implementation

If the family wants to keep the business in the family, there are many different ways to approach it, and this paper has explored some of the most common ones. They won't all be right for every family business, which highlights the importance of beginning discussions as early as possible around what the family are hoping to achieve and the resources and skills they have available to do it. The family can then begin to map out the best way forward and work towards a successful succession.

7. The Coutts Institute

We understand that wealth means more than money. So when clients talk to us, they often want advice on broader issues, such as discussing their wealth as a family, preparing the next generation for the responsibilities and opportunities that wealth brings, and getting involved in Philanthropy. They know that without a forum to address these issues, the risks of family conflict and loss of wealth are much higher. That is why the Coutts Institute was established. The Coutts Institute focuses on the governance of wealth. We support clients wherever they are located, including the UK, Russia and CIS, Switzerland, Asia and the Middle East. We run a programme of forums on current issues and produce a series of handbooks and thought-leadership pieces.

Philanthropy

Having supported many philanthropists, we recognise that there is no single way to give to chosen causes. The options are more varied and exciting than ever. We provide specialist knowledge on creating giving strategies based on personal passions and beliefs.

Wealth Succession

At Coutts, we know that the ability to pass wealth successfully from one generation to another is a process not an event. Our specialists are equipped to help clients tackle key questions, such as when and how to talk to the next generation about wealth.

Next generation

Inheritance can be a tricky subject to approach with children. At Coutts, we understand the importance of starting those conversations early and giving the next generation the tools and insights to start to plan for the future. Through a series of programmes, we introduce the next generation to a like-minded peer group, in order for them to fully understand and discuss key themes such as entrepreneurship, financial awareness, social impact and personal development.

Family business

We believe that the key to a healthy family business is careful planning and open communication. Our experts are an invaluable resource, sharing insight and expertise around themes such as family governance, ownership succession and leadership development.

To find out more about the Coutts Institute, please visit coutts.com/couttsinstitute

Disclaimer: This document is produced by the Coutts Institute and does not constitute financial research nor does it specify Coutts products therefore may not be subject to guidelines and/or regulation in any jurisdictions in which Coutts operates.

This document is produced for information purposes only and for the sole use of the recipient and may not be reproduced in part or in full without the prior permission of Coutts.

Nothing in this document constitutes investment, legal, financial, accounting or tax advice and does not confirm that a representation or strategy is suitable or appropriate to your individual circumstances or otherwise constitutes a personal recommendation to you. Recipients should seek independent tax and legal advice regarding tax and legal effectiveness of their succession proposition.

To the extent permitted by law and any applicable regulation, neither Coutts nor its affiliates accepts responsibility for any direct, indirect or consequential loss suffered by you or any other person as a result of your or their acting, or deciding not to act, in reliance upon such information, opinions and analysis.

Calls may be recorded.

Wealth division of Royal Bank of Scotland Group.

Coutts & Co. Registered in England No. 36695.
Registered office 440 Strand, London, WC2R 0QS.

Authorised by the Prudential Regulation Authority and regulated by the Financial
Conduct Authority and the Prudential Regulation Authority.

Calls may be recorded.

coutts.com