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SUCCESSION PLANNING IN TOUGHER TIMES

With thanks and acknowledgement to David Krause, Associate Director, BDO Kendalls Corporate Finance Division

The tight credit market and diminished business confidence has drastically slowed business and property sales and reduced prices. Yet the fundamental challenge facing Australia has not changed, namely the ageing of the population and the need to transfer ownership to the next generation.

This challenge places those in the midst of succession planning in an unenviable position. But despite the gloomy business conditions there are strategies that can be put in place to unlock the value built up in the business.

For those who have made the decision to sell their business, a desired strategy may be a complete divestment. However, buyers are nervous at the present time, so this outcome is not always easy to achieve.

This means that vendors need to think "outside the square" to help alleviate the concerns of buyers. Some of the successful strategies that have been employed recently include: -

- Vendors taking a convertible note from the buyer as part consideration;
- Merging with a compatible company with a put and call option to sell at a later date; and
- Recruiting new management with an option or obligation to acquire an equity interest in the business.

Each strategy has its benefits and shortcomings, but they can help achieve reasonable value from the asset concerned.

Convertible Note

Under this approach, the vendor receives an upfront payment, usually from bank finance and the purchasers equity, for a significant proportion of the value of the consideration and takes a convertible note from the buyer for the balance of the consideration.

This effectively means the vendor is providing additional equity for the buyer to obtain the bank finance. The convertible note may provide the option to redeem the note in cash or convert to equity in certain events, such as a trade sale or initial public offering.

This approach may help the buyer gain confidence in the business since the vendor remains financially involved. The approach may also maximise the sale price.

Merger

The opportunity to exit the business may be the most significant benefit of a merger. This can be achieved by agreeing to a friendly merger with a competitor, coupled with an obligation or option to sell, thereby allowing the vendor to gradually exit the business and giving less risk to the buyer.

It is also important to consider the time period over which the option can be exercised and the methodology to determine the price of the exercise. If a longer option period can be negotiated, the economy may improve in that time and ultimately result in a higher price, depending on the structure of the option.

To complete a merger, a contract will need to be negotiated to include a shareholders agreement. This document will set the ground rules for the way in which the merged business will be managed.

Partial Sell Down to New Management

This approach is similar to a management buy in, except a full divestment does not occur immediately. This style of transaction may be useful where a ”hands on” owner and operator is looking to retire and has found it difficult to divest a 100 per cent interest in the business.

To execute this approach, the vendor needs to recruit appropriately skilled and compatible managers to run the business and must hand over management duties over time. The new managers are recruited for two reasons: -

- They have the skills to run the business; and
- They have the desire to operate and own their own business.

Often an agreed amount of equity is purchased, either upfront or after a probationary period. One outcome of this approach is that it releases capital owned by the vendor that is locked up in the business. This gives the vendor value for their asset and potentially improves their lifestyle by removing the pressure of having full responsibility to operate the business.

The current state of the economic environment may prove challenging for those parties wishing to continue with succession planning in the short term. However, if vendors (and their advisors) think outside the square, a positive outcome is achievable. By undertaking the right strategy, a fair and reasonable price can be obtained for an important asset which may have taken years (if not a lifetime) to develop.