

Effective Succession Management

A study of emotional and financial aspects in SMEs



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Publisher's Foreword

For many years, Credit Suisse has provided custom-made advice and specialized publications to assist Swiss companies in effective succession planning. Today, we are helping hundreds of companies throughout Switzerland to meet this challenge. Our experience shows that effectively managing the social and economic dimensions of succession has important consequences for the national economy.

Fortunately, the discussion of this topic has shifted to new ground. In the past, business people identified financing, taxes or legal requirements as the greatest obstacles to a smooth succession. Today, they can and should also talk about emotional stumbling blocks: How do I deal with losing my social status as a business owner? What activities will I choose to fill my days? How can I work out a solution that benefits all those involved, while at the same time ensuring that my company continues to prosper?

When entrepreneurs know the answers to these questions, financing, taxes and legal intricacies become manageable technical issues. Credit Suisse experts and their network of additional advisors can help to address them. Financial planning can set out the framework for a possible sale. Purchases take shape through a tailored financing structure. Employee participation plans introduced at the right time pave the way for the financing of management buyouts.

Both for the sake of the economy and for business reasons, we are interested in continuing to foster open dialogue about succession management in Swiss companies. The University of St. Gallen study presented here should provide a foundation for all those interested in this topic.



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Authors' Foreword

Why another study of succession management?

We believe there are good reasons for addressing this topic in the study presented here. As evidenced in a comprehensive survey conducted in 2005 by the Center for Family Business at the University of St. Gallen (CFB-HSG) (see PwC, 2005), succession management has considerable economic and social importance for Switzerland. Therefore, the purpose of this study is to portray the current situation and describe any recent developments. We intend to delve more deeply into the complexity of the succession process and give due weight to its emotional aspects. Accordingly, we designed the study to combine a comprehensive written survey and 46 interviews with entrepreneurs before, during or after the succession process.

In both approaches, we found that corporate succession *within* the family has continued to wane; consequently, by choice and often by necessity as well, business owners look *outside* the family for a successor. This paradigm shift, which has become evident over the past ten years, poses particular challenges for companies, families and entrepreneurs from a practical standpoint. Is there even a market for the company? How much money can, or must, be generated by selling it? How readily can, or must, the incumbent owner let go? Consequently, in this study we focus on the financial and emotional aspects of succession.

In conducting this independent study, we expressly set out to derive from the findings important aspects for entrepreneurs to consider as they plan for and implement succession in their companies. We hope that you enjoy reading this report and that it offers useful insights.



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Executive Summary

This study investigates the current landscape of entrepreneurial succession in Switzerland and demonstrates how increased public attention has changed the situation. The results indicate that *succession planning will be an issue for 77,270 Swiss companies, 26% of the total*, in the next five years. This is projected to affect 976,220 jobs, about 30% of the total. In addition, they point to a marked rise in the importance of family-external arrangements: In at least half of all cases, the owners are explicitly seeking a solution outside their own families.

The study focuses especially on the emotional aspects of succession, which until now have received only very limited investigation. The close connection between entrepreneurs and their “life’s work,” the problem of letting go, and a very strong sense of responsibility to employees represent aspects of succession management that urgently require attention. It also transpires that monetary aspects are less important as objectives for succession than the company’s continued existence and future prospects, along with the preservation of jobs.

Despite a marked increase in the availability of consultancy and other services, only a limited number of business owners take advantage of these, mainly to address specific issues such as tax and contract laws. Owners very seldom rely on comprehensive and integrated support throughout the process.

The study particularly emphasizes the financial aspects of transferring ownership, which become a very important strategic task in the context of succession outside the family.

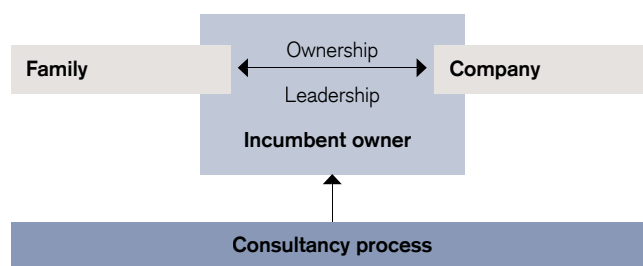


1 Company Succession as a Complex Process

In recent years, the subject of company succession has been of great topical interest in Switzerland. Many publications and media reports have taken up the issue, heightening awareness of its major significance in the Swiss economy. Accordingly, the objective of this study is to demonstrate how the landscape of entrepreneurial succession has changed in recent years. There are various reasons why we assume that such a change has taken place.

Since the Swiss Federal Court's 2004 decision (BGE 2A.331/2003), there has been some uncertainty about the tax burden on companies that are changing hands. Therefore, we assume that some succession processes have been postponed. This raises the question of whether and to what extent the overall economic importance of company succession has changed since our last survey in 2005. In addition, we have observed that more and more companies are not handed down within the family; instead, owners try to sell to an outside party. The reasons for this can vary widely. What matters, however, is that transferring ownership to outsiders poses major challenges to all those involved – challenges with emotional as well as financial aspects. Therefore, the purpose of this study is to demonstrate what makes the transfer effective, where obstacles and stumbling blocks lie, and how we can manage these. Underlying this is the great complexity of relationships among stakeholders. As shown in Figure 1, in the context of succession we distinguish between the social systems of *company* and *family*. The two are closely connected, with the entrepreneur (the incumbent owner) as the link between them.

Figure 1: Selected Perspectives on the Phenomenon of Company Succession



During the handover, this link between *family* and *company* is redefined (if succession occurs within the family) or dissolved (if succession goes outside the family). Accordingly, the *incumbent owner* stands at the heart of the process, at the interface between family and company. We therefore concentrate particularly on these entrepreneurs and their goals, wishes and challenges. We will also consider the role of external service providers who offer a wide range of *advice and support options*, thereby likewise influencing the succession process.

This study places special focus on the emotional aspects of succession, which until now have received very little attention. Our interviews with the people involved in these processes found that entrepreneurs view their management of succession as highly objective and try to approach the matter pragmatically. However, they often underestimate the emotional aspects arising from their close connection with the organization. Time and again, dealing with such emotions can present obstacles; all too often, it determines the success or failure of a handover. This can have a variety of consequences: In the positive case, the entrepreneur takes up the matter early on, with the result that both the business and the transition run smoothly. However, what we have seen in many instances is that in practice, during the transition – often to the surprise of stakeholders – emotional aspects come into play that can impede or even derail

the process. In addition, they may cause entrepreneurs to put the topic of succession management on the back burner, which later adds time pressure that can further complicate matters. Therefore, the primary goal of this study is to update previous findings regarding succession and deepen what is known about the role of emotions, making it possible to develop practical recommendations for business owners.

Underpinning this study is research designed to combine a *survey of almost 9,500 business owners* in Switzerland with *46 interviews* of entrepreneurs engaged in the succession process.¹ With this mixed form of data collection, we aimed to discern various details and subtleties about the process, elements that cannot be adequately ascertained through a written survey alone.²

¹ In the end, the entire data set consisted of 931 evaluable questionnaires, which represents a response rate of 10.4% of the questionnaires distributed.

² An overview of the total sample is provided in the Appendix.



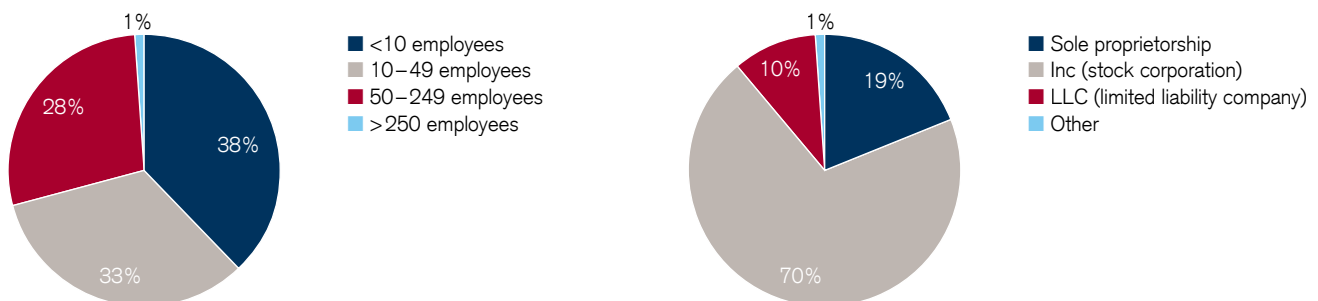
2 The Succession Process in Practice

2.1 On the Validity of the Study

The majority of the companies surveyed are stock corporations (70%). The rest are sole proprietorships (19%) or limited liability companies (10%). Just over half (54%) of those surveyed are active in the secondary sector, compared with 46% in the tertiary sector. Of the firms surveyed, 38% are microenterprises (<10 employees) and 33% are small businesses (10–49

employees); these two groups together constitute most of the firms surveyed. Just over one-fourth of respondents come from medium-sized enterprises (50–249 employees), while the remaining 1% are large companies with 250 or more employees (see Figure 2).

Figure 2: Sample Structure According to Company Size and Legal Form



In line with findings from earlier CFB-HSG studies on succession, the topic receives less attention in the tertiary sector, where microenterprises predominate, than in the secondary sector, where medium-sized companies with stronger traditions are more prevalent. Among firms in the latter category that have existed for more than one generation and thus have already experienced at least one passing of the baton, greater importance is attached to the topic of succession management. Overall, we find that the SME landscape is relatively well mapped in this sample; accordingly, the survey results may be described as representative.

In the course of the study, we occasionally draw distinctions among planners, implementers and successors. These are defined as follows:

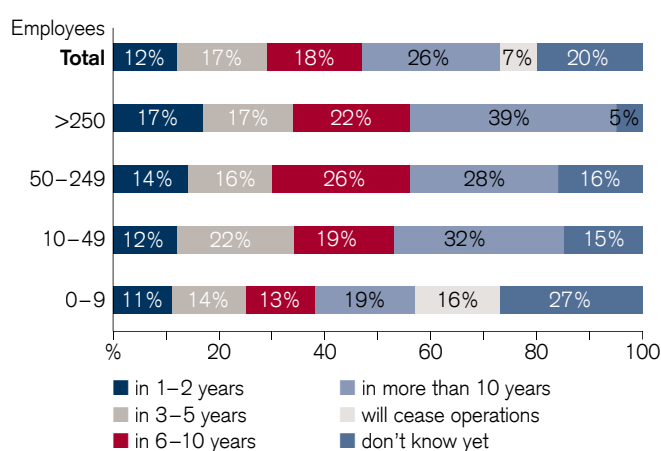
Table 1: Definition of Planners, Implementers and Successors

| | |
|--------------|---|
| Planners | Entrepreneurs who anticipate a company succession |
| Implementers | Entrepreneurs who have already completed the transition |
| Successors | Entrepreneurs who have taken over the company in years past |

2.2 The Status Quo in Switzerland

An initial goal of the study is to identify the status quo in regard to company succession in Switzerland. Asked about specific plans for such a transition, 73% of companies responding stated that they had already made concrete plans for a future transfer of ownership or had thought about the process (Figure 3). As expected, the time horizon varies considerably, with 12% of surveyed companies planning a transition in the next two years, 17% in three to five years, and 18% within the next six to ten years. By contrast, one-fourth of these companies expect succession management to occur more than ten years down the road.

Figure 3: Planning for Succession by Company Size



The responses indicate that *larger companies generally address the issue more concretely* than, for example, microenterprises, where more than one-fourth of respondents answered “Don't know yet.” Also, the percentage of microenterprises that will cease operations rather than be passed on is above average, at 16%.

For comparison: The survey conducted by the CFB-HSG in 2005 found that at that time, barely 60% of those surveyed already had concrete plans for handing on the company. Nearly one-third of respondents in 2005 answered “Don't know yet.” In the current survey, this figure dropped to 20%. This trend is especially clear for microenterprises, just over half of which responded “Don't know yet” in 2005, while today only 27% gave that answer. Thus, in the wake of increased attention to the topic of succession in Switzerland, a greater percentage of entrepreneurs have already gained some idea of how their company's future should unfold. We take this as occasion to estimate in a model calculation the economic importance of company succession.

If the survey results are extrapolated to the entire national economy of Switzerland (see Table 2), then 77,270 Swiss companies plan to complete a succession by 2013, which corresponds to a *mean succession rate of 25.9%*. These companies account for 976,220 jobs, *just over 30% of jobs in Switzerland.*

Table 2: Economic Importance of Company Succession

| Employees | Small and medium-sized enterprises | | | Employees | | |
|--------------|------------------------------------|------------------------------|---------------|------------------|--------------------------|-----------------------------|
| | Absolute number* | Succession within five years | | Absolute number* | Absolute number affected | |
| | | Percentage | Absolute | | Within five years | Annually (affected/5 years) |
| 0-9 | 261,584 | 24.8% | 64,873 | 839,366 | 208,163 | 41,633 |
| 10-49 | 30,638 | 33.9% | 10,386 | 692,285 | 234,685 | 46,937 |
| 50-249 | 5,472 | 30.5% | 1,669 | 618,532 | 188,652 | 37,730 |
| >250 | 1,028 | 33.3% | 342 | 1,035,197 | 344,720 | 68,944 |
| Total | 298,722 | 25.9% | 77,270 | 3,185,380 | 976,220 | 195,244 |

* Data: Swiss Federal Statistical Office, 2005 Business Census

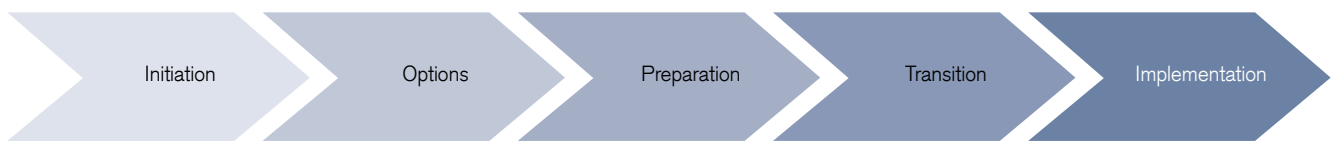
2.3 Company Succession as a Process

The development and execution of a company's succession is a highly heterogeneous process. Wishes and expectations within the company on the one hand and the family on the other are manifold and not necessarily congruent. Accordingly, the major challenge is *to develop an individual and well-balanced solution* and then put it into practice. At the same time, this cannot be accomplished with one simple decision followed by a signature.

Rather, succession is a *relatively long process that must be thoughtfully managed*. A common process model that has proved useful is shown in Figure 4, which distinguishes the five phases of initiation, choice of options, preparation, transition and implementation.

Figure 4: The Five Phases of Succession

(from Credit Suisse, "Nachfolgemanagement in KMU: Eine praxisorientierte Wegleitung", 2007).



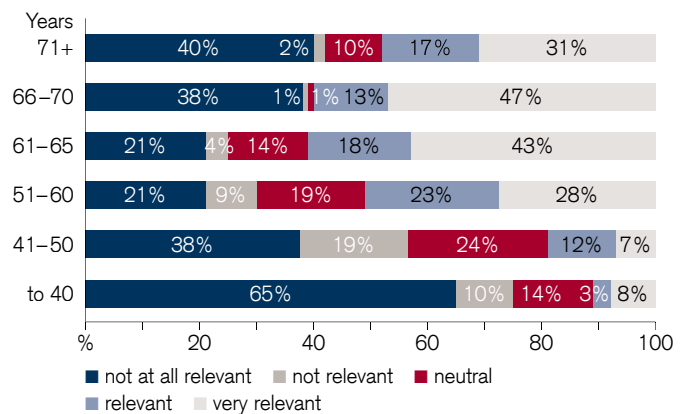
From the practical standpoint, such models are useful for orientation and for structuring a solution, even though the phases identified overlap and cannot be simply checked off one by one. Experience has shown that the highest hurdles usually crop up in the first phases, during initiation, the choice of options for succession, and the preparations made by the entrepreneur. If these phases are well executed, however, the remaining steps can generally be accomplished with relative ease.

2.3.1 Personal Relevance of Company Succession

That the importance of company succession strongly correlates with age is to be expected.

Figure 5 shows a clear picture: Nearly 65% of entrepreneurs up to 40 years old consider managing succession in their own company irrelevant. By contrast, older business owners consider the issue much more relevant. In particular, the impact is most direct for people just before and after the official retirement age: 61–65 years old (43% said "very relevant") and 66–70 years old (just under 47% said "very relevant"). A decline in relevance among those over 70 years old may be attributable to the fact that they have already managed the succession and handed over the company.

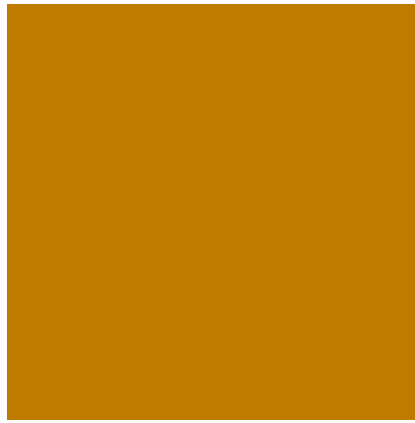
Figure 5: Age and Relevance of the Succession Issue



As obvious as these findings may be, the evaluation also shows that entrepreneurs do actively address the issue of succession even in their younger years. This reflects a discernible *shift in the personal view of life* of many young business owners. They are no longer willing to stay at the same company until retirement; instead, they often sell the company for reasons other than age, then go on to build a new enterprise, take the helm of another business, or even switch to a regular salaried position. This entails a certain emotional distance from their own entrepreneurial activity; they do not identify completely with the company nor do they regard it as their sole purpose in life. As a result, the succession process is undertaken much more deliberately and above all more consistently, thereby making it easier for the business owner from the emotional standpoint.

During our interviews, we asked entrepreneurs about their *rational and emotional responses* to the succession issue. According to their statements, their management of succession was quite rational, concentrating particularly on objective and technical questions. They made little explicit mention of emotional aspects, but these were certainly present: In contrast to the foregoing description of many young entrepreneurs, most of the people we interviewed belong to a generation of business owners guided by a strong traditional understanding of roles. This intensifies their emotional attachment to the company and its employees, and most of them regard the company as their life's work. Consequently, as they grow older and the time of transition draws near, they generally experience a rising tide of contradictory feelings about letting go, and in extreme cases they may even sabotage the process. In this context, we can identify two central reasons for the difficulty of letting go. The

first is the *potential loss of status*. As employers and active members of society, entrepreneurs enjoy a good deal of respect from others in the community. They fear losing that respect. The degree of concern depends on the social and regional context as well as the company's line of business. Status considerations are more prominent in rural areas, for example, than perhaps in urban regions. Similar status considerations were also discernible among entrepreneurs in the construction sector. A second important aspect is the incumbent owner's fear that giving up entrepreneurial activity will mean *losing what matters most in life*. This fear arises because most entrepreneurs invest enormous amounts of time and emotional energy in their business, in many cases to the exclusion of most or all other activities. Even their private concerns generally take a back seat to serving the company.



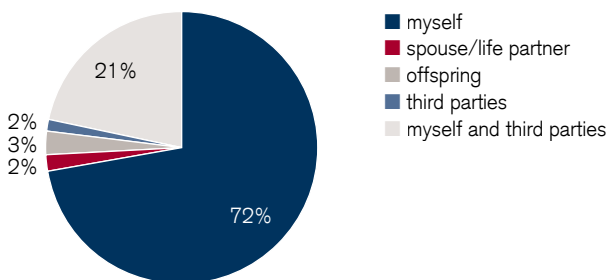
2.3.2 Initiation of the Succession Process

“I feel pressure from other women in my circle of friends and from the business environment to think about the issue of succession.”

(entrepreneur before succession, born in 1947, small business)

Even though public attention to the topic of company succession has greatly increased in recent years, the question arises: In the end, *where does the crucial impetus to initiate this process originate?* Among the entrepreneurs we surveyed, 72% stated that they had decided on their own to tackle the issue (see Figure 6). Another 21% regard themselves, working with third parties, as the driving force behind the transfer. The third parties are generally employees, but also accountants and bank advisors who bring up the topic in discussions with their clients and support the decision to initiate the process. By contrast, strikingly few said the impetus came from family members – that is, life partners (2% and offspring 3%). However, experience indicates that the life partner’s role in the course of succession planning should not be underestimated, even though the figures here do not reflect this.

Figure 6: Where Does the Impetus for Succession Planning Originate?



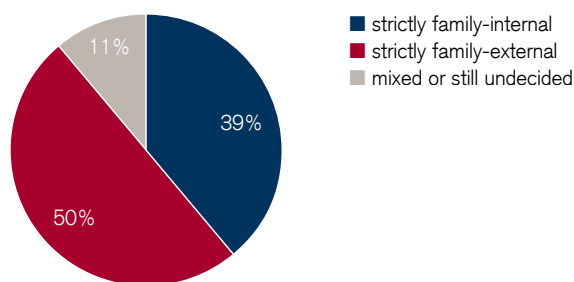
Interesting results also emerge when we consider the responses according to company size. While 87% of the owners of micro-enterprises said they were the sole driving force for initiating a transfer, this percentage declines with each step up in company size. Among large companies, for example, only 42% of business owners reported taking the initiative for succession planning on their own. This is attributable to the rising influence of third parties, which seems logical: The complexity of succession management increases in proportion to the size of the company, as does the owner’s reliance on specialists such as accountants and financial advisors. Ultimately, however, we believe that the entrepreneur must take the initiative; the incumbent owner’s full engagement is essential for a smooth and effective transition.

2.3.3 Choice of Options for Succession

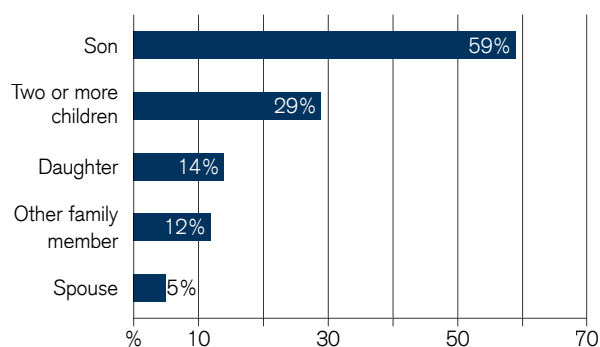
“If you have a potential successor on the hook, you don’t dare miss that opportunity to retire.”

(entrepreneur after succession, born in 1943, small business)

Given the fact that more than 88% of all companies in Switzerland are family-owned businesses (Frey, Halter & Zellweger, 2004), it seems reasonable to surmise that the majority of them would strive for a succession plan within the family. Thus, the survey in 2005 found that although its importance was declining, in the majority of cases family-internal arrangements were still planned (58%) or already implemented (63%). In contrast, the current survey shows that merely 39% of those surveyed are explicitly seeking or have already applied a strictly family-internal solution. Rather, one out of two would prefer a succession plan outside the family (Figure 7). Furthermore, 11% of respondents would consider both possibilities or have executed a mixed succession plan.

Figure 7: Internal vs. External Succession

When we look at the options for a *transfer within the family*, a son is the preferred successor in 59% of cases, though often the company is passed on to two or more children together (29%; see Figure 8). Less frequently, other family members (12%), a daughter (14%) or the spouse (5%) are listed as the intended or actual successor (multiple responses to this question were allowed).

Figure 8: Options for Family-Internal Succession
(multiple responses allowed)

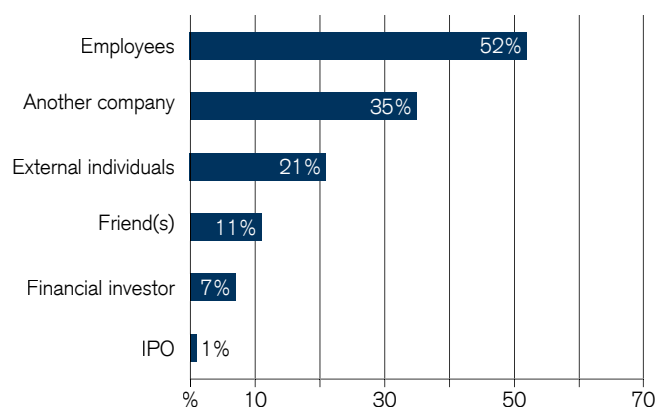
Among all respondents, a *total of 50%* stated that they were explicitly seeking a *solution outside the family* because the entrepreneur's family did not include a suitable successor. The reasons for this can vary widely. While in some cases the family members were simply not interested, other business owners regarded the potential family candidates as unsuitable or not yet ready to manage the company. For example, they cited inadequate social skills or insufficiently developed "toughness" for the daily routine of business. In turn, other entrepreneurs explicitly opposed passing on the business to their children, saying they had higher aspirations and should embark on a different career path. As one business owner from the construction industry put it,

"My son (a surgeon) has two golden hands; there's no way you can put him in charge of a small business."

(entrepreneur during succession, born in 1943, small business)

In only a few cases is there a sign of deep regret that a family-internal solution has not worked out, such as when the family has owned the company for several generations. As our interviews with entrepreneurs made clear, emotional conflicts within

the family around this issue had generally ended by the time specific plans for succession were being made. This explains the high percentage of responses that explicitly aim for an external solution. That path offers various options. The preferred variants are a sale to one or more employees (52%) or to another company as a strategic investor (35%). Sales to friends (11%) or other external individuals (21%) play a major role. In contrast, little consideration is given to financial investors or the possibility of an IPO.

Figure 9: Options for Family-External Succession
(multiple responses allowed)

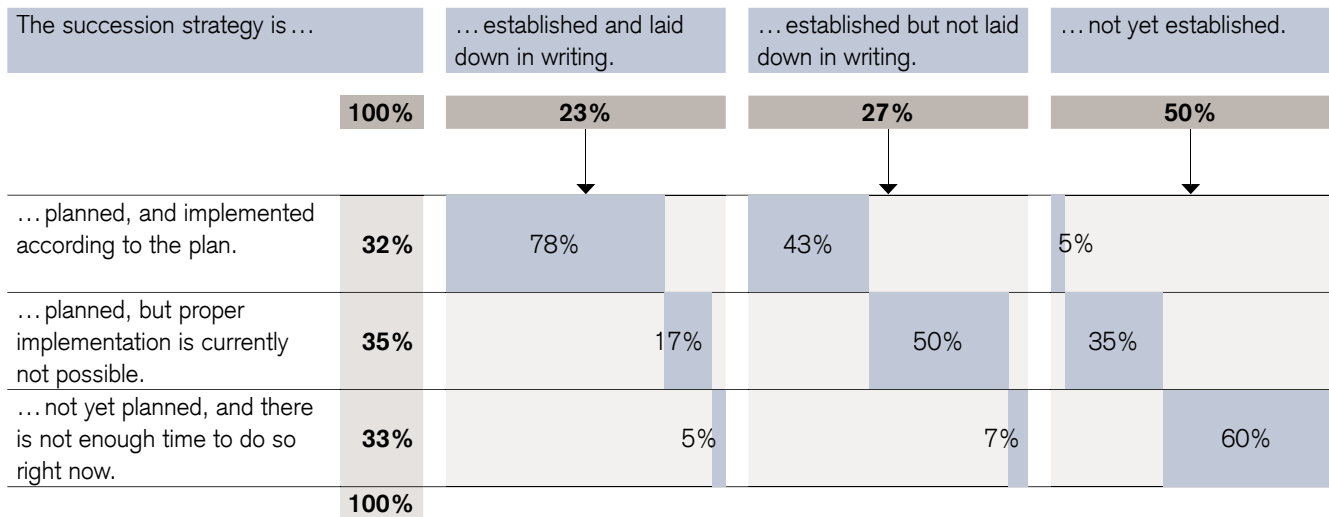
2.3.4 Anchoring the Succession Process

Depending on the choice of strategic options, the magnitude of necessary preparations will vary – but preparation is always essential. Accordingly, we asked the planners – that is, the business owners who were actively involved with planning a succession process – about the extent to which they had established a succession strategy in advance and spelled it out in writing. *Just over half* of the companies stated that they had *developed no explicit strategy*. The proportion of microenterprises that had done so, at 68%, is considerably higher than that of large businesses, where only one in three had done so.

An interesting question here is how much a plan set down in writing can support implementation of the transition plan. Therefore, we also asked the planners about how their plans had progressed. Table 3 contrasts the results. According to the responses, in 78% of the companies that had prepared a written strategy, the succession was proceeding as planned. Only 17% reported that they were currently unable to carry out their plan. In contrast, at companies that had worked out a transition strategy but not put it in writing, only 43% of respondents stated that the succession was proceeding as planned, while half said the succession could not currently be executed as planned. This justifies the conclusion that a *formal plan supports succession management*, inasmuch as it gives the process a *certain binding character* and encourages a *stronger commitment from all those involved*. Thus it can be said that anchoring the succession process in a written plan serves an important purpose – indeed, it ranks among the crucial strategic tasks for the entrepreneur whose career is drawing to a close.

However, it should be noted that the results in Table 3 can be explained at least in part by the fact that a written plan is often not developed until the process it would govern appears to have a realistic chance of being implemented.

Table 3: Formal Succession Planning and Implementation



2.4 Key Insights from Section 2

- The importance of company succession within the owner's family has further declined. This puts all the more focus on whether the company is marketable outside the family and whether such a market even exists.
- Managing succession is an important strategic challenge for the business owner.
- A certain level-headedness and an ability to maintain a "healthy distance" with respect to this strategic task are important attributes. The older the entrepreneur, the smaller the company, and the more rural its location, the more important these become.
- Deliberately stepping back from day-to-day business and delegating responsibility make it possible to develop skills, abilities, structures and processes early on. The older the business owner, the more important these become.
- The smaller the company and the more the owner is involved in its business operations, the more important it becomes to organizationally anchor the succession process.
- Ideally, entrepreneurs should set their sights on being able to say with pride at the end of their professional careers that they have left their business in good hands.



3 Goals, Motives and Expectations for Company Succession

3.1 A Focus on the Company's Future

“The company must continue to thrive. For me, the most important thing is that if I come back to visit five years from now, I can look every employee in the eye.”

(entrepreneur during succession, born in 1945, medium-sized company)

All the entrepreneurs we interviewed agreed that they would consider liquidating the company only as a last resort. They gave various reasons. Along with the *low price obtained from liquidation*, they most often cited their sense of responsibility toward their employees and customers. Accordingly, it is necessary to “shape up” the company before the transfer, readying it for future challenges. This applies both to the company's structure and financing and to its strategic direction and the develop-

ment of a viable business model. Crucial elements for finding a suitable successor and garnering what the entrepreneur views as satisfactory proceeds from the sale include an appropriate capital structure and, above all, the company's prospects for the future.

From the practical standpoint, therefore, the key question must be what should and can be transferred to the next generation. *Elements not essential to the business* must be trimmed early on, and *processes* and *structures* adjusted to pave the way for the incumbent owner's departure. The *business model* and hence the *basis for profitability* must have growth potential, especially since succession outside the family continues to gain importance and external successors are often hard to find. Preparing the company for a handover is usually a long and difficult process that can entail serious strategic decisions. As a result, it also often takes place in cooperation with external consultants. Of course, this requires a relationship of trust between the parties involved.

3.2 Expectations of Succession Management

“If you’re a business owner, you can’t operate by the motto ‘After me, the flood.’”

(entrepreneur during succession, born in 1945, large company)

“In my opinion, a business has a right to life. If you retire, you have to put someone in place who has a good chance of leading the company effectively.”

(entrepreneur after succession, small business)

One important aspect of managing a company’s succession relates to its incumbent owner’s expectations and goals. When the company is the entrepreneur’s “life’s work,” that close connection can be expressed in problems with letting go, as well as in a very strong sense of responsibility to employees. Thus, many of the entrepreneurs we interviewed considered it their social obligation to take care of their employees and give them the best possible foundation for future growth:

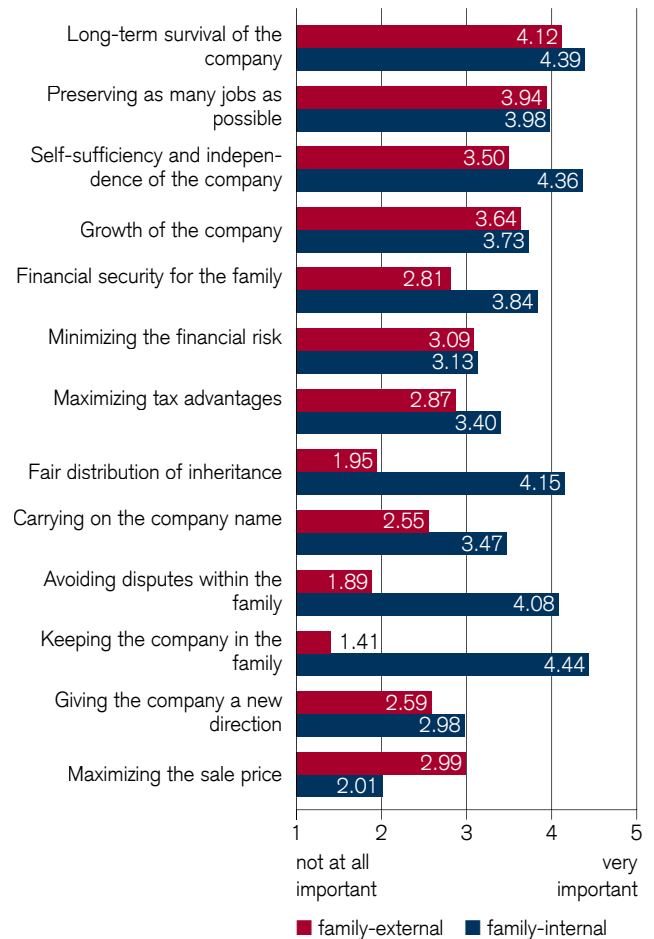
“In today’s society, entrepreneurs are held in high regard; they are valued. People know that they create jobs. Especially in contrast to managers, who are viewed as rip-off artists.”

(entrepreneur, born in 1952)

According to our findings, the entrepreneur’s most important goals – on a scale of 1 to 5 – are the *company’s long-term survival* (mean score = 4.2), *preserving as many jobs as possible* (mean = 3.9) and *maintaining the company’s self-sufficiency and independence* (mean = 3.8). By contrast, maximizing the sale price (mean = 2.7) and giving the company a new direction (mean = 2.7) were considered less relevant. It is fascinating to observe the differences between succession within and outside the family (see Figure 10). If we look only at

family-internal succession management, it becomes clear that goals such as fair distribution of the inheritance, avoiding disputes within the family and keeping the company in the family clearly take precedence.

Figure 10: Objectives of Succession Management (arithmetic mean)



An important role in these considerations goes to the process of business valuation and the corresponding determination of the desired transaction price. Launching the business valuation process immediately puts the incumbent owner in a certain mode of expectations that in some cases the market cannot meet. This raises the question of whether and how the ranking of goals will change as well as how willing the owner might be to make certain concessions.

3.3 Concessions in the Succession Process

“If I had two interested buyers, I wouldn’t sell the company to the one who offered to pay half a million more if that meant my employees would lose their jobs.”

(entrepreneur after succession, born in 1946, small business)

We asked entrepreneurs who had already turned over their companies (“implementers”) about the extent to which they were prepared to *make concessions in regard to their goals* during the process or had actually done so. We found that 27% of them had had to lower the sale price. We also found a relatively high willingness to compromise in regard to the company’s long-term survival (23%) and keeping it in the family (18%). The implementers showed less willingness to make concessions when it came to avoiding family disputes (7%), providing

for the company’s growth (10%) and distributing the inheritance fairly (11%). Particularly the goals that are specifically central to family-internal succession can increase the complexity of the process and necessitate compromise (see Figure 10). Observations in practice have shown that it is often also precisely these points that motivate incumbent owners to avoid family conflicts by opting for succession outside the family.

A final question is what business owners expect of a potential successor and whether they are willing to make concessions in this regard as well. In a somewhat exaggerated summary of numerous statements from the interviews, it can be said that many entrepreneurs *seek a younger “clone”* who can carry on the business seamlessly. Often they lack flexibility and tolerance in this regard, which makes it even more difficult to find a suitable successor. This can be observed particularly in founding owners with a relatively paternal leadership style in relatively small companies. At times the owners almost celebrate their own irreplaceability, which always makes it harder to let go and hence can cause the succession process to break down even in the early stages.

3.4 Emotional Attachment to the Company

“This company is my life.”

(entrepreneur during succession, born in 1950, small business)

“My house and my garden are my hobbies. But that alone is not enough to fulfill me.”

(entrepreneur during succession, born in 1947, small business)

As a rule, the decision to choose entrepreneurial activity entails consciously accepting more work and more personal commitment than a regular salaried position requires. Particularly for the founding generation, these demands as well as the fusion of the subsystems of family and business generate strong emo-

tional ties to the company that represents the very center of their lives. *The company* has the power to stamp their identity, and the generation planning to pass it on explicitly or implicitly perceives it as *their life’s work*. In addition to this emotional connection to the company itself, entrepreneurs also perceive their status as defined by their position in the company. This makes them apprehensive about retirement because it can mean a certain loss of identity. For psychological reasons, they put off actively initiating the succession process.

To depict the emotional aspects of succession management, we asked the business owners about their feelings in regard to various facets of the process. The scale ranges from 1 (= very negative feelings) to 5 (= very positive feelings), and in Figure 11 we show the results for planners and for implementers separately. Significantly, the implementers in retrospect evaluate all the aspects of succession more positively than the planners; that is, these emotions clearly change over time.

Figure 11: Emotions Regarding Company Succession
(arithmetic mean)

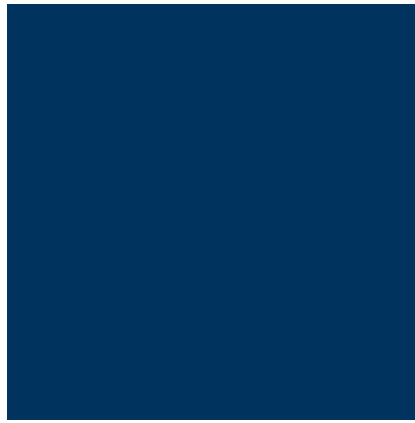


Furthermore, the key strategic task of succession management quite often must be tackled in tandem with running the day-to-day business. In particular, the smaller the company, the greater the owner’s involvement in its operational affairs. In many cases, therefore, succession planning is regarded as a necessary evil and undertaken tentatively at best. There is very little appreciation of succession management as an entrepreneurial challenge; rather, it is largely perceived as an additional burden. *Only the distance achieved over time by the implementers allows them to take a more positive view.*

In practice, this means that lightening the load of operational tasks can be one approach to making room for necessary emotional work. Succession planners must develop an awareness of personal goals and create scenarios for their own future. This entails pondering which goals take center stage, and where concessions can be made and where not. The process *resembles the mental preparation of a top athlete before a competition.* For despite all efforts to approach the arguments and decisions rationally, emotions play an important role. Whether these emotions are recognized, acknowledged and thereby also accepted can determine the success or failure of a transition.

3.5 Key Insights from Section 3

- A company is marketable only if it has prospects for the future and no major lingering problems.
- Incumbent owners must have a clear understanding of what they are willing and able to sell.
- In conjunction with that, they should address the question of identifying areas in which concessions can be made.
- It is essential to consciously develop an understanding of their own more deep-seated goals, because these have a defining impact on their later options, choices and behaviors.
- Founding owners in particular are well advised to address early on the necessity of letting go, such as by deliberately turning over responsibility to employees.
- The earlier the burden of operational tasks is lifted, the more likely it is that planning and implementing the succession will go smoothly.



4 Available Support and Consulting Approaches

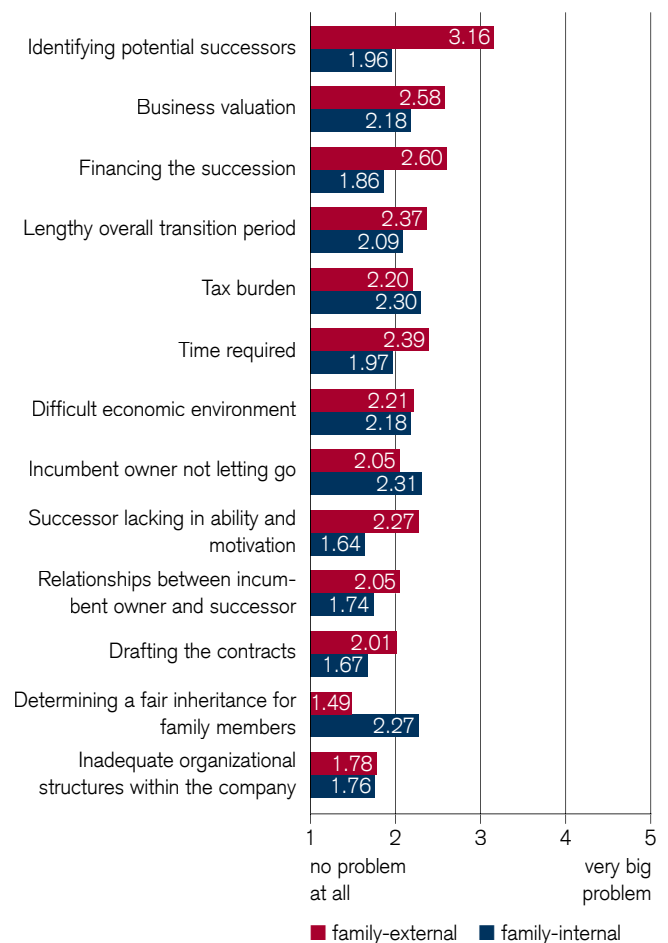
4.1 Problem Areas in Succession Management

“I was astonished when the accountancy firm told me the entire process would take five to seven years.”

(entrepreneur during succession, born in 1947, small business)

During the various phases of the succession process, business owners often unexpectedly encounter serious problems that can take very different turns depending on the chosen option for succession. The greatest problem was reported to be identifying potential successors (mean = 2.81), though this applies primarily to transfers outside the family. Further problem areas include the business valuation (mean = 2.46) and financing the transaction (mean = 2.40), likewise with a particularly strong prominence in family-external solutions.

Figure 12: Problem Areas in Company Succession
(arithmetic mean)



Questions related to business valuation and financing often have to do with the fact that many SMEs have considerable assets that are not essential to business operations. Separating these from the transaction volume or assigning them a monetary value is a task that ordinarily requires expert assistance. Furthermore, questions of financing often loom larger in the case of family-external solutions, insofar as the amount to be financed is greater than if the business stays in the family (more on this below).

In contrast, the tax burden and establishing fair inheritance within the family are perceived as greater problems in family-internal than in family-external succession. The former is primarily attributable to the circumstance that a value-added tax must be paid in the course of the transaction, although in some circumstances no liquid assets are conveyed to complete the transfer.¹ Establishing fair inheritance presents difficulties especially when not all the children can be treated equally in terms of management and ownership. However, that sort of equality is not always possible without tying the hands of the successor who runs the business.

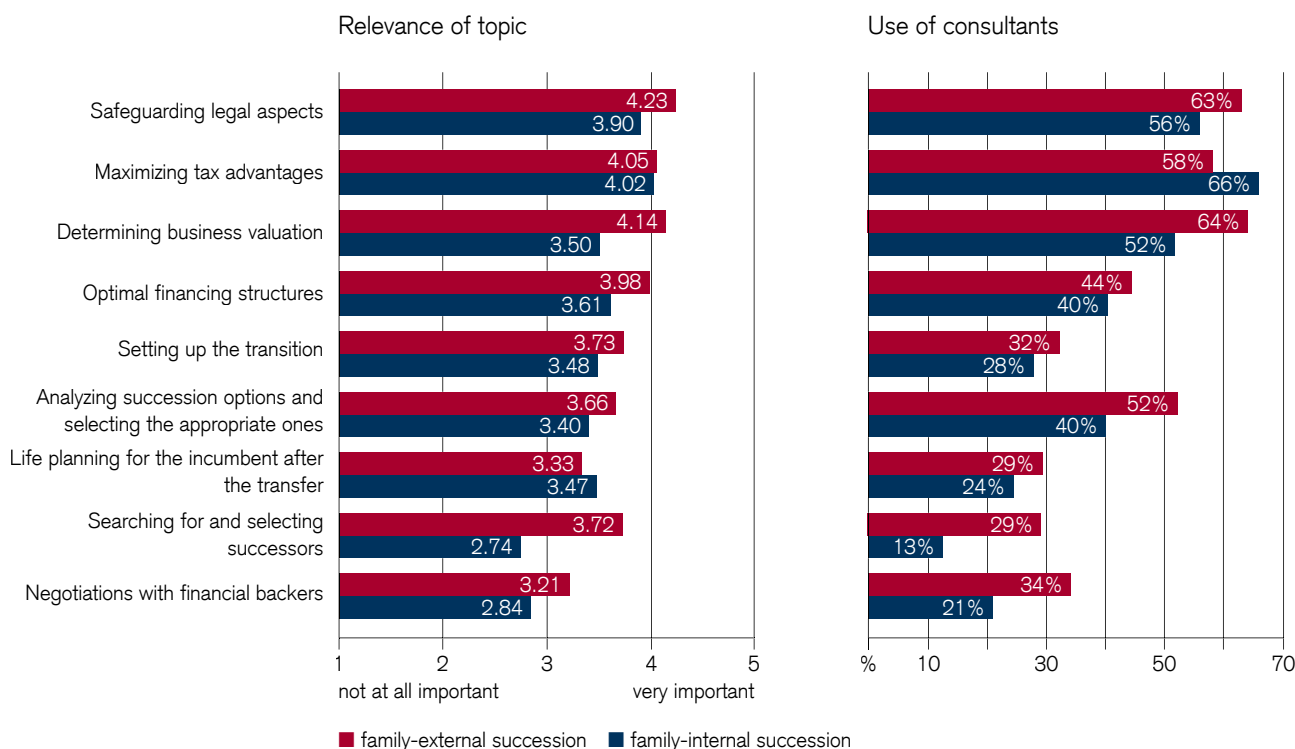
4.2 The Need for and Use of Available Support

“But when you talk in general terms about service providers: Most of all, you need capable people within your own company. And then you can bring in outside experts on a case-by-case basis.”

(entrepreneur during succession, born in 1928, large company)

The succession process brings up various issues that the company leadership does not have the expertise to address with full competence. This makes it necessary to call on the appropriate consultancy services. Here we pose the question of which topics are mainly handled with third parties and whom business owners turn to for support.

Figure 13: Relevance of Topics for Advice from Experts (mean value) and Use of Available Consultants in Each Context



¹ This problem area should be considered in the context of Switzerland's Unternehmenssteuerreform II (business tax reform II).

On average, the *specialized topics* such as safeguarding legal aspects (mean = 4.08), maximizing tax advantages (mean = 4.03), and determining the business valuation (mean = 3.87) or the optimal financing structure (mean = 3.82) were ranked as most relevant. The most interesting observation here is the difference between succession within and outside the family. Most of the topics for expert advice are deemed less important when the company stayed in the family, with the one exception being life planning for the incumbent afterwards. For family-external successions, the topics of safeguarding legal aspects, determining the business valuation, finding the optimal financing structure, and especially searching for and selecting the successor are deemed considerably more important than is the case for family-internal transfers.

In addition to the importance assigned to these issues, it is interesting to look at the actual *use of available consultants* to deal with them. Here the responses show that in family-external transfers, consultancy and support services are used significantly more often, with one exception: Experts are called in to help optimize tax advantages more often when the company is

kept in the family. This contrasts with the estimation of relevance (see Figure 13, left column), suggesting that business owners often initially underestimate the complexity of tax questions in a family-internal succession but later realize that it would be advisable to obtain expert advice on the matter.

When the results are sorted by company size, the findings for all topics show that, as expected, the use of consultancy services increases with each step up in category. In searching for and selecting successors as well as in drawing up their own business plans, microenterprises are somewhat more inclined to seek support than small and medium-sized companies.

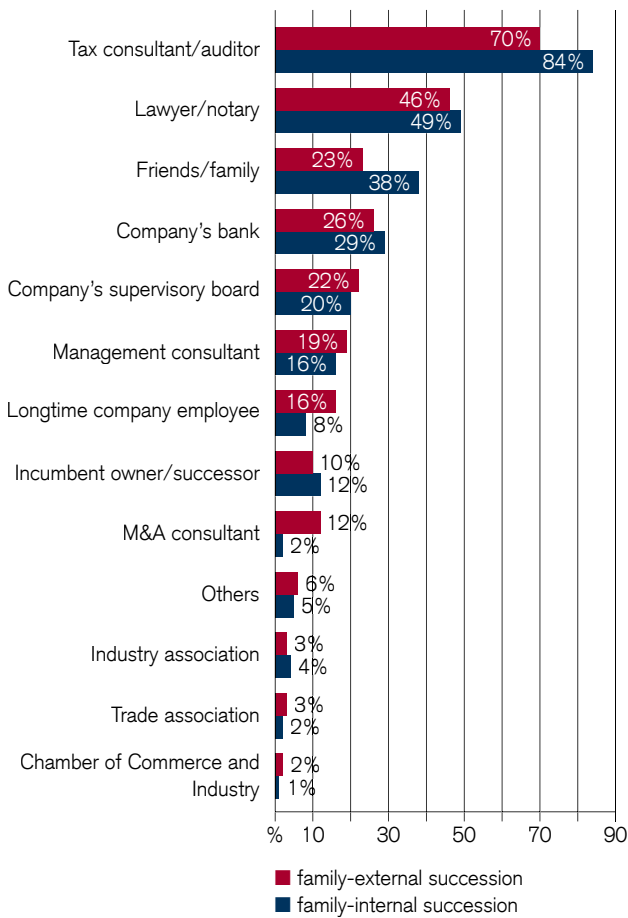
The interviews also show that *family-owned businesses* can be described as *more "advice-resistant,"* again with the exception of tax issues. In particular, evidently these business owners seldom want comprehensive support and accompaniment – in the sense of “coaching” – through the succession process; they prefer to work through its challenges on their own. However, those who have made use of such services generally speak highly of them in retrospect. Especially at critical moments, they value an outsider's neutral opinion; furthermore, the inclusion of a third party makes the process more binding for all participants.

4.3 Providers of Support Services

Lastly, the question arises of *who provides support during the succession process*, or where business owners turn for the services needed (see Figure 14). In most cases, respondents listed tax consultants/auditors (75%), followed by lawyers/notaries (47%), friends and family members (30%) and the company's main bank (29%). The company's supervisory board (20%) and general management consultants (18%) play a less important role. Various respondents also mention longtime company employees (12%) or the opposite party in the process (the

incumbent owner or the successor = 10%). Consultants specializing in mergers and acquisitions (M&A) are used primarily in major transactions, and more often for family-external (12%), hardly ever for family-internal successions (2%). Also noticeable is that tax consultants and auditors are used significantly more often in the context of succession within the family (84%) than succession outside the family (70%). Friends and family members play a lesser role in both instances (family-internal = 38%; family-external = 23%).

Figure 14: Which Advisors Did You Consult?
(multiple responses allowed)



We conclude that support during the succession process is necessary and that people do make use of it. Upon closer inspection, it becomes clear that the support is mainly limited to advice from experts in specialized fields; however, relatively few take advantage of comprehensive monitoring throughout the process. In view of the complexity of tasks involved (i.e., the diversity and interconnectedness of the issues), at this point we take the liberty of recommending process monitoring and project management/coaching by an outside party.

4.4 Key Insights from Section 4

- Identifying a successor outside the family is not always easy. It is advisable to think in scenarios and to initiate the succession process early on.
- For specialized topics such as tax or contract law issues, business valuation and financing, it is advisable to consult experts in the field.
- Also advisable is process monitoring by experienced succession experts with generalist knowledge, to provide the foresight necessary to ask the right questions at the right time.
- The use of outside advisors is helpful not only because it gives access to expert know-how but also because it anchors the succession process itself.
- Business owners often consult a number of different specialists during the succession process. For best results, boundaries and interfaces should be precisely defined.



5 Company Succession from the Financial Standpoint

From the financial standpoint, company succession raises questions particularly about retirement planning for the business owner, the emotional impact of changes in cash flows, the busi-

ness valuation and the determination of the subsequent transaction price. The question of how the transaction will ultimately be financed must also be considered.

5.1 Company Succession and Retirement Planning

“I’ve made provisions for my retirement, but it would be nice to add a little more.”

(entrepreneur before succession,
born in 1949, small business)

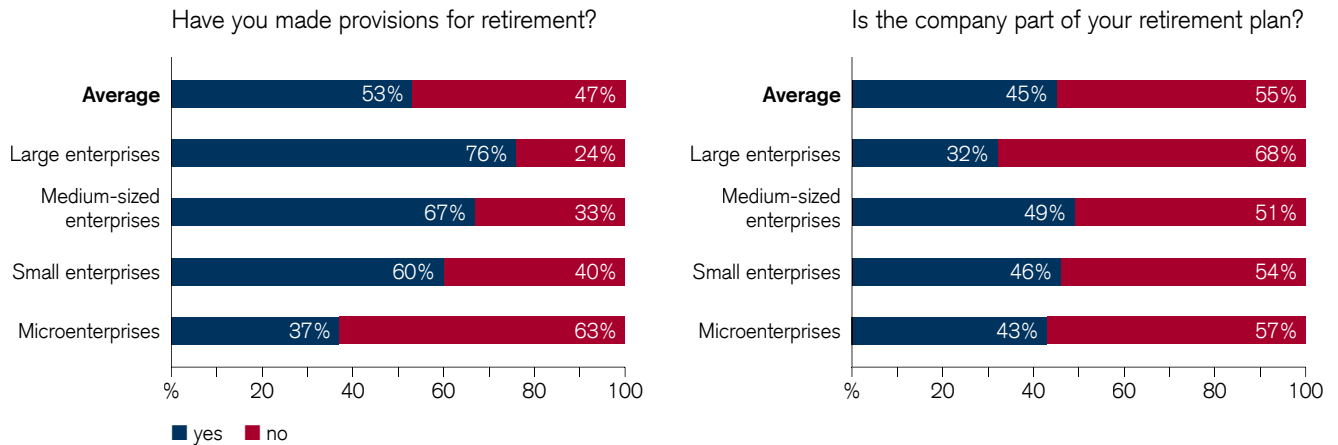
“Here’s the thing: I don’t have a retirement fund, so I absolutely must get something from these businesses. Ultimately, the sale price is the most important consideration, and my other wishes are secondary.”

(entrepreneur before succession,
born in 1945, small business)

In regard to planning for their own retirement, the results show that 53% – a good half of respondents – have already made these provisions (see Figure 15). However, in 45% of cases, the *company itself constitutes part of their personal retirement plan*. As expected, the older the entrepreneurs, the more already have retirement plans in place. Nevertheless, it is astonishing that one-third of all entrepreneurs over 65 years old say they have not yet provided for their retirement.

Viewing the results by company size shows that the *smaller the company, the greater the likelihood that retirement planning is neglected*. Thus, 63% of owners of microenterprises report that they have not yet made any provisions for retirement. In large companies, by contrast, the rate is just 24%. Accordingly, greater attention must be paid to personal retirement plans particularly at microenterprises, because that is evidently where the least preparations have been made. At the same time, however, the results indicate that smaller companies tend to be included less often as part of the owner’s retirement plan; these owners make other arrangements. It apparently makes no significant difference whether company succession is managed within or outside the family.

Figure 15: Provisions for Retirement



If the company represents a large component of the owner's retirement plan, two questions demand urgent attention: Is there a market for this company? And will the sale yield sufficient funds to provide for the owner's retirement? Ideally, the business owner has begun planning for retirement very early on and has not included the company itself as a fund of last resort, because there is no guarantee of that.

Personal retirement planning has serious consequences for the succession process: The less the owner depends on the sale proceeds, the greater the flexibility in making arrangements for succession.

5.2 Emotions and Financial Issues

Ordinarily, longtime business owners have drawn a steady paycheck for decades and thus become accustomed to a more or less constant deposit of money into their personal accounts. But as soon as the arrangements for transfer of ownership have been made and the transaction is completed, management responsibilities end and the paycheck stops. From both the emotional and the financial standpoint, the *absence of a steady flow of income* represents a profound change.

The accustomed influx of money gives way to a regular depreciation. Our observations indicate that this change can also trigger existential worries. These worries are justified in cases where personal retirement provisions and the sale proceeds do

not suffice to maintain the standard of living. But they are not justified in cases where the proceeds will last far beyond the seller's life expectancy. Nevertheless, existential worries can also be observed in the second group. In our view, there is a connection between this and the comment often heard in interviews that the owners of SMEs intend to continue working as long as their health permits.

From the financial standpoint, this means that particular attention must be paid to financial provisions in the private realm, to the determination of the business value and transaction price, to the form of financing and to managing the sale proceeds.

5.3 Determination of the Business Value and Transaction Price

“The owner and seller looks from here into the past. As the buyer, I look from this point into the future. That can lead to huge differences in perspective.”

(entrepreneur during succession,
born in 1944, small business)

There are various methods and approaches for determining the value of a business. These offer (more or less) objective instruments that make it possible to leave the emotional aspects out of the discussion. But at the same time, quite apart from any instrument, emotions come into play that influence people's expectations, perceptions and assessments. In this context, the term *total value* is used, a *combination of financial and emotional valuations* (Zellweger, Fueglistaller 2006) that can lead to a higher or lower overall valuation.

Establishing the business valuation represents the first challenge; the second is realizing it on the transaction market. The valuation ordinarily involves calculating several values. But these can then deviate significantly up or down from the transaction price, depending on a number of factors that include whether there is a market for the company or not.

Our interviews revealed that the outgoing and incoming owners have different perspectives on the valuation. A successor ordinarily focuses on the company's future potential. This means that there must be the potential for future cash flows to justify an investment in an existing enterprise. Above all, this is crucial if the transaction price is financed with third-party funds, such as a bank loan that must be refinanced. While the successor thus looks to the future, the outgoing owner most commonly views the sale price as remuneration for past investments (both monetary and personal). This often leads to quite a gap between the amount the successor is willing to pay and the amount the incumbent owner expects to receive.

5.4 Transactions with and without Remuneration

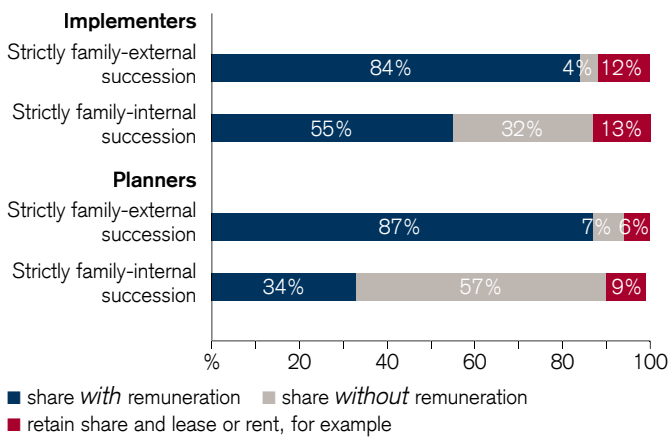
“If I have a good man to take over, I'm generous. I might even give him the majority interest. It would be different if my retirement weren't secure.”

(entrepreneur after succession,
born in 1952, large company)

The questions about motives (see above) have already revealed that *maximizing the sale price cannot be counted among the most important goals*. This raises the fascinating question of whether company shares are transferred with or without remuneration and in what form they are transferred in either case.

Overall, the planners – that is, the entrepreneurs facing succession in the immediate future – want to pass their shares to the next generation with remuneration in two-thirds of the cases (66%) and without remuneration in 27% of the cases. At the same time, 7% want to keep their shares. Where the transfer has already been implemented, the percentage of cases with remuneration is considerably higher (75%), the percentage without remuneration correspondingly lower (13%). The percentage of shares retained (12%) is definitely higher for the completed transfers than for those in the planning stage. Figure 16 shows the results, categorized by family-internal and family-external succession processes.

Figure 16: Structuring of Company Succession with and without Remuneration



Here we can see that for the planners, the remunerated portion is considerably lower for successions within the family (34%) than outside the family (87%). This can occur, for example, when children do not have sufficient capital to purchase the company from their parents. But a look at the implementers shows that for successions within the family, the percentage of transfers with remuneration (55%) is actually considerably higher than anticipated in the planning stage. Here our interviews indicate that the children were called upon to step forward to the limits of their individual tolerance, financially as well, in order to maximize their commitment to the company.

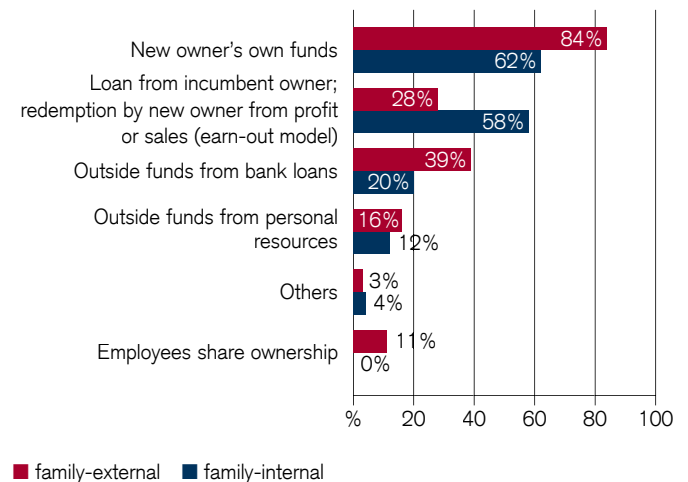
The quantitative survey results do not reveal when and how the retained minority shares are transferred. From the practical standpoint, the question arises of what influence is exerted with those shares (more on this below), but also whether there is even a transaction market for minority shares. In practice, it can be observed that the transaction contract stipulates the arrangement for passing on the temporarily retained minority shares, for there is hardly any market for minority shares.

5.5 Forms of Financing the Company

The transfer of the company in the narrower sense – that is, how the shares (with or without remuneration) are conveyed to the next generation – can be structured in various ways. For transfers with remuneration, we first looked at *how the succession is financed by the successor*, a question for which multiple responses were allowed. Overall, financing with the successor's own funds headed the list, with this option more widely used for transfers outside the family (84%) than for succession within the family (62%). Various approaches can be taken to cover gaps in financing; on average, the options cited most frequently were loans from the outgoing owner (41%), debt financing through bank loans (33%), funds from personal contacts (14%) or employee share ownerships (6%).

Looking at the results by category, we find that when succession takes place within the family, the main focus is on loans to the next generation (58%). For succession outside the family, debt financing through bank loans is the most common supplementary instrument (39%). Alternatives such as mezzanine financing or funding from business angels are not considered significant in the succession process. Figure 17 depicts the results for family-external and family-internal cases.

Figure 17: The Financing of Company Succession with Remuneration (multiple responses allowed)



In the *transfer of company shares without remuneration*, on average both planners and implementers give priority to succession and inheritance, followed by advance against inheritance and transfer by way of gift or partial gift. The establishment of a foundation is currently not given much weight in Switzerland. Because transfer without remuneration comes into play mainly when a company is passed on within the family (see above), this finding is not surprising. From a practical standpoint, it remains to be clarified whether this is subject to inheritance tax or not – at present this is handled differently from canton to canton.

Finally, there is the question of *what role business owners assume* when they retain portions of the company. Both succession planners and succession implementers regard a further position on the supervisory board or advisory board as relatively

important. Among planners, the results show that this seat holds significantly higher value when the company remains in the family than when it passes out of family ownership. But the data also show that this form of continued involvement in the company is more highly valued among implementers in the context of succession outside the family. This can be taken as an indication that when a company is purchased, for example, the generation taking over wants to retain the network of customers, suppliers and other stakeholders. Surprisingly, the continued involvement of the outgoing generation at the operational level is considerably higher after succession outside the family than after succession within the family. By contrast, silent partnerships, renting, leasing or even employing an outside manager play a minor role.

5.6 Key Insights from Section 5

- Provisions for retirement well managed in advance expand the range of options when planning for company succession and help put the owner's mind at ease when the time comes to let go of the company.
- The smaller the company, the greater the importance of building a solid private retirement fund well in advance.
- The smaller the private retirement fund, the greater the importance of the transaction market for the company.
- Emotional states can facilitate or impede a transaction process.
- There is no guarantee that the business value determined in an appropriate valuation can actually be realized in the market.
- Incumbent owners are also willing to forego remuneration if the succession plan achieves their central goals and there is no pressing financial need.
- Unless the successor can contribute significant funding, it is very difficult to finance a transfer.

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Appendix

Table 4: Composition of the Data Set and Response Rates

| | Surveys sent | Undeliverable | Would/could not complete survey | Respondents (response rate) |
|-------------------------------------|--------------|-----------------------|---------------------------------|-----------------------------|
| Basic total | 6,000 | 312 (5.2%) | 55 (0.9%) | 572 (10.0%) |
| Boost ¹ | 2,000 | 130 (6.5%) | 24 (1.2%) | 175 (9.4%) |
| Implementers (succession completed) | 1,443 | 27 (1.9%) | 37 (2.6%) | 125 (8.8%) |
| Uncategorized | | | | 59 |
| Total | 9,443 | 469 (5.0%) | 116 (1.2%) | 931 (10.4%) |

Table 5: Overview of Companies in the Qualitative Survey

| | |
|----------------------|---|
| Survey region | <ul style="list-style-type: none"> ■ 38 in German-speaking Switzerland (cantons ZH, ZG, SG, BE, AG) ■ 8 in Romandy (canton VD) |
| Position of subjects | <ul style="list-style-type: none"> ■ 32 owners ■ 14 part owners and shareholders |
| Company size | <ul style="list-style-type: none"> ■ 32 with 10 to 50 employees ■ 14 with more than 50 employees |
| Company situation | <ul style="list-style-type: none"> ■ 16 before transfer (including 4 within the family) ■ 16 during transfer ■ 14 after transfer |
| Branches (selected) | Printing/publishing industry, retail trade, wholesale trade, business and tax consulting, holding and investment company, advertising agency, craft trade (plumbing), plastering, cleaning services, electronics, masonry, cabinet-making, overland transportation and logistics, architecture office, information technology, wood and furniture industry, medical logistics |

¹ These are additional addresses of entrepreneurs about to implement succession.

Practical Questions for Entrepreneurs to Consider in Advance of Transferring Ownership

Company succession is a key strategic task that the incumbent owner must address. Based on the findings of this study and a range of practical experience, we have developed the following

15 pertinent questions. If the answer is an honest “Yes” to most of these questions, we think there is a good chance of successfully managing the company's transfer of ownership.

| | Questions | Yes | No |
|----|---|--------------------------|--------------------------|
| 1 | Do you know which elements of the company you are able and willing to transfer to the next generation or sell to new owners (e.g., business model, real estate, moveable goods)? | <input type="checkbox"/> | <input type="checkbox"/> |
| 2 | Are you sure that the company to be transferred has justifiable and evident potential? | <input type="checkbox"/> | <input type="checkbox"/> |
| 3 | Are you sure that there are interested buyers and therefore a market for your company? | <input type="checkbox"/> | <input type="checkbox"/> |
| 4 | Have you made sure that the company has the structures and processes it needs in order to continue without your involvement? | <input type="checkbox"/> | <input type="checkbox"/> |
| 5 | Have you anchored the project management for succession within the company and/or in your private circle? Alternatively, have you worked out the strategy for succession and put it on record, in writing or otherwise? | <input type="checkbox"/> | <input type="checkbox"/> |
| 6 | Have you already undertaken a realistic valuation of the company? | <input type="checkbox"/> | <input type="checkbox"/> |
| 7 | Can you maintain your standard of living after you leave the company, even if the proceeds from a potential sale fall short? Alternatively, have you made provisions for your retirement years that do not necessarily depend on a good sale price? | <input type="checkbox"/> | <input type="checkbox"/> |
| 8 | Do you have your eye on a variety of potential successors (e.g., family members, employees, sale to a third party), rather than focusing on a single option? | <input type="checkbox"/> | <input type="checkbox"/> |
| 9 | Do you think in scenarios (“What if ...?”) when you consider succession planning and the development of your business? | <input type="checkbox"/> | <input type="checkbox"/> |
| 10 | Do you know whether you are able or willing to transfer leadership and ownership of the company simultaneously or one after the other? | <input type="checkbox"/> | <input type="checkbox"/> |
| 11 | Have you clearly and explicitly defined your personal goals for the succession process, and have you written them down for yourself? | <input type="checkbox"/> | <input type="checkbox"/> |
| 12 | Are you certain that your current service providers, such as your trustees, lawyers or main bankers, are competent in the area of company succession? | <input type="checkbox"/> | <input type="checkbox"/> |
| 13 | Are you aware of all the opportunities and risks, strengths and weaknesses of your company that an external purchaser could identify and cite during the sale negotiations as part of determining the sale price? | <input type="checkbox"/> | <input type="checkbox"/> |
| 14 | Are you ready to relinquish responsibility to the next generation and grant your successor the freedom to make decisions in the form of a voting majority? | <input type="checkbox"/> | <input type="checkbox"/> |
| 15 | In all honesty, can you say that you have begun in due time to plan for company succession? | <input type="checkbox"/> | <input type="checkbox"/> |

