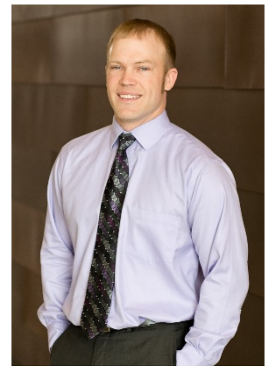
MANUFACTURING
in Lehman's Terms

Succession Planning Optimization



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I hope everyone is enjoying their fall! I just attended the 2019 Main Street ND Summit in Bismarck, and the topic of succession planning came up. The discussion was in the context of Main Street businesses in our rural communities where it's getting harder to find electricians, plumbers, grocery stores, etc. I feel some of these businesses (including manufacturers), may be saved through succession planning. Here's how a common progression of how these business cycles can play out:

1. **Startup:** The year was 1980 and Bob starts a business out of his basement. Demand rapidly grows and he happily swaps his 9-5 for a 24-7. The freedom and pride of growing a business make it all worthwhile.
2. **Growth:** Business is booming, and Bob is forced to lease a shop on Main Street. He hires an office manager. Gradually, he hires more office staff and expands his team. Energized by the growth, Bob spends what little free time he has experimenting and trying new things to streamline and grow his business. He's developing his systems and product offering.
3. **Maturity:** The business is doing well. Bob has purchased the building and has even expanded it to accommodate his business. His payroll is now at 20 employees (an impressive number for the size of his small community). The business has a good reputation. He is happy with his staff and the business in seemingly working autonomously. The business has plateaued and exhibits very little growth. Bob reasons this is typical with a mature business. Business is good, and Bob is happy with where they are at.
4. **Decline:** Fast forward to 2015. In preparation for retirement, Bob cuts expenses. No new investments have been made to keep up with the ever-changing market. Efforts are made to reduce his tax burden, and cash sales rarely get reported. Bob is saving money for retirement. Bob elects to patch rather than repair the aging building. He considers selling the business on his own, basing the price on how he feels it should be performing. If he receives any interest he'll sell, if not he's got time he figures.
5. **The Sale:** A couple years go by. Bob doesn't have the energy he once had, nor the appetite to risk his retirement on new ventures. To make matters worse, Bob, has developed health issues forcing him to aggressively market the sale of his business. Bob is shocked when he gets an offer for a fraction of what he's asking. How did this happen?
    a. **Bob's Perspective:** Based on the glory years, Bob decided he wants $2M for his business. He figures someone with some fire in their belly could easily make enough to justify that amount. Although the profit and loss (P&L) statements show a net operating income (NOI) of approximately $100K/yr. Bob admits he can make $250k/yr, if he were to declare his cash sales, but he doesn't like to report it on his taxes.
    b. **Investor's perspective:** Investors invest in businesses to achieve some rate of return. Savvy investors base buy/sell decisions on competing rates of return (stocks, bonds, rental property, etc.). Although there are many ways to determine this valuation, net income is generally a factor. For example:

    i. From Bobs P&L statements, the NOI is $100K/yr. The investors want a 10% return. Since they are paying cash for the business, the valuation is simply the NOI ($100K) divided by the return (10%). This puts the business valuation at $1M.
    ii. $1M is the starting point. Further consideration factoring in the cost of deferred maintenance on the building and equipment lowers the valuation to $800K.

So, who's right? Bob, who thinks his business is worth $2M, or the investor who values it at $800K? Had Bob reported his cash revenue, his P&Ls and tax returns may have supported his asking price. Unfortunately for Bob, the investors and banks ultimately decide the valuation. They base their valuation on facts (P&Ls, balance sheets, tax returns, etc.), not on Bob's word. In an effort to save a couple of bucks on taxes, Bob pays big time through reduced business valuation.

Having a real estate background, I can assure you this is a common scenario. Unfortunately, in many instances the seller and buyers can't come together, the business loses steam to the point to where it is shuttered, and another Main Street building goes vacant. How could this scenario have been avoided?

1. Plan early! Like a business plan, it never hurts to have a succession plan in place in case the unforeseen should occur. If something were to happen to you, could your operation continue? Who would run your business? How would they run it? Are they adequately trained?
2. Keep your business valuation up. This will ensure an optimum return for you, and a business banks will finance.
    a. The best way to do this is to ensure your tax returns and running three-year P&Ls are accurate and show a healthy net income.
    b. Don't become complacent! Make sure you are continuing to build your business until you sell.

There are far too many considerations when planning for succession to cover in this article. It's important to start planning early for the best hopes of transferring your business at a fair value or for it to continue to survive in your absence. This should be done well before you begin thinking of retirement. Had Bob been actively engaged in succession planning years prior, he would have likely had a healthy business with revenue that would be bankable for his successors. He may have even been able to work someone into managing and then owning the operation. Maintaining and passing along a healthy business will help to keep our communities vibrant. This is even true of the café on the corner or the factory on the outskirts.

If you are interested in succession planning for your business, there are entities in North Dakota that can assist you. Please contact Impact Dakota at (701)-204-7000, your local SBDC, or NDSU Extension. These entities can help ensure all of the bases get covered when planning for the future of your business.

For additional information on this topic or general manufacturing inquiries in North Dakota, please feel free to contact me, and best of luck during the during the career fair season!

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