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The Family Business Succession Conundrum

Presentation to the Estate and Taxation Planning Council

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'Mittelstand'

- Small to medium sized enterprises in smaller cities and communities in Germany, Austria and Switzerland.

- Family-owned, independent, socially responsible and very successful.

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New Zealand's SME sector

The lifeblood of the New Zealand economy is our SME and family owned commercial enterprise sector.

The valuations of these businesses have increased exponentially in recent decades.

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Succession: the conundrum

- Understanding the human elements in succession planning.
- Having meaningful succession discussions.

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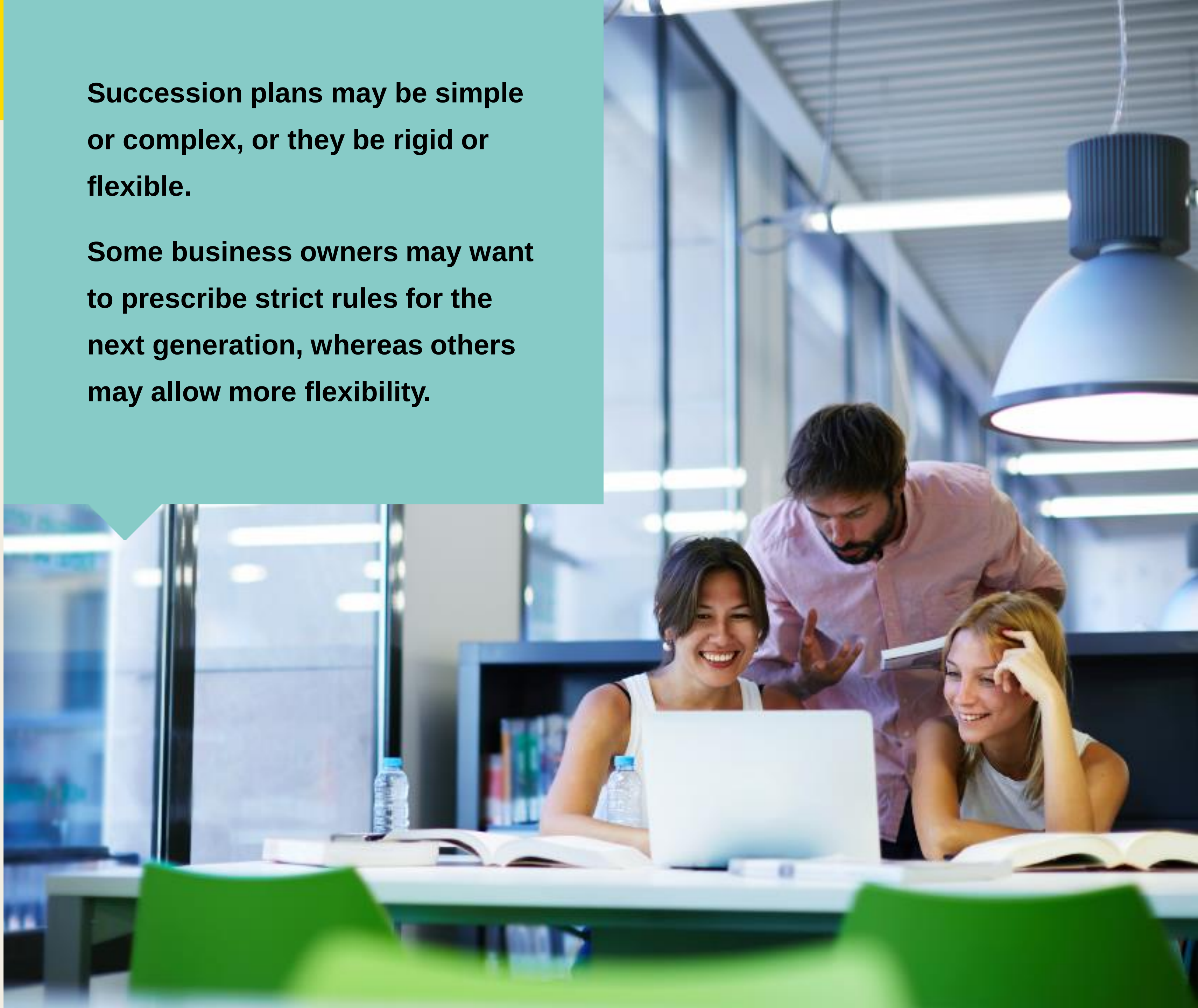
Any plan is better than no plan

Succession plans may be simple or complex, or they be rigid or flexible.

Some business owners may want to prescribe strict rules for the next generation, whereas others may allow more flexibility.



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The Best Outcomes

- Involve early engagement
- Are not tax driven
- Require collective involvement and an understanding of family dynamics

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The Best Outcomes

- Involve open communication and collaboration
- Are human based, and distinguish between management and governance

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‘Kiwistand’

A well designed succession plan can lead to inter-generational prosperity and have tangible public policy benefits.

The challenge is to overcome the disconnect between strategy and execution.

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Questions

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Thank you.

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Geoff's Notes: **11 July 2018 : FAMILY BUSINESS SUCCESSION**

Henry usefully referred to the German small to medium enterprise family business culture where businesses have been passed down through generations. Traditions underpinning this include a culture of emotional attachment through those generations and investment by the business beyond corporate parameters in wellbeing of staff, regional development and other community initiatives. These generate loyalty and goodwill and tend to be associated with successful businesses. An example is Sthil which is an 80 year old private worldwide company. It is governed by a supervisory board appointed by the family whose members still own the shares.

By comparison, New Zealand has good fundamentals for small to medium enterprise businesses, but they tend to have property-based valuations which depend more on inflation in property values than the intrinsic value of a business. The No. 8 wire mentality can be good for innovation and experimentation but can also be used as an excuse for not reinvesting or doing things properly.

Execution of succession works when human behaviour around money is thought through beyond emotion. This makes mechanisms possible such as equity sharing between siblings and restrictions on issuing shares to non-family members. A good starting point is to have a charter which documents the principles (rather than the rules) by which the family intends to own and operate a business. This provides for latitude in interpreting those principles according to the circumstances. The charter should be underpinned by documentation such as shareholders agreement or terms of trust. The charter should set out the history of the business and other relevant matters, current circumstances, and objectives.

Although these businesses may be relatively small, it is useful in their planning to combine techniques which are used most often as corporate and commercial tools such as options, preference shares, pre-emptive rights, and shareholder-employees schemes.

The next fundamental is to make sure that the business has intrinsic value, that there is value in owning the business rather than owning a job. The business needs to be successful without management involvement of the owners. To achieve this, businesses must ensure that governing is done as an activity separate from work.

Success involves financial independence and good family relationships. A succession plan should be discussed well in advance of any ownership transition. Each situation is different. The planning process should involve engaging with key advisers, family members, and key people in the business.

The worst results are tax driven. The family need to be familiar with the advisors and have faith in them rather than family members trying to micro-manage and control everything. There needs to be a free flow of information and documentation, an 'open architecture' so that various advisers can share documents and materials in a trusting way.

Often these processes are best led by people who are professionals trained in human behaviour. They also need to be predicated on independent valuations and financial reporting which is trusted. Those processes create trust and fairness fundamental to successful family dialogue.

Consideration should be given to using financial products to manage risk, rather than just relying on legal structures such as trusts, which may be costly and hard to run. One way in particular is to arrange insurance for public liability, statutory liability, directors and officers cover and other risks.

It is important to distinguish advice from management and governance. One set of advisers cannot act for a growing family, as that is bound to create issues of conflict. This is best resolved by having an independent governance structure.

Using some of these resources can overcome the disconnect between strategy and execution. It is hard to develop the superior returns achievable in successful transition in private business ownership through instead holding stocks and bonds as the result of a liquidity event.

Planning should commence when everyone is fit and well and healthy. Thought can then be given to the governance role, particularly the older generation leading that role.

There is value in involving a financial planner at an early stage to speak to each family member about personal outlook and issues which may not otherwise be apparent. A financial planner can help with managing risk and liquidity when it arises, and the person in that role needs to be well-informed and trusted early in the process.

In terms of professionals trained in human behaviour, it can be useful to involve a trained mediator to fulfil that role. Henry has experience with using people like that who run workshops with the family and ask questions we are not trained to ask, flushing out issues around inequity or prejudice. Either that or a trained psychologist for whom the family is their client.