

HIGHIMPACTPROGRAM

NURTURING THE PROSPERITY OF GREATER LOUISVILLE'S GROWTH BUSINESSES

High Impact Report Series #1

A look at growth leadership

EXIT STRATEGY AND SUCCESSION PLANNING FOR THE HIGH IMPACT COMPANY



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INTRODUCTION AND OVERVIEW

The High Impact Program is a public/private partnership, initiated by Mayor Jerry Abramson, funded by Louisville Metro Government and administered by Greater Louisville Inc. - The Metro Chamber of Commerce (GLI) that identifies and serves fast growth companies, companies with the potential for fast growth and those companies that enable growth in others. This program focuses on companies of these types headquartered in Louisville that have a disproportionately higher impact on the metro area economy.

Through economic development solutions, our objective is to establish a firm relationship with these companies that results in further job and wealth creation.

HIGH IMPACT PROGRAM REPORT SERIES

The High Impact Program continues its mission to nurture the prosperity of Greater Louisville's growth businesses. We are pleased to introduce another element of the High Impact Program – the High Impact Report Series – enabling us to provide you with research, survey data and business information on various topics of interest relative to the life cycle of your growth business. Research conducted among national business leaders, authors, and theorists is combined with data about the actual activities and experiences of your local peers – other high impact leaders – offering valuable perspectives to consider in your business leadership.

Succession and exit planning is the focus of the first report in the series– the way in which high impact business owners may extricate themselves from their business at the appropriate time. This report looks at succession as a leadership issue and explores CEOs' strategies and experiences through a survey of high impact company CEOs, anecdotal stories and thought-provoking research.

“What keeps me going is goals.” Proclaimed by Louisville hometown boxing legend Muhammad Ali, these words also ring true for business leaders; those who work to meet a myriad of goals, including sustaining growth, increasing profits and expanding market share. Studies show, however, that most CEOs plan for the near future (up to five years) without keeping an eye on the ultimate goal: successfully exiting the business. In fact, 61.9% of high impact firms in greater Louisville lack a written exit strategy. Though reluctant to admit it, there will come a time when every CEO will inevitably exit his firm. Without proper planning, CEOs have a significantly lower chance of fulfilling personal and financial goals associated with their succession. Exit strategies also serve to safeguard the company, employees and relatives of the CEO in case of an unplanned injury.

This report highlights the value of a thorough, written exit plan as one of the most important components of a successful business strategy. It examines the major succession concerns of high impact CEOs in greater Louisville, including an analysis of CEOs' options regarding to whom to sell the company and suggestions for building an effective succession advisory team. In addition, current and former CEOs of high impact companies share their succession experiences, offering advice concerning a variety of aspects of the succession process.

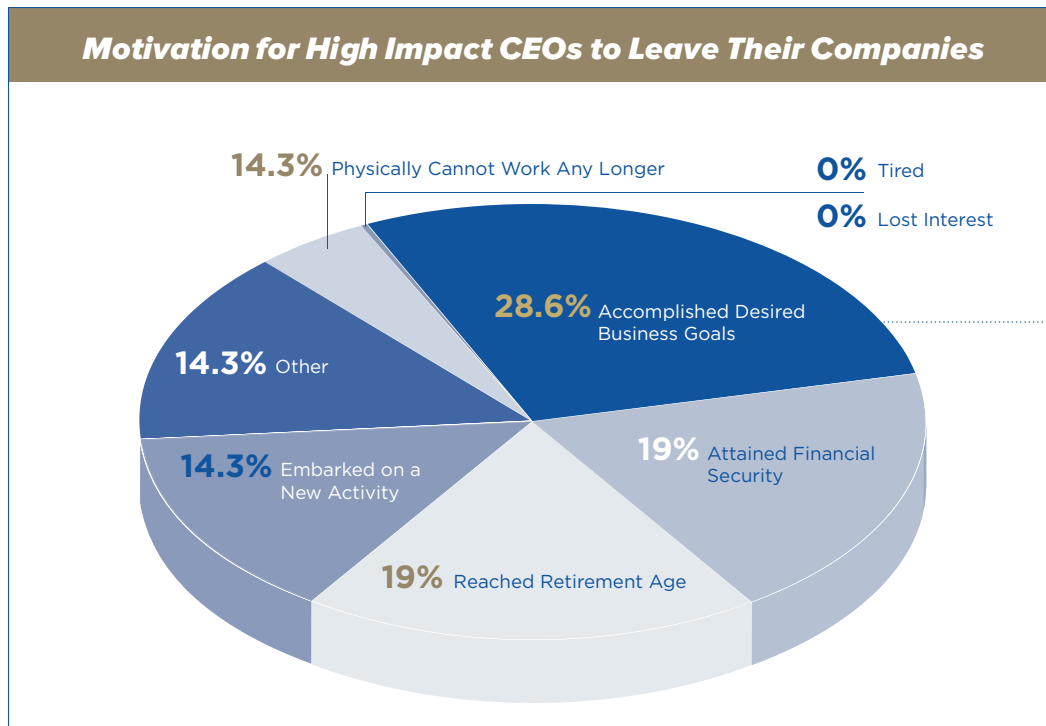
MOVING ON: A REALITY

Many high impact CEOs lack a fully developed exit strategy because daily tasks and decisions preclude planning for the (hopefully) distant future. The sooner CEOs acknowledge the certainty of their eventual succession, the sooner they can begin to plan for its success.

According to Andy McKay, president of bCatalyst Advisors LLC, a business brokerage firm specializing in mergers and acquisitions, the benefits of exit planning include:

- **Achieving personal goals and objectives**
- **Obtaining a higher value for the business**
- **Minimizing taxes**
- **Creating better family relationships**
- **Peace of mind**
- **Leaving a positive legacy**

As more time spent leading a company usually translates into more superior business accomplishments, the same holds true for exit strategies: well established plans meet succession goals more often than short-lived approaches. Among high impact CEOs, however, the trend indicates that top executives form exit strategies as retirement approaches. Statistics indicate that 61.9% of CEOs had not prepared an exit strategy when they assumed their position. According to our survey, various reasons propel high impact CEOs to leave their business:



LETTING GO: WHEN IS THE RIGHT TIME TO CALL IT QUILTS?

According to McKay, a personal inventory might be in order to determine what the CEO wants upon exiting the business. He advises the CEO to answer the following questions candidly to determine their goals:

- **Do you enjoy working?**
- **How long do you want to work?**
- **How much money do you need to live your chosen lifestyle?**
- **What are your volunteer and charitable objectives?**

After completing this evaluation determine the business' value:

- **What is the business worth?**
- **Are family members and/or management truly interested and capable of running the business successfully?**
- **What is the long term prospect of the business?**
- **Where is the CEO in the value creation curve?**

Answering these questions thoroughly and honestly can lead CEOs to realize clearly what they wish to walk away with financially, to whom they would like to leave the business and if they are truly adding value to the longevity of the business.

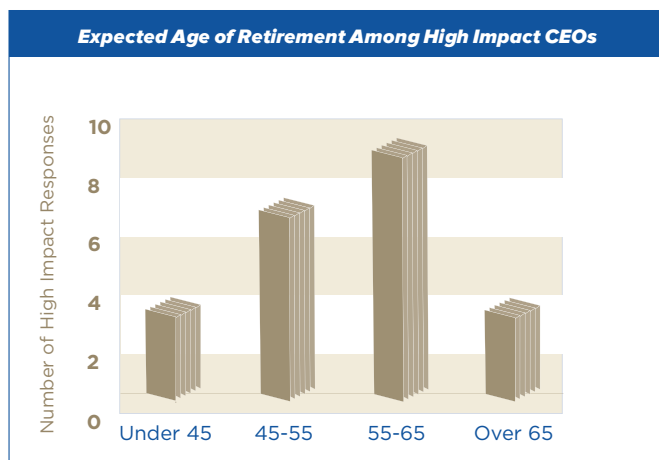
EXIT PLANNING: BLUEPRINTS FOR BUSINESS

Failure to create an exit strategy could prove detrimental to a company and its CEO. Most experts recognize exit planning as the most important component of a business strategy – one that should be constructed as soon as possible.

To understand the importance of an exit strategy, think of the CEO as a bricklayer building a house. Hard work during each quarter is analogous to laying bricks on the foundation with a five-year business strategy representing plans for adding various wings to the house. A blueprint is necessary before beginning construction to assure each section of the house joins properly to form a cohesive finished product. Similarly by establishing an exit strategy early in the leadership process, all subsequent business plans will align to fulfill the exit strategy goals. These goals generally encompass choosing the desired departure date, obtaining the income needed for financial security and deciding to whom the CEO desires to sell the business.

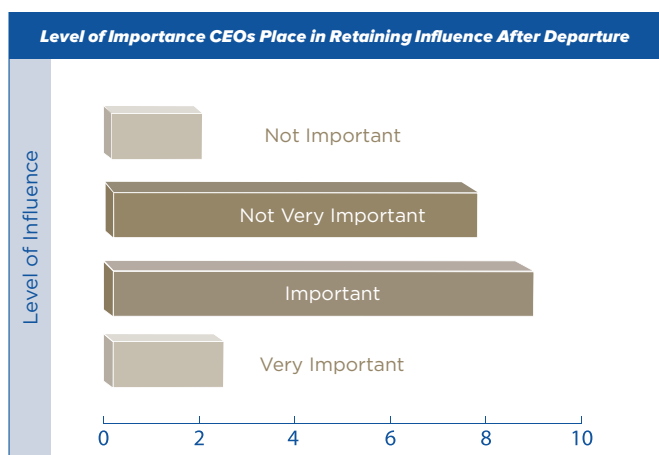
DESIRED DEPARTURE DATE AND INCOME NEEDED FOR FINANCIAL SECURITY

Quantifying an ideal retirement age and a definition of financial security surely varies with each CEO. The following graph depicts the anticipated age of retirement for the high impact CEOs of Greater Louisville.

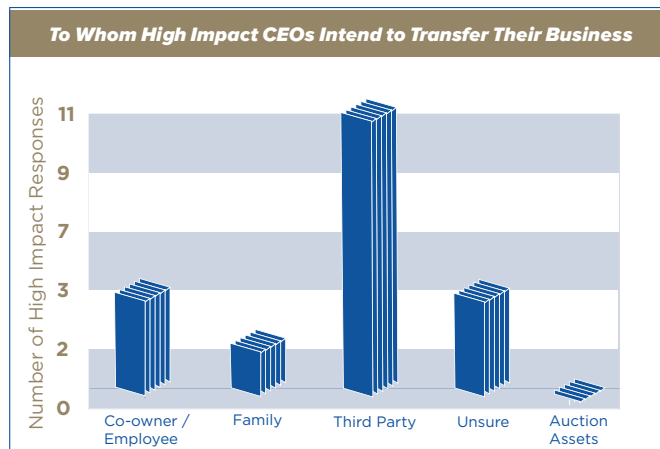


TO WHOM TO LEAVE THE BUSINESS

Investing time and energy into their respective companies for years, many CEOs prefer not simply to walk away from their businesses after retirement. For many, their companies occupy too special a place in their heart and they desire to retain influence even after departing from their company.



Depending on the level of influence that they wish to retain, as well as other variables, CEOs have a variety of options to whom to sell the business.



Depending on the expected buyer, exit strategies must be adapted to meet the goals, needs and purpose of the existing plan in order to fulfill its criterion.

KEEPING THE BUSINESS IN THE FAMILY

According to our survey, 9.5% of high impact CEOs plan for their children to succeed them. However, the national success rate of family-owned businesses surviving to the second generation is only thirty percent with only fifteen percent of businesses remaining in the family for a third generation. A lack of quality succession planning is the most compelling reason for these alarmingly low figures. The following score sheet outlines the advantages and disadvantages of pursuing a succession strategy that calls for selling the company to the CEO's children.

Pros

- Provide for children's security

Parents want to do everything in their power to ensure that their children maintain a high quality of life. Passing a successful business onto them is one of the most obvious ways of achieving this goal.

- High degree of involvement after retirement

As the parent of the new CEO and the former CEO of the company, a high degree of influence naturally remains post succession.

- Continuity of business goals

After raising, grooming and training the new ownership, the company will most likely move in the same direction as it did under the former CEO. This provides great ease to many CEOs, knowing that their hard work will continue rather than assume a radically new direction. This also includes the retention of employees, since the new CEO has no incentive to change the current workers.

Cons

- Potentially harmful family dynamics

While keeping the business in the family would seemingly reinforce familial bonds, it also has the potential to tear families apart through miscommunication, differing expectations or greed. Perhaps even more potential for trouble arises when multiple children succeed the CEO. While it may seem natural to treat successors as equal partners, this may not be in the best interest of the company. Experts suggest a “first among equals” strategy, with all being treated fairly, but with one child fulfilling many of the day-to-day duties of running the company. This ensures that merit, or selection based on ability, prevails over familial ties.

- High taxation

The most prominent reason that family companies do not survive to the next generation is the high rate of taxation. The estate tax, in certain instances, can reach levels of up to sixty percent. Proper planning, however, such as one-time gifts, reporting the lowest defensible value of the business, and freezing the value of interest are all methods that the CEO’s accountant should be familiar with in order to reduce the burden of taxation. It is important to stress that while it is possible to avoid taxation, especially double taxation, this can only occur with proper long-term planning.

- Financial risk

Depending on the manner in which the CEO arranges the transfer, it is likely that the CEO’s former company will generate much of his or her post-retirement income. With this comes inherent risk, since financial security lies in someone else’s hands, even if it is a family member.

PATH FOR FAMILIAL SUCCESSION

Knowing in advance that the CEO’s heir will succeed him affords the CEO the unique opportunity to groom his child to best fulfill the requirements of the job. Experts suggest that heirs work outside of the family’s company in order to gain an understanding of different business techniques. After gaining this knowledge, he should work within his future company, though not necessarily in a management position. In order to lead effectively, it is beneficial to experience being led. Once fully immersed in the company, the CEO should groom his child, demonstrating the requisite management skills and techniques.

KEEPING IT IN THE COMPANY

Approximately 14% of high impact CEOs plan for another owner or an employee to succeed them. The following score sheet outlines the advantages and disadvantages of pursuing a succession strategy in which another owner or employee will succeed the current CEO.

Pros

- Structure Deal in Advance

Similar to transferring ownership to an heir, selling to another owner or an employee affords the opportunity to plan for the succession well in advance. This provides a degree of security and a stated goal: identifying the correct successor. Though initially daunting, experts suggest that the CEO first assemble a list of qualities necessary to assume the company’s top position in the search for a successor. It is unnecessary to pick a single person immediately. Instead, it may be beneficial

to offer several young employees middle management positions. Once a successor has been chosen, it is the CEO's task to prepare him for the succession both financially and managerially. Many CEOs plan to sell their business to someone in their companies, but fail due to inadequate financial planning. Consult a succession advisory board (discussed later) regarding methods, such as ESOPs (Employee Stock Ownership Plans) or deferred compensation to ensure that the chosen successor can secure the finances to purchase the company. Some experts claim it takes up to five years to groom a successor. They suggest ample time for training, which includes a trial period in which the former CEO supervises the new top executive.

- **Continuity of Business Goals**

Since the CEO has handpicked, groomed and trained the successor, he will most likely move the company in the same general direction as it has been traveling. This provides ease to the CEO, knowing that his company will stay the course rather than take a radical new direction. This also includes the retention of the current employees, since the new CEO will most likely hold allegiance to them in the same manner as the former chief executive.

Cons

- **Risk**

As mentioned above, employees usually have a very difficult time attempting to purchase the company, and generally do not possess the funds in the form of cash. Most transfers of this nature consist of the successor financing the sale through the business. This appears counterintuitive, since the retiring CEO will be paid from the assets of the company that he is selling. However, a degree of risk is involved because the CEO's future is essentially intertwined with the future of the business that he no longer manages. Consulting a succession advisory team is the best means of overcoming this obstacle.

CHOOSING AND GROOMING THE RIGHT SUCCESSOR

To David Jones, Sr., Co-Founder and Chairman Emeritus, Humana Inc., succession planning occurs constantly by delegating responsibility, as evidenced by his mantra "work through other people." Running one of the most successful national health care companies, Jones realized that he "never had all of the skills that he needed" in order to successfully run his company, and postulates that most CEOs probably face a similar predicament. Instead of attempting to undertake more responsibility, he advocated the need for well-trained employees at all levels of a company, from the CFO to sales. This allows the CEO to extract the maximum amount of resources from his employees and, in addition, creates an environment in which everyone succeeds. Jones cites the need to "create conditions for people to grow" as being one of the most valuable assets of a company.

It is for this reason that Jones's first successor was not a good fit for the company. In 1997, he retired from his post as CEO and was succeeded by his Chief Operating Officer. The former COO increased the number of people reporting to him directly from six to nineteen and felt compelled to make all the final decisions. This micromanagement precluded him from working through other people, making him unfit to continue performing the duties of the CEO.

Following this failed succession, Jones once again assumed the responsibility of CEO, though preparing for his retirement. Along with his Board of Directors, which Jones believes should place succession as one of its most important functions; they enumerated qualities Humana was searching for in their next CEO. These included intelligence, experience, tenacity, passion and most importantly, integrity. “The finish line is down there,” said Jones, “and we’re going to operate honestly to get there.”

A national search for a successor yielded several appealing candidates, but Humana selected Mike McCallister, a long-time employee of the company. Jones cites this as a product of working through other people - his employees were ready to assume larger responsibilities when given the chance to prove themselves. While Jones admits that it is sometimes beneficial to bring in an outsider, he believes that the culture accepts an insider much more readily. One problem with his first successor, claimed Jones, is that his origin in the sales side rather than the health care side kept him out of touch with the culture of the company.

While Mr. Jones, as chairman, certainly made himself available to McCallister during his transition to the position of CEO, he permitted McCallister a large degree of independence. “I made a practice of not going to see him,” noted Jones, arranging for McCallister to seek him out so that the new CEO felt a level of autonomy and comfort. Jones recognizes that a successor should not be a clone, as companies in different stages require different types of leadership.

Looking back on his career, Mr. Jones believes that the best way of ensuring smooth transitions for succession is to constantly hire new, young, talented employees. “Products and cohorts change, so companies need younger people to take on responsibilities. Flexibility and youth bring new life to a company.” Among this pool of qualified talent rises middle management, and eventually senior leadership including the position of the CEO.

SELLING TO A THIRD PARTY

Surveys reveal that 52.4% of high impact businesses plan on selling their company to a third party. In this scenario, it is not necessary to groom a successor as it is when selling the company to a child or another owner or employee. On the other hand, it is important to consider the value that the CEO adds to his company. To be sure, most companies could not function without its CEO. While this validates the performance of the CEO, it may harm the sale of the company. For example, if the CEO’s work constitutes twenty percent of the firm’s value, then only 80% of the company’s value is salable. Therefore, it is prudent to train others in order to convert unmarketable ownership interest into value for the company.

The following score sheet outlines the advantages and disadvantages of pursuing a succession strategy in which the company is sold to a third party.

Pros

- **Cash**

When selling to a third party, the CEO can arrange to receive a large bulk of the money at the time of closing the deal. This limits risk, and provides for the financial security for which CEOs are looking. In addition, it provides an easy means to transfer money equally to family members since assets are in the form of cash.

- Catching a “hot” market

An unplanned benefit of selling the company to a third party is the ability to take advantage of business and market cycles. If the market starts to expand, this can translate into a sale for a value higher than the business’s average valuation. Of course, this can work the other way, as well. With the proper planning time, however, a CEO can pursue measures to prevent troughs in the business cycle and capitalize during a boom.

Cons

- Radical Changes

Selling to a third party leaves the CEO with marginal to no influence over his former company. This can be very difficult to handle, especially after so many years of hard work. The direction in which a CEO has built the company can change dramatically and the employment of his workers may change as well.

PLANNING FOR THE UNPLANNED

Beyond providing a means for achieving personal and financial goals, succession planning can help mollify the negative effects of an untimely event, such as a death or disability. Without a clear, written contingency strategy, there may be great confusion concerning ownership and management of the company. CEOs should discuss with an advisory board the possibility of an unplanned event in order to assure the best care for the business, its employees, and the CEO’s family members.

This document, a “will” for the business, should be prepared with the help of an attorney. Items important to include in this document are the employees who will assume responsibility for supervising business operations and administration, trusted advisors to consult in the ownership transfer, lists of contacts of business that have expressed interest in purchasing the business, compensation for key employees, and any other special requests that the CEO may have.

DON’T BE AFRAID TO GATHER VOLUNTEER SUPPORT DURING A CRISIS

According to Bryce Johnson, Ph.D., president and CEO of Peptides International, a biotechnology firm, “usually a CEO possesses something special” that has kept the company going and growing. It is imperative for CEOs to indicate clearly what type of person should be selected along with instructions indicating what should be done in the event of their untimely death. Such is the case of Peptides when their long-time leader and company founder, Dr. Arno Spatola, passed away suddenly. Dr. Johnson advises the advance purchase of “business interruption insurance” which identifies who should have control of the company, what the business is worth and protects against loss of revenue with the loss of a person.

Fortunately, Peptides International was a family-owned business and was poised to go on after Dr. Spatola’s death. They were also fortunate to have a strong advisory board with fundamental processes in place on which they could rely heavily during their period of loss. Mrs. Jackie Spatola brought together additional experts in the areas of real estate, technology, finance, sales and marketing to assist Peptides’ Board of Directors through the difficult transitional period. Dr. Johnson suggests, “Don’t be afraid to gather a volunteer board to help during a very difficult situation.”

BUILDING THE RIGHT ADVISORY TEAM

As advisors are essential for executing an overall business strategy, they are also vital in the succession planning process. In particular, a succession or exit advisory team should at least consist of an attorney, an accountant and a financial advisor. As impartial observers, these advisors assist the CEO, providing support for development and implementation of the exit strategy.

Attorney

With continually changing legislation, consulting a lawyer is imperative in order to understand the intricacies of the legal system. The legal advisor should be experienced with employee incentive plans, buy and sell agreements, legal audits, estate planning and taxes. A single attorney may not be able to meet all of these needs, so a team may be necessary to comprehensively address the legal aspects of the succession plan.

Accountant

The CPA should be well versed with tax planning and be able to suggest ways to minimize taxation. This could be the difference between meeting goals and falling short.

Financial Advisor

This advisor ensures that the CEO's financial goals will be met upon succession. Essential skills for this role include business valuation and knowledge about benefit plans for both the CEO and employees.

In addition to identifying quality expert advisors, they should function effectively as a team in order to provide the best results. Experts suggest that the CEO schedule regular meetings with the advisory group so that they can work together seamlessly in order to realize his desired goals.

It is recommended that a CEO interview at least three prospective advisors in each area choosing those that best gel with the current management team.

Successfully utilizing the advisory team

After assembling the necessary experts that compose the advisory team, the first task should be identifying the three key objectives regarding succession: (1) when the CEO desires to exit the company; (2) his financial objectives; and (3) to whom he wants to sell the company.

It is important that these goals be written rather than just spoken or considered. Writing serves to clarify the goals of the CEO, providing direction and peace of mind. A written exit strategy also attracts investors, who feel more confident investing in a firm with a clear vision. As discussed earlier, a written exit strategy also serves as a way to best manage a company, employees and family in case of an unexpected death or disability.

Even a written plan is flexible and subject to change. For example, perhaps a third party makes an offer that the CEO cannot refuse. Since the written exit strategy includes the three key business objectives, seriously considering the offer is easier because a baseline exists for purposes of comparison.

Once the three goals have been identified and written, experts suggest a thorough review of the current state of the company. Taking a step back and evaluating the firm is always a beneficial endeavor for both the present and future.

Experts suggest that an attorney perform a legal audit as part of this review. Only 57.9% of high impact firms had conducted a legal audit by end of year 2005. A legal audit calls for a review of corporate documents, operating documents, and ongoing practices. If a problem does exist, the early discovery saves time, energy and money. In addition, the legal audit is a precursor to the due diligence review that must be performed before a business is sold. It is very difficult to sell a business with legal problems, so the legal audit prepares the company for a successful due diligence review.

After examining the current state of the business, the advisory team serves to realize the CEO's goals. Perhaps the best method of implementation is the fiscal year-end review. 89.5% of high impact companies currently perform a fiscal year-end review. It serves to update the CEO and the rest of the management team regarding the company's status during the past year. More importantly it provides a forum for communication between the CEO, management, and advisors. The fiscal year-end review affords the advisors to collaborate, continues progress toward goals and allows the CEO to examine business techniques in order to improve the company.

PREPARING THE PLAN

Finally, the CEO needs to put the plan in writing. Similar to a living will, the exit plan solidifies and communicates the intentions of the CEO for the business. Along with putting the plan in writing, the CEO needs to promote the business' value proposition. By this, the CEO should identify the value drivers, clean up any loose business ends, address existing problems and address any opportunities that increase the business' value.

SOURCES, SUGGESTED READING AND RESOURCES

bCatalyst Advisors LLC, the region's leading middle-market mergers and acquisitions specialists, www.bccatalyst.com

Brown, John H. *How to Run Your Business So You Can Leave It in Style*. Edited by Kathryn B. Carroll. Golden: Business Enterprise Press, 2004.

Business Enterprise Institute, www.exitplanning.com

Cotton + Allen, full service accounting and advisory firm serving the region since 1921, www.cottonandallen.com

Passing the Torch: Lessons Learned – Wisdom Shared, Conversations with Louisville Leaders About Life, Leadership and Service. Louisville: Butler Books in partnership with Greater Louisville Inc. and the Leadership Louisville Center, 2005.

SCORE (Service Corp of Retired Executives), Louisville KY, chapter 75, www.score-louisville.org

The Entrepreneurial One-Stop, Louisville KY, www.greaterlouisville.com/content/community/1stop

METHODOLOGY AND ACKNOWLEDGEMENTS

The first topic of The High Impact Report Series, Exit Strategy and Succession Planning was selected from response to the first Inc.tank Business Life Cycle conference on a similar subject in addition to responses from an online survey conducted among high impact CEOs, presidents and business owners. Research was conducted and compiled by Jason Karl, Yale University, among various publications, high impact surveys and personal interviews. The report was edited by Lisa Bajorinas and Greg Virgin with Greater Louisville Inc. and reviewed by Mark Crane and Vik Chadha with Enterprise Corp. and Eileen Pickett with Greater Louisville Inc. The printed copies were initially distributed at a launch event, the Mayor's High Impact Recognition event, featuring Mayor Jerry Abramson and Greater Louisville Inc. president and CEO, Joe Reagan on May 25, 2006.

This report is the result of numerous supporters of the High Impact Program, dedicated to nurturing the prosperity of Greater Louisville's growth businesses. Thanks to all those that contributed to, edited or reviewed this report in an effort to enhance the leadership of our growth businesses. Thanks to Beth Howard of Greater Louisville Inc. for final editing services, Beth Harper of Greater Louisville Inc. and Stacey Wade of NIMBIS Inc. for championing the graphic design and production assistance.

Most importantly we thank the high impact companies in Greater Louisville for sharing their experiences, anecdotes and contributing to our statistical information to make this a valuable learning tool.



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HIGHIMPACTPROGRAM

NURTURING THE PROSPERITY OF GREATER LOUISVILLE'S GROWTH BUSINESSES

