



Bridging the Generation Gap

Ensuring the Successful Succession
of Family-Owned Businesses

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Foreword

The majority of family business owners believe that passing a company down from one generation to the next is a straightforward process that requires little planning. Often, they don't recognize the complexity or anticipate the challenges that lie ahead.



For family businesses, succession planning can address numerous objectives, including maintaining business continuity, preserving wealth, avoiding disputes among siblings and other key stakeholders and managing tax obligations. The end goal is to achieve a successful succession of the business from one generation to the next—a process many families significantly underestimate.

According to research by the Family Business Institute, only 29% of family businesses in the US are successfully passed from the first generation to the second, and about 10% from the second to the third. About 3% of family businesses make it to the fourth generation or beyond. These statistics emphasize the challenges associated with such business succession, as well as the importance of planning.

Many of the obstacles that are typically faced can be avoided through timely and in-depth succession planning. It's important to begin early and seek the help of experienced, professional advisors who offer in-depth knowledge of the unique nuances of family-owned businesses and who can help guide them through the entire process.

The following article addresses a range of succession planning issues, highlighting common areas of misunderstanding and other matters that are often not considered. These include the need

for a robust governance structure; the importance of understanding the younger generation; recognizing the role of both non-family members and non-stakeholder family members; and understanding the process of selling a business.

Together, these factors can give families confidence and the peace of mind that comes from having made strategic, informed decisions about the future of their business.

A handwritten signature in black ink, appearing to read 'Gerard Joyce'.

Gerard Joyce
Managing Director,
Head of US Personal Trust
HSBC Private Bank—Americas

Core Elements of an Effective Succession Plan

One

A shared vision and strategy for the wealth and the business between generations is paramount. From there, the family can implement a governance framework and company structure that will provide the foundation for the succession plan.

Two

There should be a clear understanding among everybody involved of the ownership, management and operational control of the business—and full commitment to these decisions.

Three

Between the generations, there should be agreement regarding when the older generation will relinquish control of the business to the younger generation, and ample training for the younger members to prepare to take on this responsibility.

Four

Communication is key. Succession can be an acrimonious process and can lead to ill will between generations and among siblings. It is important for the older generation to express their decisions early and clearly, and articulate them objectively.

Five

There is value in bringing non-family members to the business. They bring essential industry knowledge and experience and an understanding of the competition. The key is ensuring that they are aligned to the family's vision, core values and ethos.

Six

It's important to evaluate the role of family members who are not stakeholders in the business. These could include owners who are not decision-makers; those who may sell their stake to other family members; and others who wish to be involved in non-management activities such as philanthropy.

Seven

When it's time to sell the business, it is important to understand its current and future value, and seek close alignment with the buyers, who will be concerned with how well the company will operate without its current owners and how successful it will be in the future.

Eight

Post-sale, families are faced with deciding what to do next. They may want to invest in a similar business or a completely different one. Or they may wish to invest their proceeds to grow their wealth. Whatever their path, they will benefit from having a clear plan in place well in advance.

Common Themes Among US-based Family Businesses

The older generation is reluctant to let go:



40%

of family business leaders find it hard to relinquish control



50%

of family business leaders believe they need to be more involved in the succession process

Taking the business in a new direction is welcome, but for many this is not easy:

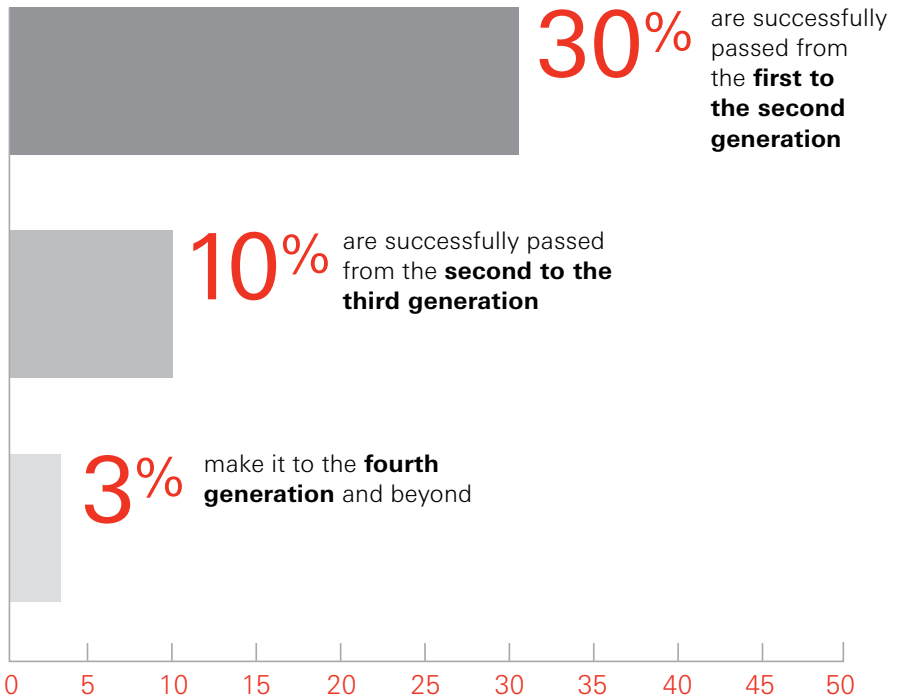
53%

OF FAMILY **BUSINESSES** FEEL THAT THEIR BUSINESSES REINVENT THEMSELVES WITH EACH **NEW GENERATION** BUT

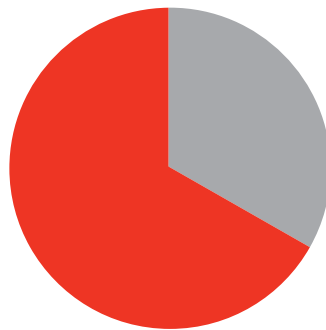
65%

VIEW THE NEED TO CONTINUALLY **INNOVATE** AS A MAJOR **CHALLENGE**

The likelihood of passing a business to the younger generation:



Non-family members are viewed favorably by family business owners:



Two thirds

of family businesses have non-family members on the boards of their companies



One quarter

of businesses have non-family member board executives with stakes in their companies

Governance and Structure

With a clear operating framework and well-articulated rules in place, disputes can be minimized, allowing families to capitalize on opportunities.

The most important part of succession planning is instilling structures that address how a family business is to be administered, and how it is to be passed from one generation to the next.

encourage the use of professional management services in functions such as finance, marketing, operations and sales while retaining ownership and control.

Outsiders bring industry expertise where it is needed. In particular, external consultants bring two strengths: first, they are aware of what the competition and the industry is doing, so they often give a broader and more informed perspective; and second, they are not swayed by family-influenced viewpoints and the pressures that are associated with running a family business, such as loyalty to a particular member rather than to a business case.

A United Vision

Family businesses need to have an agreed cause and a code of conduct to guide their operations. The hallmark of this lies in effective communication and a commitment by all parties—and particularly by the senior generations—that they are going to create a strategic plan.

Planning must consider:

- The business
- The family
- How the business and family are going to coexist and benefit from one another

Ownership, Management and Control

Understanding the subtleties of ownership, management and control is important. Often, business owners focus primarily on ownership concerns, unintentionally ignoring management and control, which are vital for business continuity.

Furthermore, there is still a strong misconception that those who own the business must manage it. However, this is not always effective. Business owners are advised to



A plan should also clarify:

- Who will make decisions
- What roles need to be filled in a business
- How these roles are to be filled and whether family members should assume these roles
- What provisions there are for family members to be directors or shareholders but not employees of the business

Additionally, senior generations need to demonstrate a commitment to transferring ownership and control of the business. According to a recent survey by PwC, two in five business leaders say it will be hard for them to fully let go when the next generation takes over. And more than half believe they need to be more involved to ensure a smooth transition to the younger generation, which, in other words, may reflect their lack of trust in the abilities and/or willingness of the younger generation to run the business.

Owners should establish a set of values and expectations to define the business, as these will give shape to key objectives, which in turn will provide a context for decision-making. According to PwC, mediated family meetings and councils are the

mechanisms most commonly used to align families around a common purpose.

Roles and Responsibilities

Clearly delineated roles and responsibilities can help facilitate decision-making. From overall business management to day-to-day operations, families can build trust and avoid pitfalls by laying out the specific responsibilities of each stakeholder and how these responsibilities will transition to the next generation. This clear map can help manage expectations and build the confidence that is necessary to ensure continuity.

However, trust alone is not sufficient: business succession planning often involves balancing varying ambitions. For example, while one child in the next generation may feel it is best to sell the company, another may want to expand it further.

Legal Entities

To avoid disputes and promote business continuity, families often develop estate plans that address long-term succession goals. The objectives of this are to protect assets, enable the smooth transfer of assets and manage tax obligations.

19%

of family businesses consider selling the business

Source: *Family Business in Transition*, Family Business Institute, 2016



66%

of family businesses
have no successor

Source: *Family Business in Transition*,
Family Business Institute, 2016

**With respect to legal entities,
families may consider:**

- Sole proprietorships
- General partnerships
- Limited liability companies
- Corporations
- Limited liability partnerships
- Limited partnerships

**Each has its benefits and
disadvantages regarding:**

- How easy or difficult it is to organize
- The swiftness in decision-making once formed
- Flexibility of operations
- Liability of the owners
- Business continuity
- Taxability of the entity and its owners

Family businesses should have relevant agreements in place that set terms to protect the interests of the senior generation and the next generation, while focusing on what is best for the business, too. They should include:

management agreements that outline who is responsible for each aspect of the business; buy-sell agreements among owners that are often funded with life insurance and outline the terms and conditions of ownership and to whom shares can and cannot be sold; and pre-nuptial agreements. These have the overarching goal of establishing clarity with respect to ownership, transfer of ownership, compensation and the assigning of decision-making roles.

Estate Planning

Estate planning, on the other hand, allows a family to organize personal and financial affairs in the event of any unforeseen circumstances. Important estate planning documents include a will, a living will, a healthcare power of attorney, a durable power of attorney, and trust documents in cases in which trusts have been created to ensure a structured business succession process.

30%

of family businesses
have no succession plan

Source: *Family Business in Transition*, Family
Business Institute, 2016



Such succession vehicles are becoming more popular in the US, but there is still a long way to go, as many family businesses still do not have a succession plan.

Preparing for the Unexpected

Without a succession plan, dealing with unexpected circumstances can be challenging.

For instance, recent research by the Family Business Institute revealed:

- Only about one in three family businesses had appointed a successor
- Merely 27% had a robust and documented succession plan for senior roles
- Only 21% had a succession plan in place for all senior roles
- A full 30% had no succession plan at all

Not having a plan can have very negative implications for the entire family, as well as the continuity of the business. In many cases, while there may be a will in place, very little thought is given to other aspects such as taxes, management succession and company objectives.

The absence of a contingency plan can leave a family-owned business precariously placed in the event of a death or disability in the family, as it leaves many questions about the future of the company unanswered.

It is also not enough to simply have a plan. A well-designed succession plan should be reviewed periodically and adjusted, as family and business requirements evolve due to factors such as regulatory changes, fluctuating economic circumstances or business profitability.

The Younger Generation

Managing the eagerness of the next generation while dealing with the threats of outside opportunities can be a challenge.

The older generation's desire to remain at the helm of a business can create a rift with the younger generation, as many of them are keen to take over at an early age. As such, getting the timing of the succession right is a significant challenge among family-owned businesses.

Striking a Balance

Early involvement in a business facilitates greater understanding of how it operates and its values. It also provides scope to experiment with and implement new ideas that can be beneficial for the company. This bodes well for younger family members as it makes them more confident about decision-making. However, this also involves risk. Therefore, it is important to strike the right balance in terms of succession.

When there is more than one successor, the choice of who is the ideal candidate for the business can be a difficult one. When this situation arises, families that can articulate





the requirements for company leadership and the roles of the other key stakeholders will experience a smoother transfer of power. A family business should be viewed as an extension of the family itself. While leadership is a critical aspect of the family business, experience shows that close-knit and united families are the ones most likely to be successful in business and transferring it down the generations.

External Opportunities

Today, the younger generation is exposed to many more career opportunities than ever before. It is therefore not surprising when members of the next generation have career aspirations that are not aligned to the family firm. When this happens, families can sometimes be compelled to sell a small or significant part of their business to external parties.

Even if such younger members are convinced to join the business temporarily, keeping them there is not an easy task. Successors will ask, "Is this role interesting and compelling enough to keep me engaged? Does it allow me to develop and execute new business ideas, even if it is a risk to the family?" These questions are asked

because the younger generation usually have multiple options to join other companies that will allow them to try out their ideas, if doing so in the family business appears difficult.

Another problem is the trade-off between proven, traditional ways of running a business and unconventional ideas that are untested and may or may not deliver success. The younger generation can get frustrated quickly if the older generation has too conservative an attitude.

Talent Retention

For members of the younger generation, a major concern when making a career choice is how much of their potential they will be able to achieve in their trade. How families address that concern is critical to keeping talent within the business—if they can go out and create a company on their own, what is to stop them from doing just that?

It is therefore important for the older generation to nurture an interest in the younger generation for the family business and, in particular, to train, support and empower them by placing sufficient confidence in their abilities.

73%

of family firms believe that their culture and values are stronger than those in other types of businesses

Source: Professionalize to optimize: US family firms are no longer winging it, US Family business survey, PwC, 2015

Non-Family Members and Non-Stakeholder Family Members

To successfully manage a family-owned business, its owners will likely appoint staff from outside to fulfill mission-critical roles and must ensure that all external parties are aligned to the business's goals and values. The owners must also decide on the role of non-stakeholder family members.

Family businesses may require external management and advisory services, since some of the roles and skill sets required to run their businesses will likely not be met internally. Conversely, such companies will also feature family members who have ownership stakes in the business, but who are not in management roles or controlling positions.

It is for these reasons that many businesses send a family member to work outside in order to return with much needed experience gained outside their comfort zone.

Challenges

There are, of course, a few challenges that arise from including a non-family member. First, they are not well-versed in the ethos and values of the company. Second, they will have ideas and strategies that could be opposed to the family view, and that may result in infighting and conflict. It is therefore essential that an outsider is educated about the vision, values and ethos of the business.

Building rapport is important to establish faith and confidence. Chemistry is also important. It is not easy to find an advisor who is a good match for the company, but the right person can become an extremely valuable asset.

Families are certainly of the view that the benefits of having outsiders in their business outweigh the challenges.

In a recent survey by PwC, 64% of family businesses said that they have

60%

of family businesses see the recruitment of skilled personnel as a challenge

Source: Professionalize to optimize: US family firms are no longer winging it, US Family business survey, PwC, 2015

The Role of Non-Family Members

Non-family members ordinarily bring industry expertise that is critical. In particular, outsiders can offer two strengths:

1. They are knowledgeable of the competition in the industry and provide a broader perspective.
2. An outsider brings a certain level of independence to decision-making. Outsiders are not burdened by being part of the family, and are often able to take bold actions that would otherwise not be executed.

non-family members on the boards of their companies. Furthermore, a quarter of the surveyed companies said that they have non-family members as board members with stakes in the company.

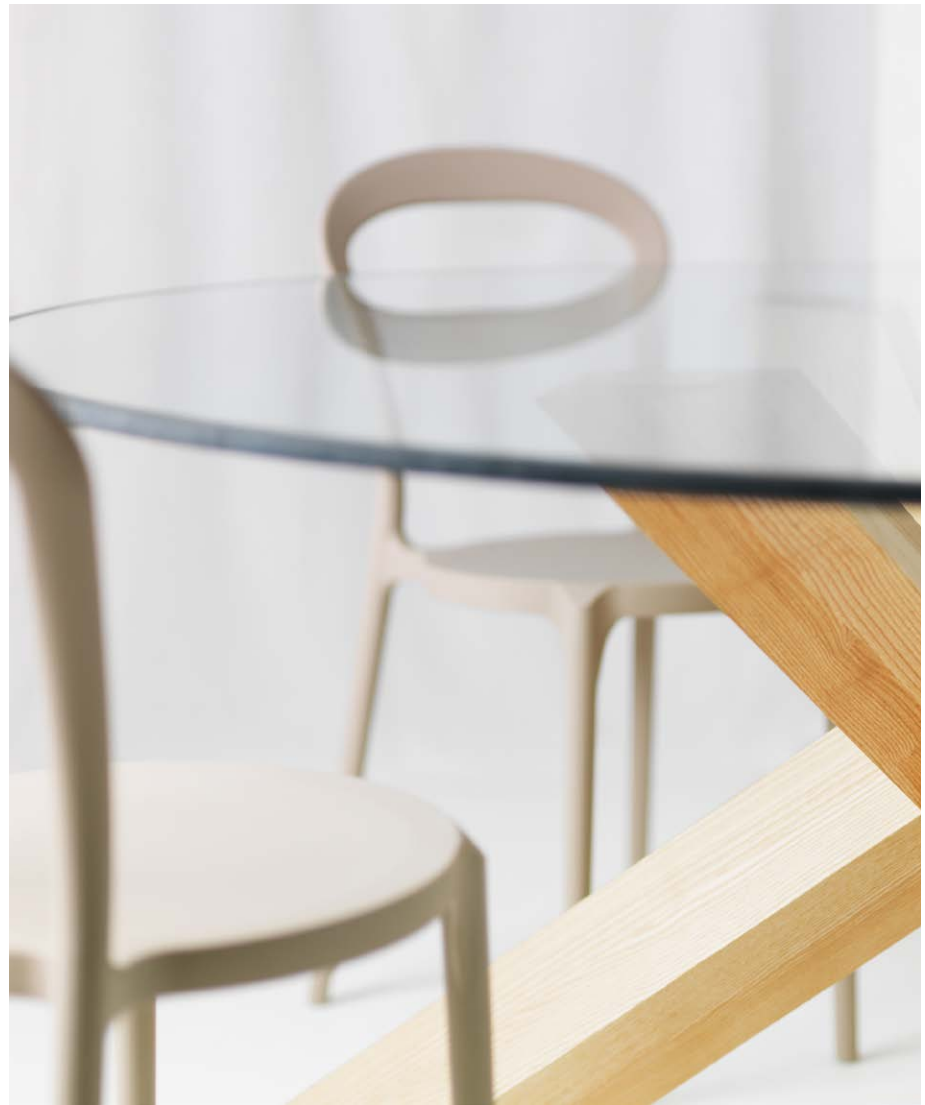
Sometimes, businesses are compelled to bring non-family members into management positions because they lose the younger generations to outside opportunities. When family members choose to work at other companies, the obvious risk lies in losing out on young talent that is most likely attuned to the values and ethos of the family business.

There are a few advantages when family members work outside of the family business—the first is that it can improve ties between family members by reducing the incidence of disagreements and conflict arising from the business; and second, it can give family members their "space" and allow them to prosper independently and in their own time, rather than remain in the shadow of older siblings or the older generation.

That said, retaining family talent is vital and goes a long way in ensuring continuity of the business and its values. Reconciling the two is not an easy task.

Non-Stakeholder Family Members

A common scenario is to have family members own or co-own the company, but not be involved in its day-to-day affairs. This is true of three



in five family businesses surveyed.

In the event that a family member works outside of the business, the family must decide on for how long, and define the skills they want the member to acquire while working externally. Similarly, when a family member chooses not to participate in the day-to-day affairs of the company, they need to decide if they will continue to own a stake or sell their ownership back to the family. And lastly, while a family member may not have a place on the management team, they may take on other roles, such as philanthropy.

With the vast array of skill sets

required to manage a company—particularly in today's ultra-competitive business environment—families cannot discount the importance of non-family members in helping to drive their companies forward. Likewise, they cannot ignore the fact that some family members may not undertake senior roles in the company, with these instances requiring careful consideration and robust planning. The senior generation may need to assess the ultimate division of their overall estate, including the business, to the next generation in such proportions as deemed appropriate.

Selling a Business

To achieve a successful sale of a family-owned business, the buyer and seller must be aligned. After the sale, some families choose to invest in a similar venture, with others seek to grow their wealth by investing in a portfolio of assets.

Selling a business is arguably the most important decision a family will make, and is directly correlated to the level and thoughtfulness of the succession planning. Once a business is sold, however, the family faces a new set of challenges, including where the proceeds from the sale will be allocated.

A Buyer's Perspective

When successful family businesses decide to sell, or are approached for a sale, planning is what guides their evaluations of the sale. The main considerations fall in two separate areas: their motivations for selling and the prospective buyers' checklists. This can sometimes lead to a disconnect.

Although business owners naturally want a premium for their companies, they sometimes fail to look at the purchaser's perspective. The chief considerations for the seller—besides the price paid for their business—often have more to do with addressing issues of succession. Buyers generally want a company that is already successful.

For instance, potential buyers look for businesses that can be managed independent of the owners. Their due diligence is conducted along the lines of any other business acquisition. They assess the level of competition and barriers to entry in the industry, profitability, future growth prospects, skill and motivation of the workforce and reputation, among other factors.

The Family View

On the other hand, from the





perspective of the family looking to sell a business, it might just be the right time to make a sale, due to a variety of factors, the most important of which is often whether the younger generation is capable of—or indeed even interested in—taking over the business. Sometimes, a family may just want to explore other business avenues. To make a profitable sale is critical, therefore, for furthering new ventures.

There are a host of things that need to come together to make a successful sale. These include who the business will be sold to, who is going to benefit and what the tax implications will be.

47%

of family businesses say the need for new technology is a substantial challenge

Source: Professionalize to optimize: US family firms are no longer winging it, US Family business survey, PwC, 2015

Achieving Alignment

According to a PwC survey of family-run businesses in the US, for instance, 19% of respondents are contemplating selling their business. And 25% of businesses in the US are not passed on to even the second generation, illustrating that the sale of a business is a prominent means of succession.

It is therefore imperative to plan carefully and put structures in place that can not only facilitate the successful sale of a business, but also yield fruitful results for all parties in the transaction.

Post-Sale—What Next?

Following the sale, the foremost challenge facing the family is where to allocate the proceeds. Historically, family businesses acquire skills and expertise that are built up over several decades, and which belong to a particular industry. Selling a business often involves clauses that forbid the seller from trading in the same line of business. Therefore, the matter of what to do next is important.

The family may wish to invest in a similar industry, a completely new venture, or choose to grow their newly acquired wealth through an investment portfolio. Whatever the choice, it is advisable to seek professional support. Even in similar industries, operating environments can be very different, and the skills required to grow wealth through investing are different from those needed to run a non-financial business.

In addition, the family will also benefit from support services in other areas, such as the formation of trusts, tax and legal matters.

Next Steps

Family businesses face an ever-changing array of challenges that are arguably more complex than before.

Globalization and the advent of advanced communication tools mean that competition in most industries is intense, whether from domestic or international players. Furthermore, the younger generation have a vast array of career choices that were unavailable to previous generations, which are enticing them away from the family business.

The majority of succession challenges faced by family businesses can be alleviated with in-depth and timely planning. From our vantage point, it is clear that a true commitment to developing and implementing a succession plan and a governance framework is often what separates those families that pass the business on to the next generations from those who do not. A wealth of research supports this view—it is hard to conceive of a situation or a company where no planning is a good option.

At HSBC Private Bank, we support families throughout the entire succession planning process, providing guidance and the solutions they need to take their businesses into the future.

How you can start your planning:

1. Recognize—early—the need for a succession plan, and for a family governance framework that assures the plan is implemented.
2. Reach out to your HSBC Private Bank Relationship Manager, who can assemble the right team to discuss your situation and evaluate the various approaches you can take, including tapping the expertise of our Family Governance or Family Enterprise Succession Planning group.
3. Work together with your family and our team to develop your plans, building in some degree of flexibility so that you may refine your plans as your family circumstances evolve.

Contact your HSBC Private Bank Relationship Manager to get started today.

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