

The trillion dollar trap

More than 300,000 entrepreneurs want to sell their businesses over the next 10 years, but a shortage of buyers and capital may dash their retirement dreams

By Rick Spence
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It's September 2012. You wake up one morning, drink your Starbucks energy juice, and check the digital news on your iPod. When you see that the price of oil has just passed US\$100 a barrel, you decide that's enough. It's time you enjoyed the fruits of building your business. You message your accountant and tell her you want to sell. Then you call up an ad for an around-the-world cruise.

But your accountant throws cold water on your dream of worry-free years in the sun. You've left it too late, she says. Your staff are not ready to run the business without you — and at the shape your books are in, you'll never get top dollar. Even worse: tens of thousands of entrepreneurs — most of whom are baby boomers seeking retirement — are trying to sell their businesses at the exact same time. If you'd started planning for this back in 2005, you might be able to afford something better than a time-share in Moose Jaw.

A far-fetched scenario? No way. According to a survey by the Canadian Federation of Independent Business (CFIB), 71% of entrepreneurs intend to sell their businesses over the next five to 10 years. Put that stat against only the 440,000-odd companies in Canada with five to 199 employees, and you'll see that more than 300,000 enterprises could flood the market in the coming decade. More than \$1 trillion would be needed to finance the transition, pushing Canada's capital markets to their limit — if not beyond. And it all presumes enough buyers will be found. Anyone selling into this market — by choice or otherwise — will struggle to attract worthwhile offers and may have to delay their exits by months, if not years.

Making matters worse: few entrepreneurs have a clue how they're going to get out of their business, or who's going to take it over. As a result, Canada is facing a succession crisis that could dash the retirement dreams of a generation of entrepreneurs and, quite possibly, undermine the entire economy. There's only one way to minimize your pain and maximize your profit: start planning now.

"Selling a business is not an immediate process. It's not like selling a car," says Glen Harry, a business valuator and partner with Grant Thornton in Vancouver. First you have to get your business in show-window shape. Then you have to identify likely successors and either woo them if they're outsiders or train them and help plan the transition if they're family or staff. And the actual process of simply selling the business can take a full year or two as potential purchasers kick the tires. "I've worked on deals that took 18 months just to negotiate," says Harry. Competition could push that timeline even further. Like many other succession experts, he says, "You should be planning your succession 10 to 15 years before you want to get out."

Most people aren't that smart. "We have people come in who are 65 and haven't done anything about succession," says Harry. "They are not going to maximize their price."

It's ironic, adds Denis Labreche, a senior VP with Ernst & Young Orenda Corporate Finance Inc. in Montreal. "Most people start thinking about this at the last minute, even though they may have been

working at their business their entire life."

The CFIB doesn't officially use the word "crisis" to describe the succession time bomb, but others do. "It will be a crisis. There will be panic," says Malcolm Scarratt, CEO of Scarratt & Associates Planning Group in Calgary. "A lot of people will continue to work, not because that's their plan but because no better alternative will come along."

The problem is a familiar one. Canada's entrepreneurs are aging along with the rest of the population. The baby boomers, the population bulge that disrupted society's notions of music, sex, work and parenting, are now in their late 40s to late 50s and looking retirement in the face. With so many business owners looking to sell, the competition will be fierce — for financing, for buyers, even for the professional advisors who can help them arrange a transition. The CFIB's findings, collected in 2004 and released last June, set out the problem:

- Within the next five years, about 41% of the 4,311 CFIB members surveyed plan to leave their business or transfer control.
- Only one-third of the entrepreneurs surveyed have a succession plan. Worse still, only one-fifth of those plans have actually been written down.
- Just 48% of those expecting to exit their businesses within five years have a succession plan. Which means time is running out.

Those numbers don't surprise Gordon Hart, president and CEO of Selectpath Benefits & Financial Inc., a financial advisory based in London, Ont. Two years ago, at the tender age of 35, Hart led a succession-planning initiative to ensure his company's future was understood and assured. But he admits that doing a succession plan wasn't easy: "I've built this business. I don't want to give up control. But the new owners have to have the opportunity to make strategic decisions for themselves."

Don McLauchlin, VP of relationship marketing at Roynat Capital in Toronto, puts a starker face on entrepreneurs' reluctance to plan ahead. "'Succession' is a word that scares the crap out of people," he says. "It's like writing a will. It's a reminder of your mortality."

What happens if you leave succession on the back burner? You may be forced to conduct a fire sale or face a delayed departure. You can encounter regulatory problems or hefty tax bites that foresight might have averted. And you may miss vital opportunities to mentor the new owners or managers. If you don't take time to personally pass along key operating procedures, customer relationships or market intelligence, you're endangering both the health and market value of the company you worked so long to build.

And it's not just the CFIB that sees this train wreck coming. CIBC World Markets issued its own study of entrepreneur retirement earlier this year, and it foresees similar problems: 60% of entrepreneurs aged 55 to 64 have not yet discussed succession with their family members or partners. Young entrepreneurs may be overestimating how much their companies are worth. Business owners aged 18 to 34 say they expect the sale will finance 36% of their retirement spending, while entrepreneurs 55 to 64 expect that their business will fund just 26% of their retirement needs. "There's a significant lack of retirement planning," says the study's author, senior economist Benjamin Tal. "And where there is planning, there is total underestimation of the time it takes."

Asked whether he thinks this is a crisis in the making, Tal chooses his words carefully. "I would look at it as a major concern," he says. "It will have a significant impact on the macro economy." He worries that many companies will mismanage their succession, and either underperform or shut down. "It's very difficult to quantify the economic cost of that, but we know it's going to be very, very significant."

Tal also believes supply and demand will reduce the market value of many companies. "Economics will definitely work here," he says. "We're seeing \$1.2 trillion worth of businesses changing hands in a really short period of time."

On reflection, he says, "I don't want to underestimate the impact of this issue. So I'll go with 'crisis.'"

The depth of individual crises will vary, based on the size of the company, its industry and the shape it's in. Right now, it's a seller's market for businesses. With low interest rates encouraging investors to look widely for better returns, lots of laid-off managers brandishing six-figure payouts and international companies looking for expansion opportunities in Canada, "there are more buyers than there are businesses available," says Pino Bacinello of Sunbelt Business Brokers in Surrey, B.C. But as the sell-off escalates, that could change. Smaller firms, service businesses with few assets beyond goodwill, commodity manufacturers under siege by Asian competitors or companies that depend on the personal knowledge and connections of the owner could all prove tough to sell. And, certainly, market conditions could change fast if the economy weakens or interest rates rise.

Valuations depend on the availability of credit. "For the next four years, maybe five, there will still be lots of money around," says Roynat's McLauchlin. Beyond that, things get harder to predict. But one thing is certain, he says: "It's going to get more complicated to realize the value you've been creating if there's 75,000 of you trying to capitalize on it at the same time."

While there may be lots of private-equity money chasing larger deals, small-business successors may have a hard time finding capital. And opinions differ on the role of the banks. Some believe they support succession transitions, others say the banks' decision-making hurts successors. One industry expert says the banks often treat buyouts like startups—restricting the amount of credit available to the new owners, thus forcing them to raise funds, often more expensively, from other sources.

Selectpath's Hart agrees with the critics. "Where are successors going to find the capital?" he asks. "The banks are very risk-averse and aren't going to write the cheques to allow new business owners to buy out the old."

And here's another problem: there may not be enough entrepreneurs to buy all those businesses. Generations X and Y are both smaller than the boomer generation. Besides, argue both Hart and Grant Thornton's Harry, there are so many other opportunities for young entrepreneurs that buying a "used" business may not look so attractive. Harry says one solution could be for Ottawa to step up its programs for attracting more immigrant entrepreneurs.

Luanna McGowan, who runs PricewaterhouseCoopers' Centre for Entrepreneurs and Family Business in Toronto, warns there could even be a shortage of specialist succession advisors if you wait too long; PwC is already looking to hire new facilitators for its offices in Alberta and Quebec.

While most entrepreneurs want to see their firms continue after them, that might not be possible. If market conditions tighten, consolidation could be the best hope for entrepreneurs selling into the succession wave. Related companies or competitors will generally pay the highest price for your firm, because they can pair it with their existing businesses and benefit from synergies, says Ernst & Young's

Labreche. But that could mean the end of a unique corporate culture, a proud company history or, sadly, the jobs of many of your longtime employees and friends.

Overall, CFIB president and CEO Catherine Swift is convinced that the coming squeeze will be an economic watershed. With small and medium-sized businesses employing 60% of working Canadians, she says, up to two million jobs are at risk over the next five years if action is not taken to facilitate the succession transfer. The CFIB believes government has several roles to play: promoting information on succession planning and on the opportunities that come from buying firms rather than starting them; increasing the \$500,000 lifetime capital gains exemption on small-business shares (which would soften the blow of selling at depressed prices); and encouraging the banks to offer more liberal terms to successors trying to finance business purchases.

Still, there is a solution to the entrepreneur retirement crisis: sound planning. The CFIB study found that formal succession planning not only increases the chance of a successful transition but actually helps the business prosper — both before and after the seller's departure.

Colleen Gibbs, a chartered accountant with Gibbs Willis in Ancaster, Ont., says it's never too early to plan: "From the day you start a business, you have to start thinking about what your objective is and how you are going to get out of it. Succession planning is very similar to contributing to your RRSP. If you wait until you're 60, you're not going to do much to contribute to your goals."

For those who expect to transfer their business to the kids, Gibbs sees succession as a 15-year process. You have to interest your children in the company, help them choose appropriate courses of study and bring them into the firm gradually.

If you expect a key staffer to succeed you, you have to create a long-term mechanism by which he or she can buy into the firm gradually. "Otherwise," says McLauchlin, "even a million dollars is a lot of money for someone to raise."

Don't hold your breath if you're expecting Ottawa to intervene. Nancy Graham, director of policy and liaison for the Small Business Policy Branch of Industry Canada, believes this is the private sector's mess to clean up. While the feds are considering the CFIB's request to add more succession information to Ottawa's business websites, it is unlikely to act on the capital gains exemption.

Would government encourage banks to show more flexibility in financing business transfers? "We wouldn't weigh in on that," says Graham.

In the government's stead, will Canada's bankers step up to the plate? CIBC's Tal believes the banks are looking at the upcoming succession sell-off as an opportunity as well as a problem: "This kind of changing of the guard doesn't happen every day, so you have to take advantage of it. There will be a great need for financing, and I think the banks will be there."

Selectpath's Hart also sees the succession crisis as an opportunity. His firm is expanding by acquiring financial-planning businesses from older entrepreneurs who don't have successors in place. "We create a succession plan for them," says Hart. "I think this will happen in other industries, too."

Over time, acquired companies tend to lose more of their identity and autonomy-but that's the price you pay for burying your head in the sand.

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