Making the Money Decisions

Succession Planning—Why So Difficult?

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"Everybody talks about it, but nobody does it" was a commonly used description during my high school days concerning the exploits of young men and women. Although there may be some disagreement on the state of these activities in high schools today, this statement has never been more correct about succession planning in the printing industry.

In fact, this is the case in most family-owned businesses. A recent PricewaterhouseCoopers survey of CEOs of privately held firms ranging in size from $5 million to $150 million concluded:

- 22% have done a great deal of succession planning
- 26% have done some to very little succession planning
- 24% have done very little succession planning
- 19% have done virtually no succession planning

I believe the reason why succession planning is not prevalent among small businesses is that it is difficult! Besides the emotional implications, succession planning is time consuming. It is a multi-year process, and its path is uncertain. Still, the lack of planning is surprising when you consider that transferring leadership and ownership to family, employees, or others is considered the "Great American Dream" to many.

The need for succession planning has never been greater. A recent *Kiplinger Report* stated: "Expect a glut of firms to go up for sale as thousands of baby boomers retire. With about 8,000 Americans turning 60 every day, more and more business owners are thinking about retiring ... an estimated 750,000 companies owned by boomers—one in every six—will be looking for buyers, up fifteen-fold from 2001."

In this article, I will further define succession planning and lay out an easy, step-by-step plan to assist in its successful execution.

Succession Planning

Succession planning has two parts:

- **Replacement planning.** The process of identifying the candidates and replacing the owner as the leader of the firm.
- **Exit planning.** The process of identifying the options and replacing the owner as a shareholder of the firm.

Many people may ask, "If I am going to sell the business, why do we need to identify a person who will replace me?" In some cases, this ultimately is a valid point. However, before you start the process, you do not know whether having a replacement will impact you negatively or not.

I strongly recommend putting a replacement in place before you commence exit planning. There are many reasons: for example, you may decide to retain ownership, or selling never turns out to be an option. In these cases, having a replacement leader increases your options and strengthens your negotiating position. But the most important reason to complete replacement planning before exit planning is that your company is worth more with a new leader in place.

Any knowledgeable buyer of a printing firm understands that the CEO highly influences the success of the firm. If a seller's objective is to exit everyday management, a buyer must factor in the possibility that the company could be less successful under new leadership. This reduces the price to the extent that the buyer perceives the situation as a risk. The risk is removed, however, if a new leader has been appointed and the firm has continued to operate as before.

Some buyers discount such risks, but not all buyers do. In fact, when I was actively purchasing printing companies, we would not purchase a firm whose current leader was not prepared to stay at least two years after the sale. This was a lesson learned only after allowing two sellers to leave and watching post-acquisition profits shrink dramatically.

The replacement process should start at least two years prior to a planned exit. If you opt not to name a replacement, then you must be prepared to stay on two years after the sale. You most likely will carry out a replacement process with the new owners during this period.

Five Steps to a Successful Replacement Plan

Identify key leadership criteria. Objectively determine what leadership skills are required in the person who will replace you. These skills may be different from yours. They should represent what you believe are the most crucially needed leadership abilities for the next three to five years. Attempting to predict needs past this horizon in an industry as dynamic as the printing industry is futile.

Find future leaders and motivate them. Identify those within your organization who currently possess or could, with training, develop the required leadership skills. If these leaders are not found within the organization, look outside.

Create a sense of responsibility within the organization. Communicate what your replacement plans are. Your people will figure them out anyway. Challenge the organization to successfully transition to new leadership.

Align succession planning with the corporate culture. You know how and why your organization works or doesn't work. Use the replacement process to reinforce your culture or modify it as required.

Measure results and reinforce desired behavior. Set quantifiable goals to measure during the process. The passage of time cannot be the only indication that your firm is now ready for your replacement.

Exit Planning

To successfully execute an exit plan that replaces an owner as a shareholder, follow these six steps:

Set owner objectives. When counseling a prospective seller, I ask two questions: Do you know what you are going to do after the sale? Do you have the resources to do what you aspire to do after the sale? If the seller does not have a positive answer to both of these questions, then I recommend not starting the exit plan until they do.

Identify business and personal resources. In answering the second question, sellers must look at resources both outside and within the firm. Adjustments need to be made if these resources are inadequate to meet the seller's post-exit needs. Perhaps the sale should be postponed until the firm is worth more, or post-sale aspirations should be altered. Owners should be realistic about the potential future value of their firms. In my experience, many more owners have fallen short of value growth expectations than have met or exceeded value growth expectations.

Maximize and protect business value. Deciding how to run your business just before or during exit planning is daunting. The overriding principle is to run the business as you always have and as if you were going to own the business for five more years. The one exception is making significant capital investments. A printing business loses value the first day it installs a new large piece of equipment or adopts new technology. It's similar to losing value in your new car as soon as you drive it away from the showroom, but even worse. Since it either reduces cash or adds to debt, the cost of purchasing the equipment or technology is a dollar-for-dollar reduction in value. Most buyers—and almost all buyers' lenders—don't credit value for such projects until their benefits are realized in the firm's income statement. Accordingly, sellers should time their exit plans late in their capital investment cycles, preferably after benefits are fully realized in income statements.

Evaluate ownership transfers to third parties and/or insiders. The options are varied, and each has different benefits and risks. The seller can choose among family members, management, employees (via ESOPs—Employee Stock Ownership Plans), competitors, or private equity firms. I strongly recommend that prospective sellers engage professionals skilled in mergers and acquisitions to assist in evaluating these options. Here, one size does not fit all. Most owners sell a business only once, and to do it right, they should seek the assistance of professionals who do it for a living.

Ensure business continuity. The replacement plan and the exit plan are executed over several years. Fatigue and longing for the next phase of your life can take a toll. Stay in the game! Ensure that your firm has the benefit of your leadership until the very end.

Complete personal wealth and estate planning. Years before you contemplate an exit, hire competent tax and wealth advisors. At the end of the day, how much you take home after taxes is more important than the sale price of your business. The structure of the transaction, coupled with the way you have structured your ownership of the business, may be the difference between having and not having adequate resources for your post-sale aspirations.

Succession planning is a natural process in the evolution of any business. Years of attention and the owner's leadership talents are required for its successful execution. The steps for replacement planning and exit planning outlined above are a road map for that execution. Here, in summary, is the most important advice I can offer for realizing what is to many the culmination of the Great American Dream:

- Start early—four to five years before the anticipated exit.
- Hire a replacement CEO, or be prepared to work for two years with new owners.
- Time exit plans late in equipment and technology investment cycles so that benefits are reflected in an income statement.
- Hire experienced advisors to assist in tax planning and the sale process.

Pricing: An Art or a Science?

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Remember when the pricing process was a formulated and direct science? In the past, you calculated BHRs (Budgeted Hourly Rates), put your customers' specs into your estimating system, marked up paper and outside cost 5%–10% for handling, and then added an additional percentage mark up for *profit*, and in the end, a price for the job was estimated. You then sent it to the customer, who usually accepted it.

In today's economy, pricing decisions are more complex. Costs have continued to rise, yet even loyal customers concerned about their own bottom lines, aren't afraid to push for lower prices—or worse yet, would consider a move to your competition. As a result, price flexibility becomes a necessary evil. In today's environment a subjective nature has been added to pricing making it more "art" than science.

So how do you determine when to be flexible and when to hold the line? Under the pressure and stress of everyday life, it is easy to make emotional decisions. So how can you interject logic? How can you justify flexibility in one instance and not another? Using a Pricing Whale Chart can help (See Figure 1).

Pricing Whale Chart

The overall objective is to increase the profitability of customer accounts first and foremost.

Here's the strategy. On the chart, the **blue line—squares** represents **actual sales** made to the printer' s top thirty key accounts. In this case, the top thirty customers comprise about 85% of the company's total sales.

The **red line—diamonds** represents the **profit by account** incurred by the printer for each of the thirty key accounts. The chart is indexed on the red line, **profit by account,** and descends as it moves from the Customer Number 1, the most profitable, to the least profitable account, Customer Number 30. The profit for each account was calculated as follows:

Profit = Value added-Direct labor-Commission paid on the account

Profit includes most, but not all, direct costs in our example. It is important to establish a system to measure profitability by job and by customer in your company. How the profit is calculated is not as important as making sure that the profit calculation used makes sense to your management team and can be applied consistently.

The **green line—triangle (arc shape)** shows the **cumulative profits** of the printing company for all accounts. On the **green arc,** profit incurred from the printer's most profitable account is represented at Point 1. Point 2 on the **green arc** is the **cumulative profits** of Account 1 and 2 and so on until you get the 30th most profitable account of this printer.

This line resembles the humpback of a whale, thus giving the chart its name. It makes it easy for us to see how the pricing might affect profits gained from a single client and where that client sits on the level of importance to our printing company.

Cumulative profits are the most important measurement to consider when making decisions for price flexibility.

Across the top of the grid are three (3) categories of customers, identified as:

- Defend
- Improve (and Maintain)
- Play Fiddle

Defend Accounts are those where you make the most money. Whatever you do, your pricing strategy should be to keep these customers. Do not let these customers go to someone else. You've got to defend these customers.

Improve and Maintain Accounts are good customers—not your best, but possibilities exist for improvement. They are the status quo. You want these customers.

Play the Fiddle Accounts are often price-driven and, hence, will come and go. They can sometimes be very big accounts but not very profitable. You work with these customers when you need the volume. You do not work with them when you don't need the volume. One thing to say about these customers is we should not add capacity for them. You may even think about shutting down capacity in your plants (to save costs) and actually letting them (the customer) go. In many cases, you may be a whole lot better off.

Once you have assessed each of your customer accounts and determined where they fall on the **Pricing Whale Chart,** you can use the tool to logically infuse some flexibility into your pricing strategy when necessary.

One way to do this is to designate what we call the "price police." The price police may be one or several people who are tuned in to management's pricing position and familiar with your customers. It is their responsibility to review all (or most) quotes. They approve or adjust the price to account for such considerations as:

- What is our relationship with this customer? (i.e., Do they fall into the Defend, Improve and Maintain, or Play Fiddle group?)
- What is the profit on the job?
- Do we need the work?
- Should we be shutting down a press, reducing labor, and reducing costs instead?
- What will the customer accept for a price on this job?

PRINTING INDUSTRIES OF AMERICA

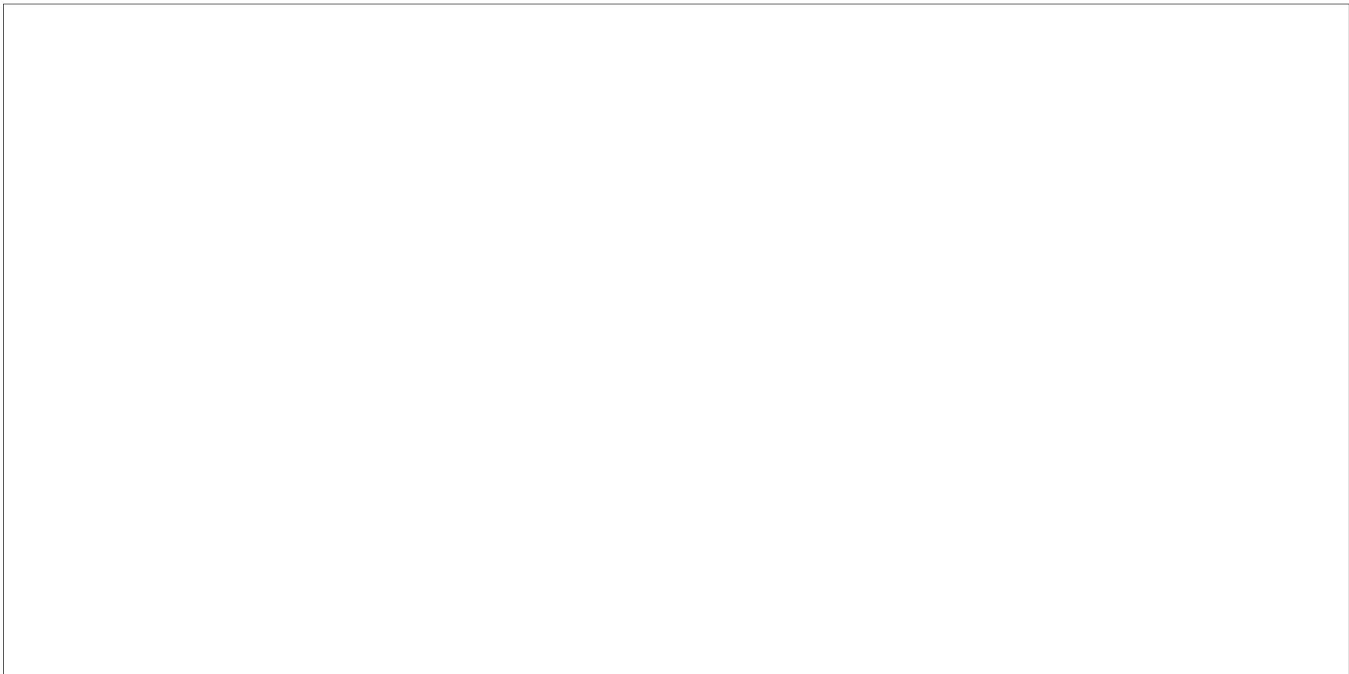

Figure 1. In this example, a pricing model for a customer-centric printing firm is depicted using a Pricing Whale Chart (chart created by Paul Reilly of New Direction Partners).

- Is this customer currently paying on a timely basis?
- What services or type of production is the customer purchasing?
- How much value added is in the job?
- How will cash flow be affected?

The Whale Chart is an important tool for the price police to use when taking into consideration each account's profitability. None of us can afford to cut prices on every job. But as the Whale Chart depicts, logic can be used to determine which accounts can be offered flexibility and which ones require holding the line or even mark up.

In cases where price flexibility is considered, remember to consider how a pricing adjustment will affect the overall profitability of the account. Always keep an eye on the effect that the decision will have on the company's profitability and its cash flow breakeven. While pricing is an important component of profitability, so is sales volume and its respective costs to produce those sales. So you will need to know your breakeven, not just your financial breakeven, but your breakeven for cash flow. The following is an example of how to compute your cash flow for this purpose:

Sales	$5,000,000
Materials and Outside Services	–$1,500,000
Value Added	$3,500,000
Overhead	–$3,400,000
Net	$100,000
Depreciation	+$500,000
Cash Flow	**$600,000**

Your cash flow needs to be sufficient to service your debt (principle and interest).

A pricing process is important to the survival and ongoing success of your firm. One way to develop expertise in this new "art" is by identifying your best customers and developing a pricing strategy designed to retain and grow them. Be account selective and job selective. If you choose to do a less profitable job, be clear why you are making that choice, and be sure it makes sense within your overall pricing structure and business goals. If price flexibility is considered, keep a watchful eye on account profitability, cumulative profitability, and on your cash flow breakeven when making your pricing decisions. The economy may not be in your control, but developing a flexible pricing strategy based on sound business information certainly is.

MargolisBecker has long been recognized as the financial expert for the printing and allied graphic communications industry, assisting thousands of companies with strategic and financial management, valuation, mergers/acquisitions, accounting, and audit and tax services. The firm is noted for its expertise in enabling printing companies to optimize profits. Proudly, it is the purveyor of the industry's Cash Is King *and* Value-Added Principles of Management *and compiles the annual Printing Industries of America* Ratios, *the industry's premier financial benchmarking tool.*

The Times They Are a Changing

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> *"Thanks, Bill, for being such a great leasing customer over the past three years. We appreciate that you paid your lease on time every month, but we won't be working with you again. Not unless you need to borrow $1 million or more. Our company made the decision to finance big deals, not little ones like yours."*

An isolated case? No. It's a very common one as the leasing industry regains its footing. In order to continue to exist, lessors invested time and money to adjust and tweak their business models. If we asked leasing company executives for one word to describe their current feelings, that word would be "uncertainty."

On their minds and slated for discussion at staff meetings are the following topics:

- The tax increase and how it will hit customers.
- The total impact of the health care legislation for all businesses.
- The fallout from the 2010 elections. "To the victor belongs the spoils," said U.S. Senator William Learned Marcy in 1832. Election results may determine the implementation and total cost of the health care bill and other pending legislation to U.S. businesses.
- Passage of new accounting rules to reform lease accounting. These guidelines are expected to be implemented by 2013. The primary goal is to make financial transactions, especially leases, more transparent to lenders, suppliers, and the financial community in general. These changes may not have much impact on the small printer. The middle market company, however, could find its financial accounting methods turned upside-down.
- The Dodd-Frank Wallstreet Reform and Consumer Protection Act (H.R.4173) and the far-reaching influence it has on the business climate for large corporations and the small mom-and-pop operations on Main Street, USA.

Before heading into the worst economic crisis in our lives, many business owners chose to finance their equipment through their banks or leasing companies. In 2005, $1.1 trillion in new equipment was acquired and 56% of that was financed or leased, compared to the 2010 projections that 45.8% of $1.24 billion was in new software and hardware. There is an excessive amount of cash in some companies and they have chosen to pay cash for equipment.

Many leasing industry experts expected a recovery in the third and fourth quarter of 2010. That is not happening. Are there signs of progress?

Yes! Some improvement is reported in the *2010 State of the Equipment Finance Industry Report* published by the Equipment Leasing and Finance Foundation. We thank the association for sharing the data for this report.

Delinquencies and charge-offs are showing a reduction. Year-to-date new business volume for Q3 2010 is at a two-year high. Receivables also showed improvement.

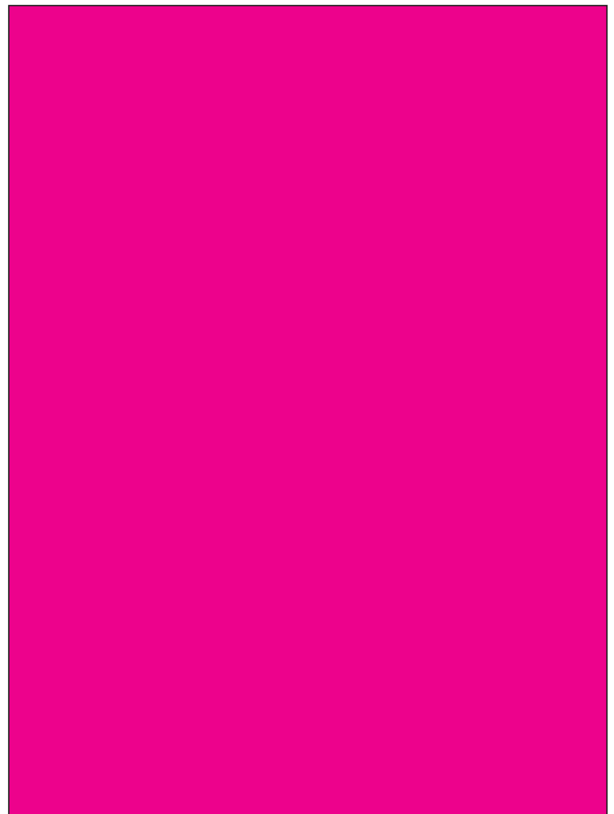
Credit approvals were at 73% in August 2010 and 72% in September 2010. That is a big improvement from the 60% approval rating in May 2009. A 60% approval means four out of every ten credit applications are declined.

The current statistics are released monthly by the Equipment Leasing and Finance Association's *Monthly Leasing and Finance Index*. The association tracks the only index that reflects capital expenditures financed in the U.S. The report is released each month the day before the U.S. Department of Commerce releases the durable goods report.

In order to keep the doors open, leasing companies found it necessary to tighten their own ships. Printers also had to take dramatic steps to react to the lessor's changes.

Leasing Companies: Ten Strategies That Affect Customers

1. Review customer portfolios and reevaluate the risk associated with each customer. Many customers saw rate increases in 2009 and 2010 on floating rate financing. A rise in rates, if risk is high, works for lessors.



2. Lease portfolios faced threats and suffered losses during 2008–2010. In order to guarantee owners and shareholders of a good investment return rates increased and credit approvals were more selective.

3. Rate spreads increased. The cost of money for lenders and lessors decreased by 90 basis points and their spread or margins over their cost of money increased. The economy allowed leasing companies to achieve an average of 3.85 basis points over their borrowing costs. That is a big jump from the 3.08 basis points offered in 2008. Pressure for lower margins appeared in very large lease requests for strong, publicly traded companies.

4. Some lessors requested two or more advance payments at lease commencement in order to reduce their outstanding risk. This effectively reduced the lessors' exposure and increased their return on investment.

5. Shorter lease terms reduced the time lessors' investments were at risk but made it more difficult for printers to cost justify new equipment. New digital presses with a shorter useful life come with sizeable investment. Shorter-length leases mean larger monthly payments. Some lessors refused to do leases for longer than three years for digital presses and other standard production equipment.

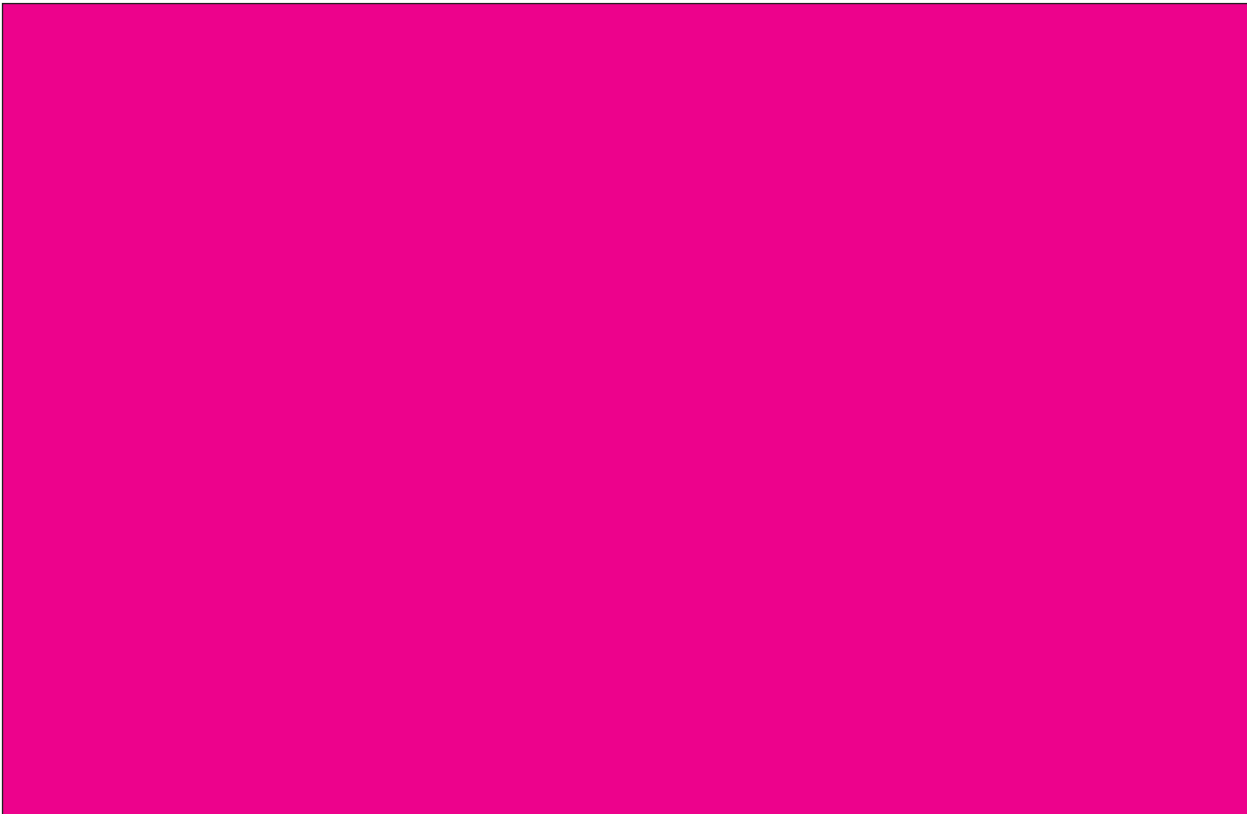
6. Leasing companies cross-secured leases. This step allowed lessors to reduce their exposure on each lease. All leases held by the same leasing company secure the performance on all other leases. A default on one lease is treated as a default on all leases.

7. Collection procedures were tightened. Printers may have noticed that instead of a letter in the mail advising of a late payment charge, phone calls came quicker as lessors tried to keep tighter control over accounts barely thirty days delinquent.

8. Exit poor performing markets. Many lessors drop out for periods of time from lending or leasing in certain industries and SIC codes. Graphic arts has become one of those exit industries over the past few years. At GRAPH EXPO 2010, there were no leasing company booths. There were six lessors represented at PRINT 09. Many of us can remember years when there were many more lessors flying their flags high. Markets that lessors seem to want to pursue are led by health care and IT. These asset categories have a shorter asset life than sheetfed presses, or bindery and finishing equipment and are more recession-proof than graphic arts.

9. Some bank-owned leasing companies have decided to only prospect and initiate business in areas in which they have a physical market presence. They count on their on-the-ground eyes and ears to help them minimize risk.

10. Lessors fired some of their vendors. To a leasing company, a vendor could be an equipment dealership that refers all their leases to that lessor. Another type of vendor is a leasing broker. In portfolio reviews, the lessor determined which vendors were responsible for the poorest credit quality customers and fired the referring vendor.



These ten changes summarize just some of the steps lessors are taking to protect and defend their turf.

What Can Printers Do?

What should printers do in order to ensure there will be financing available when they need it? And what is needed to qualify for a lease today? It turns out the same data is necessary for a new financing request as for a debt restructure.

In order to verify what leasing companies require to approve a new deal or restructure a current lease, I called Clune Leasing (www.clune.net), a small ticket lessor headquartered in Shawnee Mission, Kansas. CEO Kevin Clune is a second-generation owner of this fifty-one-year-old business. He and his analysts look for the following in a new lease application more than $75,000 or restructure request of $50,000 or more:

1. Two years corporate audited financial statements. If the statements are not audited, tax returns must be provided.
2. Current financial statements with comparative interim financials.
3. Personal financial statements of the principals of the corporation.
4. Full description of the new equipment including the cash purchase price.
5. If any of the financials show a loss, prepare a full and detailed explanation of the reasons for the loss. In addition, explain what actions have been taken to make the company profitable again. The report should include:
    - Staff reductions made and the savings this represents
    - New customers added and the revenue projections for those accounts
    - Operational cuts made and the savings realized
    - Debt due to expire soon that will free up additional cash to meet new payments in a timely manner
    - Cash infusions from friendly sources who are willing to subordinate their investment repayment to the lessor or bank

Before getting that lease approval all tied down, there are five negotiations that printers need to have. Many try to shortcut the process and the results are costly.

Five Negotiations in Every Equipment Decision

1. **Equipment Cash Purchase Price.** Focus on the right equipment, not the monthly payment. Keep your eye on the total cash purchase price. Every $1,000 discount reduces the lease payment. The lease negotiation is the fourth step, not the first.

2. **Trade-In.** Check out used equipment dealers and online sites or talk with other printers and industry experts to determine used values. Face the hard facts. The used market is flooded with equipment. This is not the time to expect much for old presses. Do not mix the trade-in negotiation with the new purchase.

3. **Existing Lease.** If you must pay off an existing lease, negotiate the payoff yourself. Do not allow the new equipment supplier to negotiate with the incumbent leasing company. Early termination payoff discounts may be possible if you negotiate yourself.

4. **New Equipment Lease.** All leases contain surprises. All leases are negotiable, if only you ask. If you are uncomfortable negotiating complex lease lingo, find an advocate to negotiate for you. The negotiator who saves you the most money will be familiar with graphic arts equipment, current market lease rates, and equipment lease contracts. To learn the "Benefits of Third Party Lease Review," check out Clint Bolte's article of the same name at www.clintbolte.com.

5. **Maintenance Agreement.** Some leasing companies bundle the lease and maintenance costs into one payment. Keep maintenance payments on separate contracts. Ask questions.

Leasing is an industry that will survive, and although not quickly, it will thrive again. Its survival is critically important to the success and growth of the graphic arts community. Working together with mutual respect and financial transparency will result in a better understanding of one another's challenges. A key is honesty on the part of both parties. If printers have cash flow problems, call your lenders and lessors. Advise them you need some help to get through the challenging cash flow times. Hiding out doesn't work. Lease contracts contain tough default provisions and will cost lessees plenty to settle a contentious lease.

Read your lease and understand it completely including early termination options, purchase opportunities, automatic renewals, default, and late penalties. An informed lessee has the power to negotiate.

Always remember, everything is negotiable if only you ask.

Mary Redmond, speaker, author, and consultant, is a seasoned negotiator in the finance industry with twenty-nine years of experience. Redmond negotiates contracts for clients as well as inspires and teaches them to believe "Everything is negotiable, if only you ask."