NATIONAL CENTER FOR
THE MIDDLE MARKET

A SPECIAL REPORT BY THE NATIONAL CENTER FOR THE MIDDLE MARKET

PREPARING FOR MAJOR BUSINESS TRANSITION

Changes In Company Ownership, Leadership, Or Structure In Middle Market Companies

IN COLLABORATION WITH

THE OHIO STATE UNIVERSITY
FISHER COLLEGE OF BUSINESS

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Contents

About This Report

In the middle market, major business transitions—such as the sale of a company, an intergenerational transfer, or CEO succession—happen with great frequency, even more than one might expect. Whether leaders are actively looking for these opportunities, or they are sprung upon them, the impact of this dynamism is significant. Transitions may change a company's ownership, strategy, and growth prospects; they can also affect the company's partners, suppliers, and customers. The changes have personal implications for the futures of the business owners, leaders, and employees. And, given the importance of middle market businesses to their local economies and to the U.S. economy overall, the success or failure of frequent transitions clearly matters on a grand scale.

The National Center for the Middle Market and its partners took a closer look at the specific types of major transitions in which middle market companies engage. We set out to understand how often companies experience transitions in ownership or governance: The sale of all or part of the company, an intra-family transfer of control or leadership, a CEO succession, restructuring or bankruptcy, large new investment, or some other change that has a significant and lasting impact on how the company is financed, organized, and run. The study explored how middle market companies prepare for and execute transitions of this magnitude, and what challenges they face during the process. We considered the data by type of transition (acquiring versus selling, for example) as well as by ownership and governance structure of the company. While approaches to and preparation for transitions vary considerably, we found insights that apply widely to middle market transition, revealing practices that characterize the companies that handle these changes most successfully.

HOW THE RESEARCH WAS CONDUCTED

The National Center for the Middle Market worked with experts from SunTrust Banks (now Truist) and Chubb and with the Center's Academic Director, Oded Shenkar, Ford Motor Company Chair in Global Business Management, The Ohio State University Fisher College of Business, to survey 404 middle market leaders with active responsibility for strategic business decision making. Three out of four of those companies have either experienced such a transition in the past five years or are preparing for one in the next five years: 262 companies (63%) had gone through a business transition in the past five years, 279 companies (67%) expect a transition in the next five years, and 54%—more than half—both experienced and expect a transition in those periods. A total of 214 of the companies are family-owned, and about half of these business (104) also have some degree of private equity investment. Among the 190 non-family owned firms in the survey, 51 firms, or 27%, are private-equity owned.

The survey respondents completed a 20-minute self-administered online survey conducted between November 11, 2019 and November 19, 2019. The findings in this report are weighted to the makeup of the total U.S. middle market.

Executive Summary

In the middle market, major transitions—such as a change in CEO, the acquisition of another business, the sale of the company, or some other event that significantly affects the leadership, financing, and future of an organization—are extremely common. More than three-quarters (77%) of middle market businesses have either experienced such a transition in the past five years or expect one in the next five years, while 54% say they fall into both categories. In other words, more than half of U.S. middle market companies can expect to face two major transitions in a decade.

That number may climb even higher in the near term, because of circumstances that create a "perfect storm" of business transition. First, baby boomers are at prime retirement age. Given that an estimated 40% of middle market companies are owned by boomers (and many others are led by them), there is a great deal of transition just waiting to happen.

Second, an enormous amount of capital is looking for a home—"dry powder" waiting to be invested. Prequin, a company that specializes in collecting data for alternative-asset investors, says private equity firms worldwide are sitting on more than $2.1 trillion in funds ready to be put to work. Third, low interest rates mean debt capital is cheap and easy to find—another incentive for acquirers. Fourth, owners, for their part, may be lured to sell thanks to near record-high valuations and prices. According to PitchBook, the median private equity deal closed for a price 11.1 times EBITDA last year—the highest multiple in more than a decade. For many owners, who still have vivid recollections of the last recession and valid concerns about the next one, there's much more willingness to listen to solicitations that they once might have ignored. Those solicitations are literally pouring in: Executives tell us they get, on average, one to two inquires a month regarding the sale of their business.

Top prices and high rates of activity are good for sellers, and most executives say the transitions they have experienced have had positive results. Still, nearly half of all firms experience both positive and negative outcomes. Revenue growth and efficiencies are high on the plus side, but disruption of culture and employee or customer turnover can significantly deflate the results. Transitions not only affect the bottom line, they change things dramatically for the owners personally as well as for the employees who have helped them build their companies. Both the good and the bad, from both an economic and human perspective, need to be weighed carefully before pulling the trigger on any change.

The more companies prepare for transitions, the better results they get. This statement holds true regardless of the type of transition. Whether it's a routine CEO handover, company sale, restructuring, or any other, middle market companies that consider their transitions a resounding success invest the time and effort to consider carefully their business goals, which vary based on whether the firm is family-owned, private equity-owned, or both. They then prepare rigorously. Virtually all leaders who say their company was "totally" prepared for their last transition report that it was a success, and almost four out of five say that it was more successful than they'd hoped. By contrast, satisfaction among companies that were less prepared is just 33%. Many negative consequences—lost sales, damaged culture, dissatisfied and defecting employees, and lower selling prices—could have potentially been avoided with better preparation.

While most middle market companies prioritize business transition planning, more than three in 10 put it down the list of business priorities, despite the likelihood that transition is bound to happen and that preparation is key. Even among companies that prioritize transition planning, the data suggest that executives are putting less time into the effort than they should. More than 40% of companies said they began planning for their last transition only in the year in which the transition occurred; the same number say they'll wait to plan for future transitions until change is in sight. Only about a third of companies have written CEO succession plans.

Companies with private equity investment do better in all of these areas—not surprisingly, since private equity firms buy companies in expectation of selling them a few years later. Executives of these companies enjoy higher satisfaction rates as a result. But all middle market companies, regardless of ownership structure, have much to gain from a comprehensive approach to transition planning. This may include expanding the planning horizon, supplementing internal expertise with a team of advisors that can help leaders understand all facets of the transition, creating concrete succession plans, and communicating clearly with employees throughout the process. Starting this process sooner rather than later, and ideally before the transition clock starts ticking, can put middle market businesses, their owners, and their employees in the best position to reap the rewards of change while circumventing the pitfalls.

Business Transitions in the Middle Market: An Overview

Change happens in all businesses. But, as growing businesses that fuel the U.S. economy, middle market companies are more dynamic than most. Indeed, more than three-quarters (77%) of middle market organizations have experienced a major transition—such as a merger, ownership change, new CEO, or restructuring—in the past five years, or are preparing for one in the next five years. More than half (54%) of companies fall into both categories: they've recently experienced change, and they plan to transition again soon. The fastest-growing middle market firms are among the most likely to undergo frequent shifts and, not surprisingly, they do it for growth-oriented purposes, such as pursuing new business opportunities, acquiring new technologies, or becoming part of a larger organization.

The transition experience can vary largely depending on the type of transition as well as the ownership structure of the company (see sidebar, p. 16). However, our study reveals several overarching insights, the most important of which are that transitions are highly likely to happen in the middle market, preparation is key to success, and transition requires careful collaboration between company leaders and their trusted advisors.

MIDDLE MARKET BUSINESSES EXPERIENCE FREQUENT TRANSITION

	ACQUISITIONS, MERGERS, ALLIANCES, AND JOINT VENTURES	OWNERSHIP CHANGES
HAVE EXPERIENCED TRANSITION IN THE PAST 5 YEARS	**37%** • Acquired another business: 19% • Acquired a division or line of business: 15% • Completed a merger: 10% • Entered into a joint venture or alliance: 10%	**33%** • Brought in a new investor: 12% • Divested or sold a division or line of business: 8% • Transferred ownership to employees: 6% • Transferred ownership to family member(s): 6% • Sold to a new owner: 5% • Went public: 4% • Sold controlling interest to a PE firm: 3%
EXPECT TO EXPERIENCE TRANSITION IN THE NEXT 5 YEARS	**40%** • Acquire another business: 18% • Acquire a division or line of business: 17% • Complete a merger: 11% • Enter into a joint venture or alliance: 12%	**38%** • Bring in a new investor: 13% • Sell to a new owner: 7% • Transfer ownership to employees: 7% • Divest or sell a division or line of business: 7% • Transfer ownership to family member(s): 6% • Sell controlling interest to a PE firm: 6% • Go public: 6%
PRIMARY DRIVERS	**For most recent transition:** • Access new markets: 16% • Expand into new geographies: 13% • Acquire technology: 10% **For next transition:** • Opportunity to scale the business: 13% • Access new markets: 12% • Expand into new geographies: 12%	**For most recent transition:** • Industry consolidation: 12% • Attractive valuation: 12% • Retirement: 12% **For next transition:** • Retirement: 16% • Expand into new geographies: 10%
SATISFACTION	• 89% extremely or very satisfied • 58% say it was much or more successful than expected	• 73% extremely or very satisfied • 60% say it was much or more successful than expected
POSITIVE OUTCOMES	• Significantly increased scale of business: 92% • Ensured continuity of business: 84% • Improved balance sheet: 82% • More capital to invest: 69%	• More capital to invest: 80% • Improved balance sheet: 76% • Ensured continuity of business: 72% • Significantly increased scale of business: 70%
CHALLENGES	• Assessing cultural fit • Understanding options • Bringing together the right internal and external team • Maintaining confidentiality/controlling rumors • Assessing risks • Tax issues • Fair valuations	• Fair valuations • Due diligence • Aligning family members • Maintaining confidentiality/controlling rumors • Ensuring business continuity • Tax issues • Identifying buyers/investors
AVERAGE PREPARATION TIME	**1.2 years**	**1.6 years**
RESOURCES USED	CFO, CEO, Owner, Law Firm, Corporate Development Executive, In-House Lawyer, Consultant, Tax Advisor	Law firm, CEO, Owner, CFO, Tax Advisor, In-House Lawyer, Corporate Development Executive, Accounting Firm, Investment Bank

MIDDLE MARKET BUSINESSES EXPERIENCE FREQUENT TRANSITION

	CEO/LEADERSHIP CHANGES	MAJOR RESTRUCTURING/ BANKRUPTCIES
HAVE EXPERIENCED TRANSITION IN THE PAST 5 YEARS	**25%**	**22%** • Went through a major restructuring: 20% • Went through a bankruptcy: 1%
EXPECT TO EXPERIENCE TRANSITION IN THE NEXT 5 YEARS	**19%**	**13%** • Expect a major restructuring: 12% • Expect to go through bankruptcy: 1%
PRIMARY DRIVERS	**For most recent transition:** • Leadership change: 23% • Retirement: 13% • Owners pursuing new business opportunity: 13% **For next transition:** • Retirement: 28% • Leadership change: 24%	**For most recent transition:** • Leadership change: 23% • Opportunity to scale the business: 11% **For next transition:** • Attractive valuation: 15% • Leadership change: 12% • Industry consolidation: 10% • Expand into new geographies: 10%
SATISFACTION	• 61% extremely or very satisfied • 58% say it was much or more successful than expected	• 67% extremely or very satisfied • 50% say it was much or more successful than expected
POSITIVE OUTCOMES	• Ensured continuity of business: 74% • More capital to invest: 71% • Improved balance sheet: 70% • Significantly increased scale of business: 66%	• Ensured continuity of business: 83% • Significantly increased scale of business: 78% • Improved balance sheet: 76% • More capital to invest: 68%
CHALLENGES	• Assessing cultural fit • Retaining key employees • Understanding options • Choosing the new leader • Aligning leaders and key employees • Ensuring business continuity • Maintaining confidentiality/controlling rumors • Assessing risks • Bringing together the right internal and external team	• Maintaining confidentiality/controlling rumors • Ensuring business continuity • Assessing risks • Employee communication • Bringing together the right internal and external team • Aligning leaders and key employees • Assessing the true value of the business • Aligning family members • Maintaining brand position/equity • Preparing owner's personal finances
AVERAGE PREPARATION TIME	**1.1 years**	**1.0 years**
RESOURCES USED	CEO, CFO, Law firm, Consultant, Owner, Tax Advisor, In-House Lawyer, Corporate Development Executive, Accounting Firm, Investment Bank	CFO, CEO, Owner, Consultant, In-House Lawyer, Tax Advisor, Law firm, Accounting Firm, Corporate Bank

Transitions are *(mostly)* good for business.

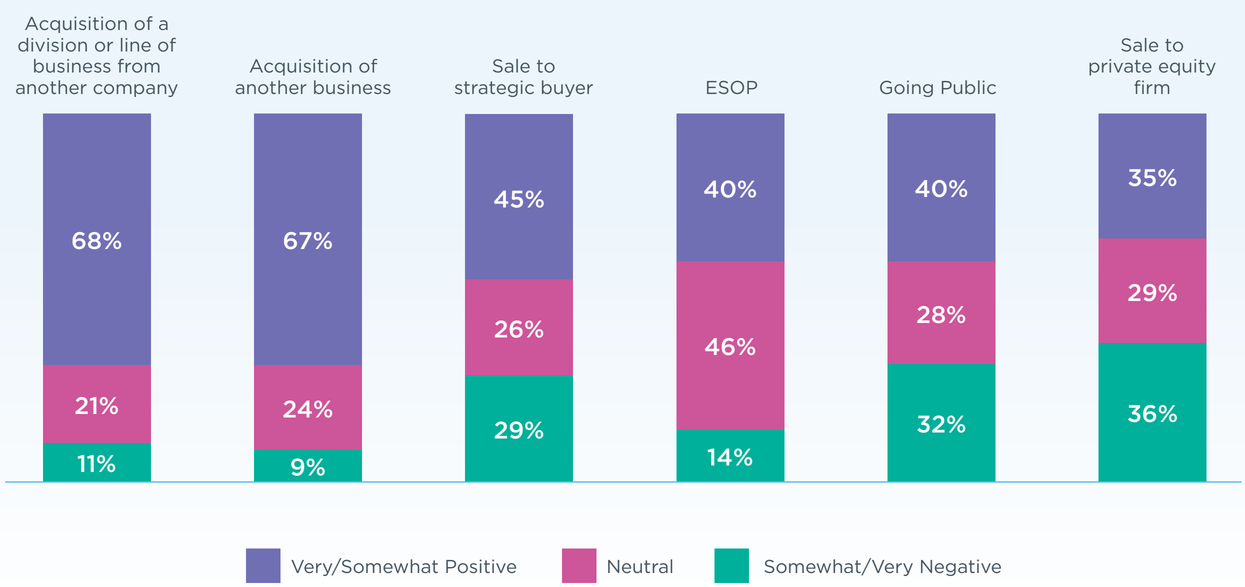
+ 63% of middle market companies experienced major transition in the past five years
+ Three-quarters of firms experiencing transition were highly satisfied with the outcome
+ 49% experienced some negative consequences including disruption to culture and employee turnover

Nearly two-thirds of middle market businesses have undergone some type of major transition over the past five years. Executives of those companies say that the results of these changes have been decidedly positive. (We should note that the men and women we surveyed were financial decision makers—that is, they do not include former leaders, whose experience might have been different.) Executives, especially at fast-growing firms, cite a range of positive impacts on company performance, with increased revenues being the most often noted desirable outcome. Companies also point to increased efficiencies; access to new technologies, product lines, and geographies; and positive impact on people. Indeed, more than half (58%) of executives say their company's most recent transition was more successful than they expected it to be.

Executives are most positive about transitions that yield growth, such as the acquisition of another business or division. They are less positive about transitions in which they yield control or ownership, such as selling to private equity firms or a strategic buyer or going public, and the least positive about CEO changes. Still, even among companies that changed ownership, 73% of businesses were extremely satisfied with the transition. Among organizations that changed the CEO, 61% were highly satisfied.

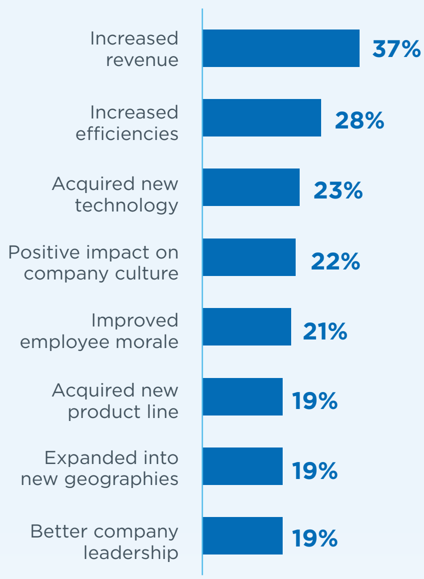
Despite positive perceptions overall, transitions are not without their risks. Executives worry about the impact of a transition on culture and their current employees, and those concerns are well-founded. Nearly half (49%) of businesses noted some negative outcomes of the transition. Culture disruption and employee turnover are the most common downsides.

MIDDLE MARKET COMPANIES ARE MOST POSITIVE ABOUT TRANSITIONS THAT RESULT IN NEW GROWTH



Positive Outcomes of Transition Usually Outweigh Negatives

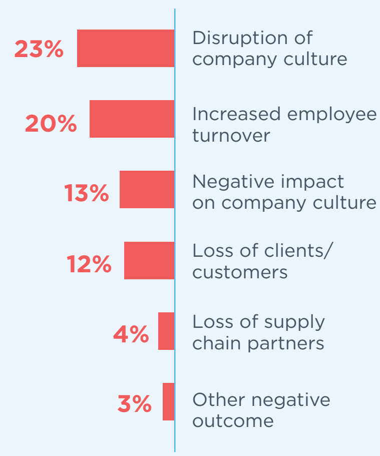
POSITIVE OUTCOMES



77%

Experienced some positive outcome

NEGATIVE OUTCOMES



49%

Experienced some negative outcome

Transitions take time and preparation is key.

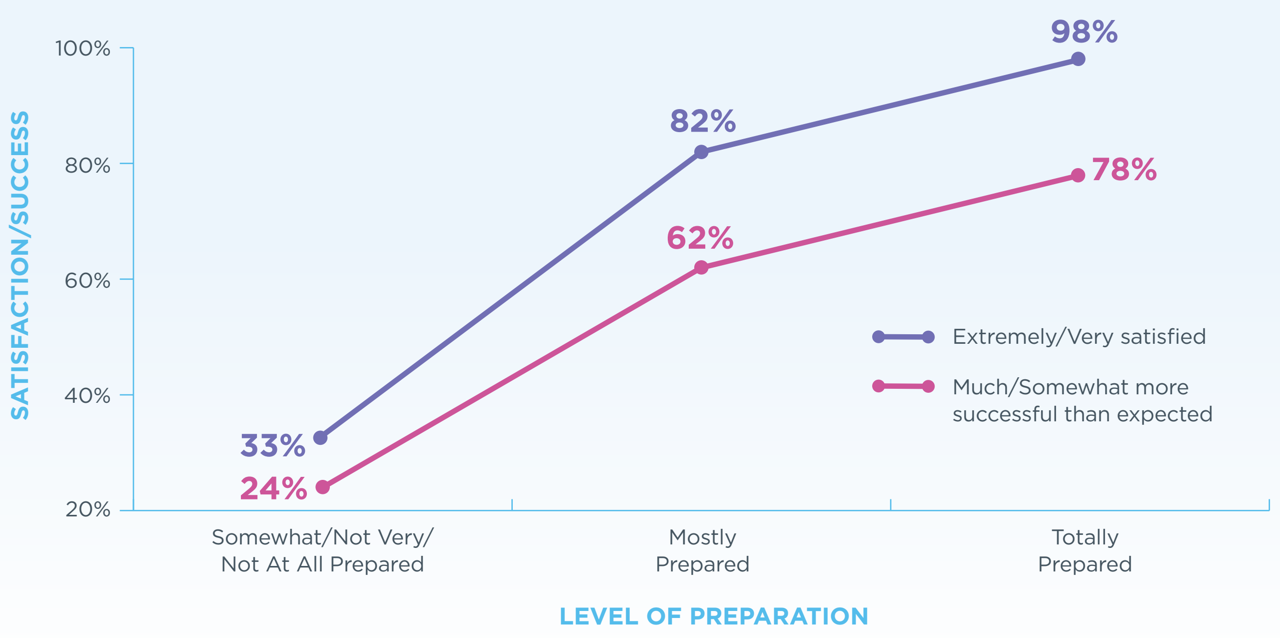
- 98% of companies that adequately prepare for transition are highly satisfied with the results
- Among less prepared firms, just 33% report high satisfaction with the transition
- Most companies begin preparing one to two years in advance of a transition

Across all types of business transition, the degree of preparation dramatically affects the success of the change. Virtually every company saying it was totally prepared for its last transition reports that it was highly satisfied with the results; almost four out of five say that the change was more successful than they'd hoped. By contrast, among less well prepared (somewhat, not very, not at all) companies, only a third report high levels of satisfaction.

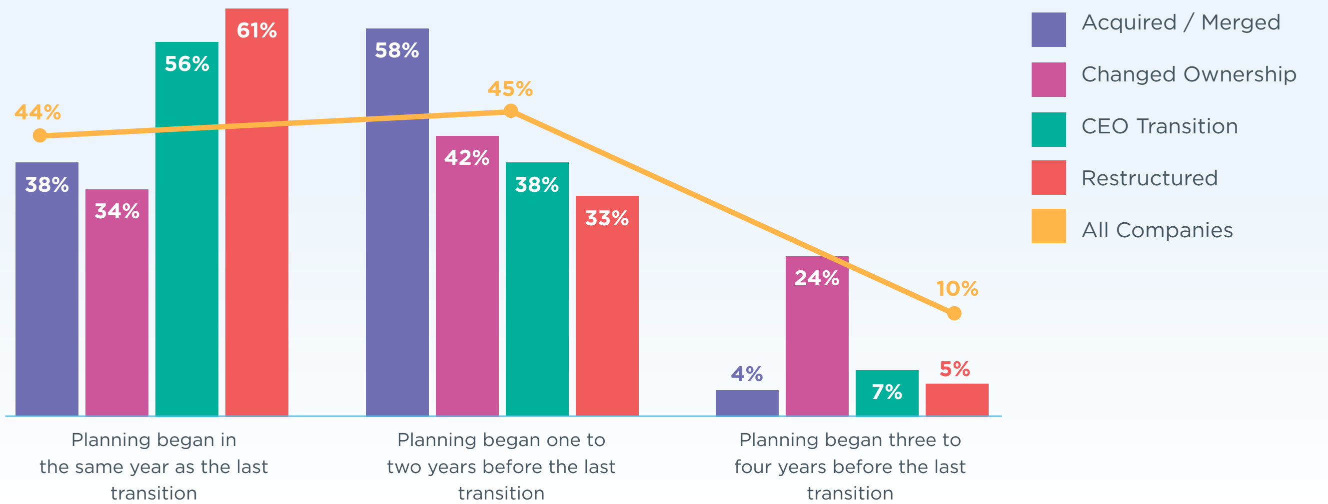
How much time it takes to be fully prepared for an impending change depends on the type of transition at hand. Ownership changes take the most legwork and companies say they spend 1.6 years, on average, getting ready for these types of events, compared to an average of 1.2 years for mergers or acquisitions. Some companies spend even longer preparing for an ownership change: About a quarter of firms say they start the process three to four years in advance of the sale date.

The most important preparation activities also vary somewhat based on transition type. Overall, preparation steps fall into four categories. Preparing the company from a legal and accounting standpoint comes first and is almost always critical regardless of transition type. This preparation includes obtaining a fair valuation, making sure the books are in shape, and conducting risk assessments. A second set of actions, which are especially critical for companies looking to complete an acquisition, merger, or sale, revolve around getting the company in shipshape condition. This set includes cutting costs, increasing efficiency, and improving working capital management. Third are actions designed to strengthen relationships with customers, suppliers, and employees. And fourth are personal preparations—making decisions about one's own finances and future.

PREPARATION DRIVES SATISFACTION LEVELS



PLANNING FOR MOST TRANSITIONS STARTS AT LEAST ONE YEAR IN ADVANCE



Companies Take A Variety Of Actions To Properly Prepare For Transition

		Acquired/ merged	Changed ownership	CEO transitioned	Restructured
FINANCIAL ACTIONS	Value of the company assessed	47%	40%	28%	32%
	Financials audited	37%	24%	29%	13%
	Personal planning	22%	11%	23%	29%
	Strengthen working capital	21%	12%	10%	25%
OPERATING ACTIONS	Improved efficiency	31%	29%	41%	36%
	Employee communications	38%	26%	26%	26%
	Supplier contracts reviewed	14%	29%	19%	32%
	Cut costs	21%	10%	19%	20%
EXTERNAL PLANNING	Customer contracts reviewed	26%	22%	18%	7%
	Sales boosted	25%	14%	20%	22%
	Potential buyers identified	9%	20%	26%	7%
	Exit strategy outlined	18%	21%	6%	7%
LEGAL AND RISK MANAGEMENT	Legal paperwork organized	30%	27%	48%	22%
	Assessed risk (including cyber)	27%	12%	24%	19%

INSIGHT III

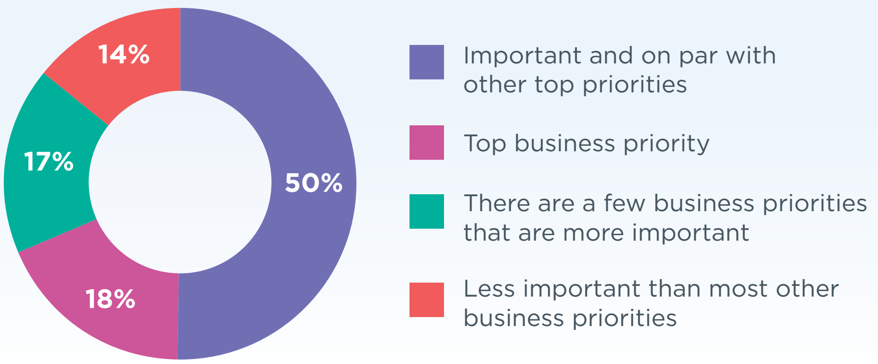
Most middle market companies see business transition planning as a top priority.

- More than two-thirds of middle market companies say transition planning is among their top business priorities; it is the number one priority for one out of five firms.
- Still, planning and preparation timeframes are somewhat shorter than experienced advisors and other observers believe is needed
- Fast-growing businesses are most likely to go through a rigorous preparation process and to prioritize business transition planning
- Firms with private equity ownership place high priority on business transition planning and are well prepared for their transitions

Nearly four out of five (78%) companies told us they were well prepared for their last transition. A similar percentage (70%) feel confident in their readiness for their next major business change. However, more than 40% of companies began planning only in the year in which the transition occurred. Looking forward, the same number say they'll wait to plan until the next change is in sight. One out of five companies indicate that planning for transition is their top business priority and another 50% say it is on par with other top business focuses. These businesses tend to have higher growth rates and higher annual revenues than companies that place less priority on business transition planning. They tend to be family owned and the majority also have private equity involvement. More than two-thirds of these businesses went through a transition in the past five years and nearly three-quarters (73%) plan to transition in the next five years. New acquisitions, restructuring, and bringing in a new major investor are the most expected types of future transition for these firms.

On the other hand, a third of middle market companies (34%) say planning for transition does not rank among their important priorities. This could be a mistake for several reasons. First, a transition of one sort or another is going to happen, and sooner rather than later based on impending baby boomer retirements and current economic conditions. Indeed, middle market executives say they are approached about selling their businesses one to two times a month on average. Second, our data clearly demonstrate that preparation is essential to successful transition and the positive outcomes of transition are much more pronounced among middle market companies that prioritize transition planning. Finally, experienced advisors tell us that the planning horizon for most transition types should be considerably longer than a year—and, among the fastest-growing middle market businesses and companies with private equity ownership, it is. These companies are most likely to say they go through a rigorous preparation process and they are more likely to say transition planning tops their list of business priorities, especially when it comes to planning to make an acquisition.

BUSINESS TRANSITION PLANNING IS IMPORTANT, BUT IS NOT THE TOP BUSINESS PRIORITY FOR MOST FIRMS



Middle market leaders are confident in their internal abilities to successfully manage transition.

+ Seven in 10 leaders are certain that their companies have the expertise to manage M&A, ownership transfer, leadership change, or restructuring
+ A firm's executives and top management play the most important role in planning and executing business transitions

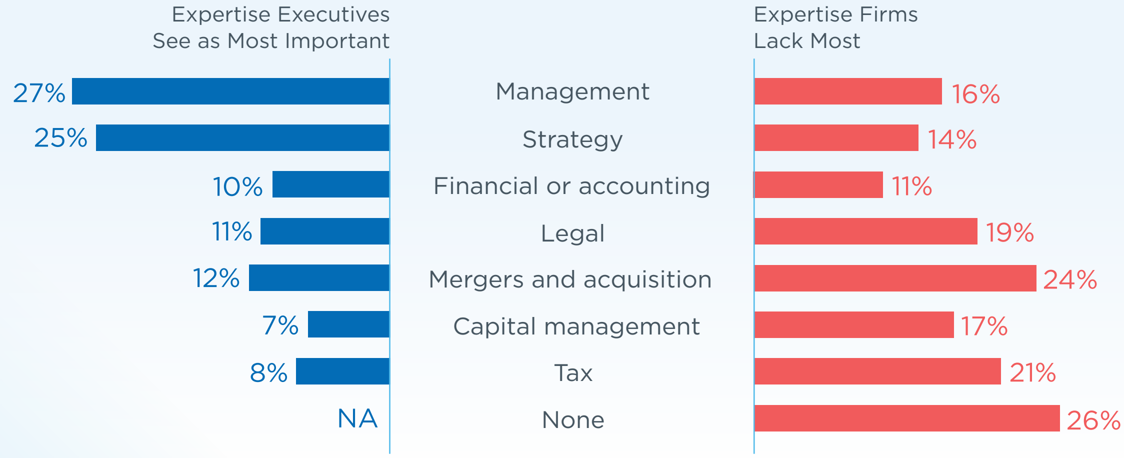
Middle market leaders have a do-it-yourself mentality when it comes to many aspects of running and growing their organizations. They take charge of their own fate, so to speak, and their tendency to use advisors sparingly shows up in their approach to transitions.

Given that transitions are so common in middle market companies, it's not a surprise that they draw on their past experience. Leaders see management expertise as the most important factor for business transition success, followed by strategic and financial/accounting expertise. In other words, they rely upon themselves when it comes to setting the strategic direction for the transition. Then they use their own internal resources to manage the tactical and financial aspects of the change, both of which are imperative to keeping the ship sailing while transition is underway. Companies, and especially those with PE-ownership, believe they do quite well in these areas; very few say their expertise is lacking.

While upward of 90% of middle market firms rely on their internal resources—especially the CEO and CFO—to lead transition, they do still call on outside experts when transitions are occurring. In general, they go outside for specific technical skills and expertise—valuation, investment banking, tax or legal advice—while ensuring that the overall direction remains in management's hands.

Only a handful of middle market companies (18%) believe they do not have what it takes in-house to execute a successful transition. These companies likely represent the few middle market firms that have not undergone transition before or don't plan to in the future. Some of this group say they have no need for business transition expertise.

MIDDLE MARKET LEADERS ARE MOST CONFIDENT IN THEIR MANAGEMENT SKILLS AND SOMEWHAT LESS CONFIDENT IN THEIR TECHNICAL SKILLS



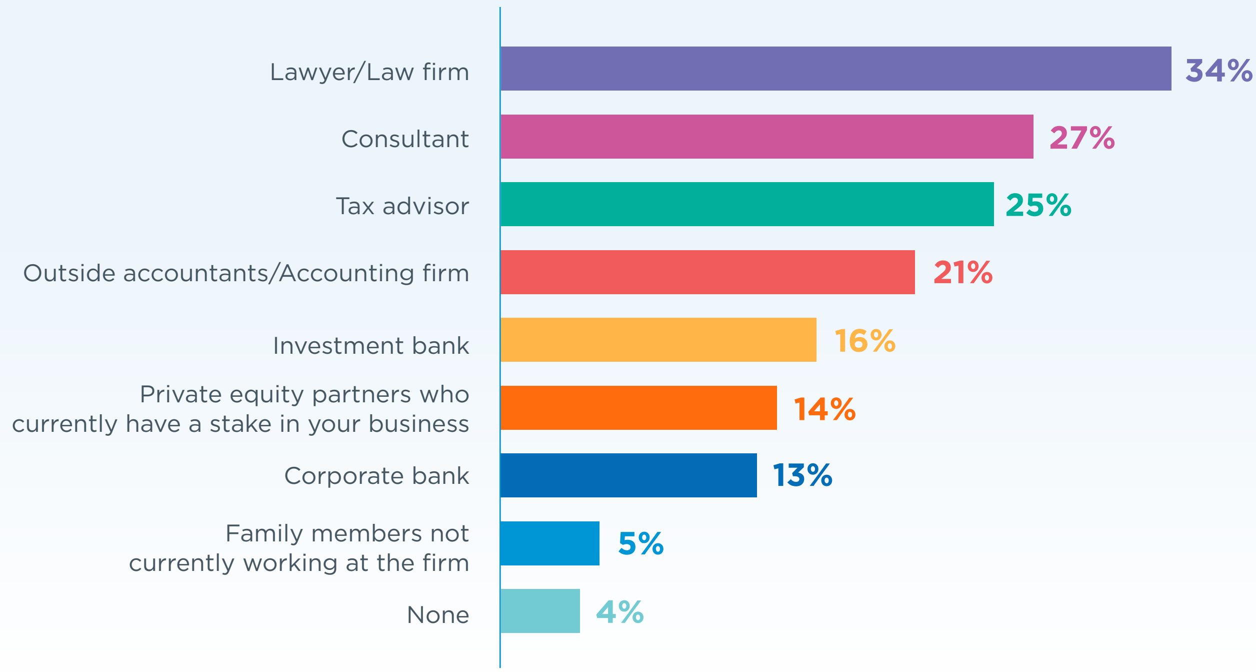
Outside advisors are critical to ensuring transition success.

+ Four out of five companies seek assistance from advisors outside of the firm for business transition
+ Lawyers, consultants, tax advisors, and accountants are the most commonly used advisors

High confidence and use of internal expertise notwithstanding, most middle market companies still need outside support for managing business transitions. Four out of five companies used external advisors during their last transition; the same percentage plans to bring in experts to help smooth the next transition. Businesses rely on a team of consultants to help fill in the gaps in their technical expertise including lawyers, business consultants, tax advisors, and accounting experts. Some companies invite their investment bankers to the table as well. Collaboration among these experts and the company's internal leaders is essential to smooth transitions and achieving the positive outcomes business leaders expect.

Transition type, of course, impacts how much and which external advisors are involved. When ownership is changing or a new investor is entering the business, external support becomes especially important. Outside lawyers are the most critical player on the team during this type of business transition.

MORE THAN THREE-QUARTERS OF MIDDLE MARKET BUSINESSES CONSULT EXTERNAL ADVISORS TO SUPPORT SUCCESSFUL BUSINESS TRANSITION



OUTSIDE ADVISORS ARE MOST CRITICAL WHEN COMPANY OWNERSHIP IS CHANGING

	ACQUIRED/ MERGED	CHANGED OWNERSHIP/ INVESTORS	CEO TRANSITIONED	RESTRUCTURED
TRANSITION LEAD	• Top management/ CFO: 54% • C-Suite executives: 47%	• Lawyer/law firm: 44%	• C-suite executives: 50% • Top management/ CFO: 43%	• Top management/ CFO: 47% • C-suite executives: 37%
CRITICAL ADVISORS	• Principal/owner: 35% • Lawyer/law firm: 33%	• C-Suite executives: 37% • Principal/owner: 35% • Top management/ CFO: 31%	• Lawyer/law firm: 35% • Consultant: 34% • Principal/owner: 30%	• Principal/owner: 31% • Consultant: 27% • In-house lawyer: 26%
ADDITIONAL TEAM MEMBERS	• Corporate development executive: 28% • In-house lawyer: 27% • Consultant: 27% • Tax advisor: 24%	• Tax advisor: 29% • In-house lawyer: 25% • Corporate development executive: 23% • Outside accountants/ accounting firm: 21% • Investment bank: 20%	• Tax advisor: 24% • In-house lawyer: 23% • Corporate development executive: 22% • Outside accountants/ accounting firm: 19% • Investment bank: 16%	• Tax advisor: 19% • Lawyer/law firm: 18% • Outside accountants/ accounting firm: 16% • Corporate bank: 15%

Companies with private equity ownership take a rigorous approach to transition planning.

PE-Owned firms:

+ Place higher priority on transition planning
+ Experience transition much more frequently than other firms
+ Are much more prepared for business transition
+ Are more likely to believe they have the internal expertise to handle transition
+ Are ultimately most likely to consider their transitions a success

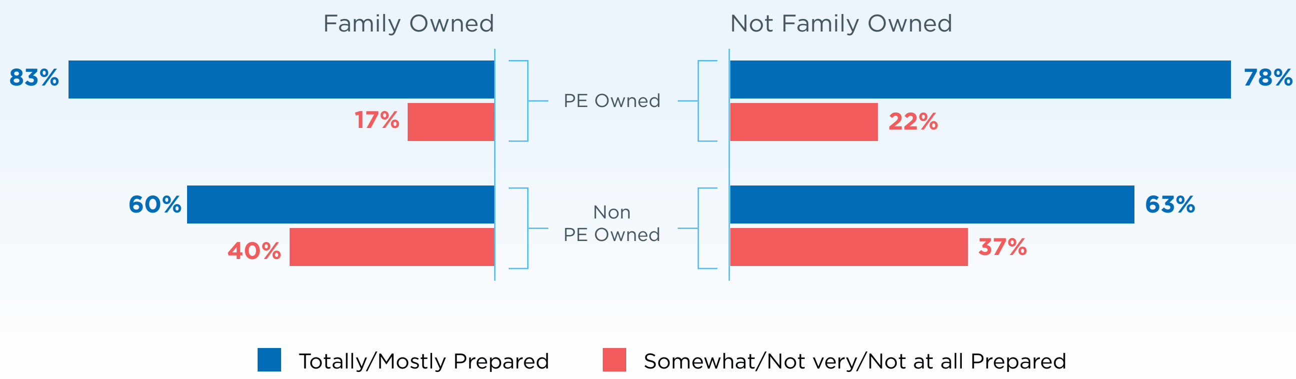
It shouldn't come as a surprise that private equity-owned firms approach transitions much differently than family-owned businesses do. PE owners buy companies in order to change them, often with new management, and ultimately sell them for a profit, typically over a five to seven-year period. Because transition is a fundamental part of their business model, they bring a level of professionalization of management that others do not.

Family-owned companies, by contrast, expect to keep the company in the family, passing it on to a daughter or son when the current owners retire. However, studies show that this doesn't materialize as often as expected. Indeed, the likelihood of a family company staying in the family is less than 50% with each succeeding generation.

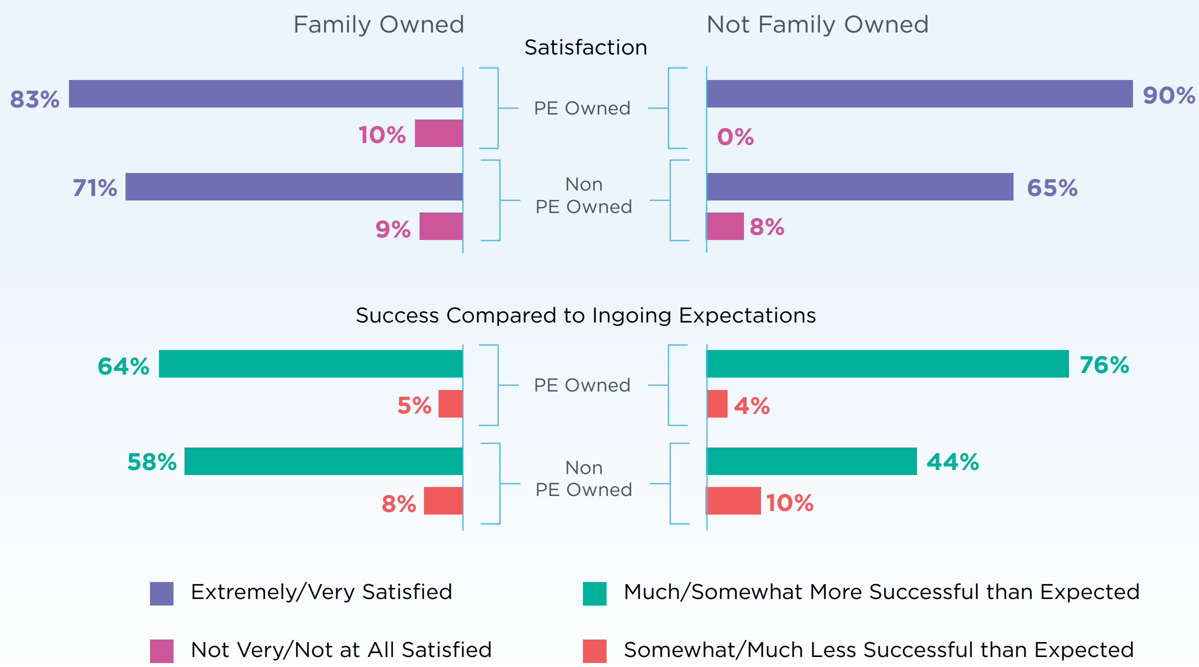
Family businesses would do well to prepare for a transition that may or may not involve their own lineage. Preparing both a robust Plan A (family succession) and a well-developed Plan B (a transition to non-family management or sale) is a formidable challenge, in terms of both strategy and family dynamics. However, PE firms also stand to learn a thing or two from family-owned executives. These leaders tend to emphasize business continuity, employee morale, and company culture in order to leave behind an organization that reflects their legacy and supports the needs of current employees. Ultimately, both activities lead to the same results: a lucrative sale and a business that is positioned to flourish in the hands of the next owners, whoever they may be.

Of course, many family-owned businesses also have some level of PE investment. And these companies may represent the best of both worlds. This group is the most likely to believe it is well prepared for the next transition. And these companies are significantly more satisfied with the results of the last transition than family-owned organizations that do not have any PE investment.

FAMILY-OWNED BUSINESSES WITH PE INVESTMENT ARE MOST PREPARED FOR BUSINESS TRANSITION



TRANSITION SATISFACTION AND SUCCESS IS HIGHER IN COMPANIES WITH PE FUNDS



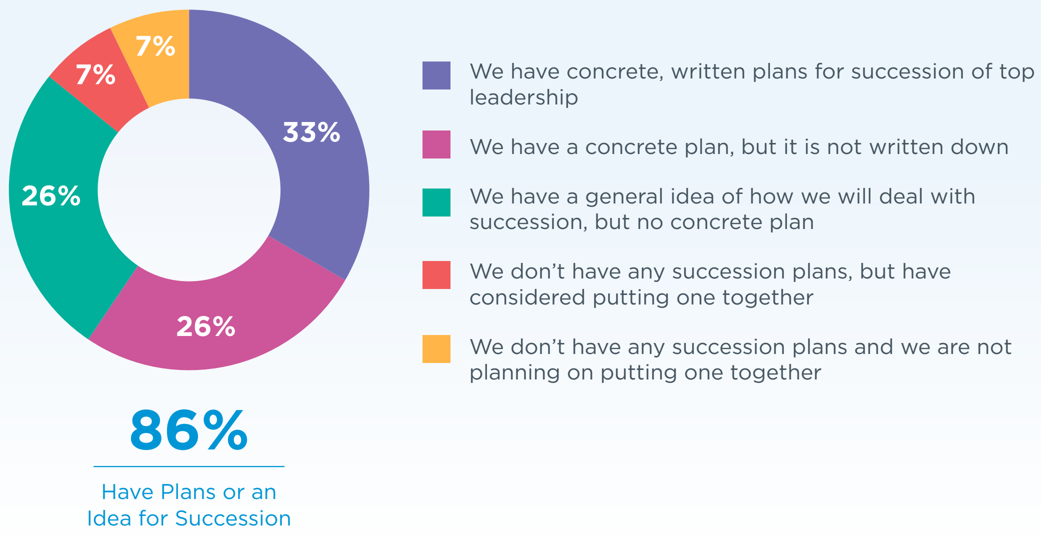
Middle market companies have plans for succession—but they may not be as concrete as they should be.

- 65% of companies with past transition experience have concrete succession plans compared to 50% of firms that have not undergone recent major transition
- Half of middle market companies have identified successors for their CEOs and owners
- Companies with written succession plans and identified successors are more satisfied with their last transition and more confident in their preparation for the next one

While most middle market companies have at least a general idea about how they will handle succession, only about a third have concrete, written succession plans in place. Just half have a plan in place to handle someone in a leadership position leaving unexpectedly. Companies that have experienced past transition are significantly more likely than those who haven't to have solid plans and to involve their in-house lawyers in the process. Past experience with change, it appears, reinforces the importance of having a buttoned up, legally sound plan for the future.

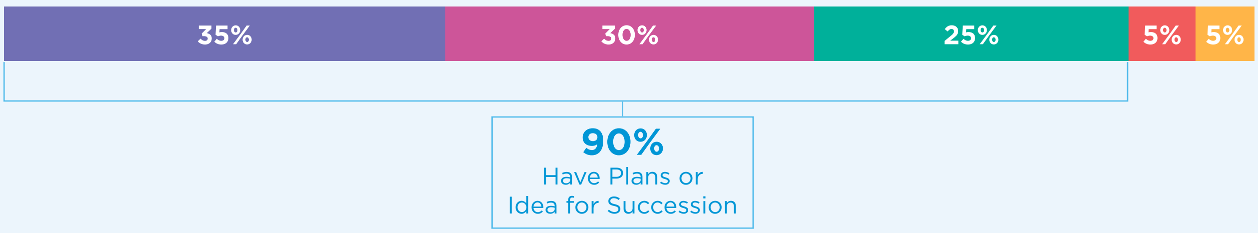
Businesses with recent transition experience are also much more likely than other firms to have identified a successor for the current owner or chief executive. And they have done their homework in more ways than one: Four out of five have considered personal or family preparation steps ahead of the sale of the business, including financial planning and setting up trusts. The current owners have their long-term plans ironed out; whether they will retire, work in a different capacity, or work as a consultant, they have a good picture of what the future holds and they are well-prepared to embrace it.

MOST COMPANIES HAVE A PLAN OR IDEA FOR SUCCESSION, BUT ONLY A THIRD HAVE A LEGAL DOCUMENT

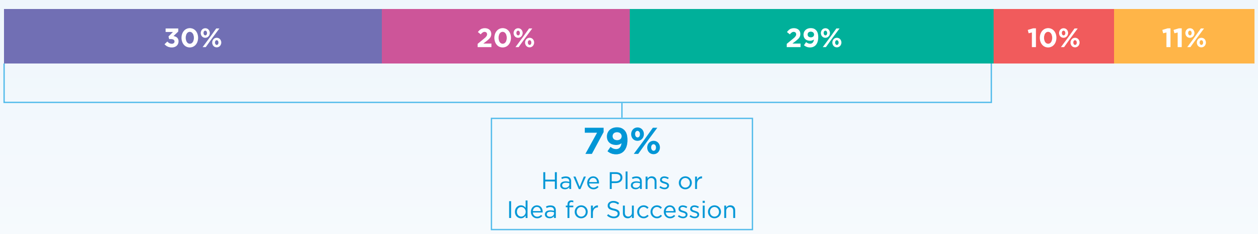


COMPANIES THAT HAVE EXPERIENCED TRANSITION IN THE PAST ARE MORE LIKELY TO HAVE CONCRETE PLANS FOR FUTURE SUCCESSION

Had a Business Transition in the Past 5 Years



Did Not Have a Business Transition in the Past 5 Years



- We have concrete, written plans for succession of top leadership
- We have a concrete plan, but it is not written down
- We have a general idea of how we will deal with succession, but no concrete plan
- We don't have any succession plans, but have considered putting one together
- We don't have any succession plans and we are not planning on putting one together

COMPANIES WITH PAST TRANSITION EXPERIENCE ARE ALSO MORE LIKELY TO KNOW WHO THEIR NEXT OWNERS AND LEADERS WILL BE

	All Respondents	Had a Business Transition	Did Not Have a Business Transition
Owner	50%	54%	42%
CEO	52%	56%	46%

Planning in the "Green Zone" so that you are prepared for the "Red Zone."

Transitions are inevitable. CEOs retire. PE firms sell portfolio companies. A family decides to turn the business over to professional managers or exit it altogether. A business falls on hard times and must restructure to survive.

But while inevitable, they are rarely predictable. Often transitions are triggered by causes a company cannot control: an economic crisis; disease, divorce, or sudden death; an out-of-the-blue offer that is too good to refuse. In our 2018 study of middle market M&A, we found that 45% of sellers had not been expecting to sell their company—and 21% of buyers had no plans to buy, but acted when an enticing opportunity abruptly appeared.

All the data in our current study underscore the fact that preparation is the key to success in transitions. Here as in so much else, the best time to make a plan is before one is needed. We call that "the green zone"—a time when the business is running well and no transition is in progress. It stands in contrast to "the red zone," when the transition clock is ticking. Red zones come unexpectedly, or they might be planned, as when a private equity firm decides to sell its stake in a company or a CEO's retirement is scheduled for the end of a fiscal year. Many red zone activities are urgent; some are even emergencies.

GREEN ZONE

WHAT THE GREEN ZONE LOOKS LIKE

The business is humming, with stable leadership and satisfied investors; the issues it faces are “good problems”—strategy, growth, profitability, customer satisfaction, etc.

WHAT LEADERS SHOULD DO IN THE GREEN ZONE

1. Have “the talk.” Bring investors, family members, and executives together to envision the future of the company—and begin the conversation with the end in mind. What are the options? How do key individuals see their own futures? Contingency planning and what-if scenarios should be part of the discussion, even if they are not pleasant to think about. In other words, what does Plan B look like if things don’t pan out as expected? Better to understand stakeholders’ hopes and goals when there is not an immediate action to take.
2. Clarify decision rights. Many mid-sized companies are governed informally, with no express delineation of who is responsible for what. The time to sort that out is before there’s a crisis.
3. Clean up your books. Undertaking due diligence and knowing the real value of a company removes a major difficulty for middle market deal makers. Better accounting will help you improve business now and get a better deal later.
4. Improve daily management: better strategic planning, process and operations management, working capital management, and talent planning all make transitions more successful while delivering performance benefits now.
5. Check and upgrade risk management. Weak cybersecurity and spotty risk management not only expose your company unnecessarily: They can delay deals and lower prices.
6. Upgrade your stable of advisors. Your lawyer, your accountant, your banker: Are the people you’re using now the same people who you would hire if you were starting fresh? Do they have—or have access to—the expertise you will need when a transition comes?
7. Deepen your ties to your best customers and employees. When change comes—and it will—you’ll want to know they will be with you on the other side of the transition.

RED ZONE

SIGNS YOU ARE ENTERING THE RED ZONE

Something happens that makes you realize a transition will come very soon: health problems, divorce, family issues, an unsolicited offer, competition changes, loss of a major customer, etc.

WHAT LEADERS SHOULD DO IN THE RED ZONE

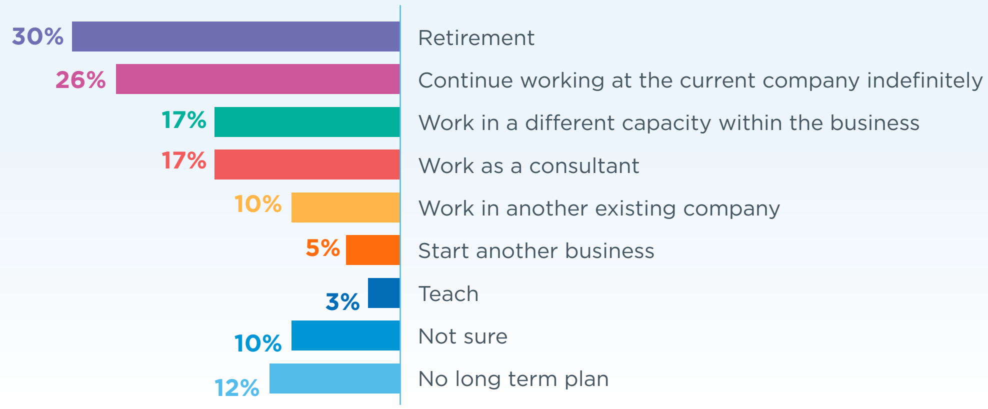
1. Don’t panic. If you planned in the Green Zone, you’re ahead of the game. Regardless, you probably have many elements of a plan, however informal.
2. Appoint a transition war room. A dedicated small team will help you separate the need to cope with transition from the need to keep the business running. Management, ownership, and outside advisors should be included in the war room team. Make sure the “continuing operations” team has the authority it needs.
3. Rank your priorities. Top price? Fastest deal? Best transition for employees? You can’t navigate the complexities of the red zone if you don’t decide which outcomes matter most.
4. Assemble a team of deal-savvy advisors—people who do this type of work every day. Remember, there is no time for a learning curve in the red zone! Then, clarify their roles. Banker, lawyer, tax expert—different transitions require different advisory skills. A normal CEO succession doesn’t need insights from a tax advisor, but a family succession does. Investment bankers are indispensable for mergers, but for restructuring, commercial bankers matter more.
5. Communicate as much as you can—then dare to communicate more. Employees, customers, and other stakeholders will know something is up; the more you keep from them, the more they will imagine the worst—and the less likely they will be there when the post-transition world arrives.

People need to prepare for transition as much as companies do.

Personal plans will influence what choices executives make about the business. Just three out of 10 middle market business owners want to retire post-transition. Almost as many—26%—want to continue working in the company indefinitely. Smaller numbers want to consult, teach, or start a new business.

In general, executives appear to prepare much better for the future of their business than for their own. Even among family-owned businesses, fewer than a quarter have taken the time before a transition to plan family roles and succession, make personal plans for what's next, define their personal and family legacies, set up trusts, or do tax planning. Instead, they wait until after a transition has occurred—and, in many cases, set themselves up for conflict or disappointment, and sub-optimize the transition itself.

OWNERS' LONG-TERM PERSONAL GOALS VARY



Personal Or Family Preparation Considered In Advance Of The Sale Of A Business

	Family Owned		Not Family Owned	
	PE Owned	Not PE Owned	PE Owned	Not PE Owned
Family roles and succession, both for active family members and passive participants setting family expectations and conducting difficult discussions early	30%	23%	25%	11%
Financial planning and cash projections for post-transition	29%	27%	39%	23%
Planning for what's next, such as relocation or retirement activities	25%	22%	31%	20%
Defining the legacy for the business, for yourself and for your family	24%	22%	12%	11%
Setting up trusts to facilitate wealth transfer or post-transition activities	21%	19%	16%	11%
Restructuring resulting in lower taxes on the transaction or its proceeds	20%	19%	14%	16%
None of these	18%	29%	15%	42%

Carve out the space to work on your business and personal goals.

Running a business is challenging, hands-on work that requires a great deal of time and attention. Yet, given the frequency of major transition in the middle market—changes of magnitude that shake up who will lead a business and how it will be run—owners and C-suite leaders need to make the space to work *on* their businesses in addition to working *in* them.

Working on the business requires different types of conversations (some with different people at the table) than conversations pertaining to current business strategy, goals, KPIs, and budgets. And it requires a different mindset, longer-range vision, and the consideration of personal goals and agendas in addition to those of the business. One eye-opening finding of this study was just how few business owners take any personal or family preparation steps ahead of the sale of the business. While not necessarily surprising (middle market business owners and executives are busy!) it does point to a need to think longer term and carefully consider what happens when the business is ultimately handed off in one way, shape, form, or another. The transition—when it happens—will have an impact on you, your family members, your business partners, board, top people, and, in some cases, your key customers. They should all be part of the conversation. Your trusted business advisors should be, too.

Making space to work on the organization can have significant positive impact on its operations and performance right now. Many of the keys to preparing for future transition—improving risk management, sharpening accounting, succession planning, improving efficiencies, and solidifying relationships with customers, suppliers, and employees—instill a level of professionalization of management that immediately translates into a healthier, better performing company. When you operate the business today as if you were transitioning it tomorrow, you'll be in the best position to succeed, whenever that change ultimately occurs.

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