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Rules of the Road in Transition Management

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This Groundhog Day the famous Punxsutawney Phil saw his shadow, signaling another six weeks of winter. However, other famous groundhogs in New York and Nova Scotia both forecasted an early spring. Well, the difficulty of predicting the future is a great backdrop to a discussion on transition management. One of the top issues facing any business, agricultural or corporate, is the transition from one generation to the next. Thankfully, there are some basic rules of the road as well as pitfalls to avoid, that can help along the way.

The bottom line is critical in a successful transition. Too often the younger generation returns to a business with a depleted asset base or dated management practices. At least temporarily, the emotion and excitement of carrying on the family legacy may overpower logic. However, a rusty asset base with obsolete technology will derail the cost structure necessary to break even, let alone make a profit. Today's bottom line is driven by efficiency which must be a point of examination in business transition.

During a generational transition it is important to manage for the cycle. For example, when the economic cycle is at the top people are drawn to the business like a magnet and extra draws on the business can easily be absorbed. However, when the economic cycle is down it is much harder to maintain the margins necessary to accommodate additional individuals. As a general rule, the younger generation that returns to the business should generate $40-$70,000 of incremental net income. In some cases, the spouse can provide outside income to supplement, but if and only if all individuals are in agreement on business and personal goals.

Success in transition depends on asking critical questions of both generations. For the younger generation, an important rule of transition is to know how much and how long compensation will be required by the senior generation. Both the younger and older generations need to develop a personal family living budget. This will help determine whether the business will generate sufficient income to meet those needs. In fact, it is appropriate to treat the senior generation like a $1 million lifetime annuity supplemented by the sale or lease of assets, Social Security and hopefully, other investments.

While matching potential income with potential expenses, another rule of the road is that net income growth must outpace the rate of inflation. For farm businesses, this means net income needs to grow 4 to 8 percent annually. For a sports team, this is similar to a coach thinking ahead to the next player needed to remain competitive. A successful business is always thinking of additional sources or ways to increase net income which are items that could also be included in the transition plan.

When reviewing business financials, examine the trends. Has the farm business been profitable and how were the profits measured? Using Schedule F tax records to set up the economics for a transition agreement is a major pitfall to avoid. Schedule F shows adjusted revenues and expenses used to minimize taxes. An accrual adjusted set of records is absolutely necessary in establishing numbers for transitional agreements. The most direct route to business failure is joining an unprofitable, unsustainable business. The old rule of thumb is that the business must be profitable at least 75 percent of the time as measured on an accrual adjusted basis, to be eligible for a successful transition.

Another rule the road is to have major documentation in writing. It is particularly tempting to skip this step with family. However, in cases of death, divorce, disagreement or dissolution of the business, lack of documentation can present a significant problem. Who owns what assets? What are the percentages and specifics of the buy/sell agreement or buyout? These details should be spelled out along with clear documentation of ownership.

An additional aspect of documentation is physical location. In case of death or another event, do you know where critical documents are physically kept? This seems like a simple detail, but can become extremely stressful. Documents like Power of Attorney, Medical Directive, bank accounts, Living wills, and Trusts are all necessary documents. Over the years, I have simulated the "drop dead" exercise with several family businesses. Place each person's name in a hat and pull out the name of the family member who just died suddenly. What does everyone do now? This places a priority on final arrangements and documents in an organized manner.

What about family members that share holidays and celebrations? While they may not seem interested in the farm when visiting for Christmas, this can easily turn the other way after the death of a parent or grandparent. The specifics of wills, estates, trusts and other legal provisions need to be discussed before any event occurs. Many individuals find this a difficult task which is why a facilitator or third-party is often needed to ask critical questions and cover crucial conversations.

Another pitfall to avoid is stopping short of your destination, which in this case is full transition. If the farm is economically successful through the management of the incoming generation, the transition needs to take another step. For a profitable, well-managed farm, it is common to begin transferring $3 of equity to the farm manager for every $1 of equity received by non-farm siblings. Often, off-farm siblings receive cash such as, life insurance proceeds. The reasoning here is that cash has no risk and maximum flexibility for investment. The farm, on the other hand, is tied to considerable risk and limited flexibility.

Another component of transition management is long-term care. Yes, both generations developed and shared living budgets, but this item may not have been included. Nevertheless, do not allow this to become an unexpected expense. Unfortunately, long-term health situations can quickly and easily become overwhelming for the younger generation if proper planning is not in place. In fact, even if transition planning was otherwise well planned, this single line-item could undo all that work. Being responsible for multiple generations is no easy task so include this aspect in any transition agreement.

While this article does not give an exhaustive list of rules or pitfalls, it does provide some areas for critical thinking. As the groundhogs show, no one can accurately predict the future all the time. Transition management is a process that takes time, communication and planning. A successful generational transition can be the bridge that delivers the business to new places or it can be the end of the road. What will be your choice?