

MODERN DISTRIBUTION MANAGEMENT

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Succession Planning: What's Next?

Make transition to next generation as seamless as possible

In the next decade, the distribution industry will come upon a huge generational shift. So why haven't many owner-managers planned for this change? This article outlines some key issues to address now to ensure a smooth transition in your company, whether you decide to sell or pass the torch to your son, daughter or a key employee.

By Lindsay Young

Rick Rogers' father served as a salesman for fluid power distributor BW Rogers Co, Akron, OH, until founder Bruce W. Rogers died abruptly in 1971. Rick's father was thrust into the top spot, with no management training and no previous view into the company's financials.

"My grandfather kept the cards close to his chest," Rogers says. "He left no information regarding his desires for the company or the financial condition of the business."

It took Rick's father many years to catch up. He learned from that experience, knowing Rick would eventually take over the nearly 80-year-old company. "He wanted to make sure he laid the groundwork for a seamless transition," Rick says.

Among other things, he had Rick work many different jobs in the company. Rick also started working with his father in the five years leading to his retirement. As a result of deliberate preparation, the company went through no operational or financial stress when, in 1998, Rick took over as CEO.

Seamless Transitions

Succession planning is about preparing for the inevitable departure of the owners and managers of your distributorship, and having all the right pieces in place when that happens. "Think about what is going to be when you're not there anymore,"

says Brent Grover, president of Evergreen Consulting.

As USESI Founder Richard Worthy pointed out in a recent interview with MDM, the next five to seven years will see quite a few owners in their 70s and 80s, many of whom will sell the business for estate reasons. But even if you're not in your 70s or 80s, it is still critical to plan for the unforeseeable such as illness or death that could leave the business on unstable ground. In addition, plan for what happens when you or other principals retire.

"The earlier you can start the process, the better," Rogers says.

Along with ensuring a clear roadmap after you leave, put a strategic plan in motion now that involves key managers in making decisions that affect the company in the near- and long-term.

Succession planning is about making a transition as seamless as possible for the next generation of owners and managers. "A company without a good succession plan could not only *not* have the management to preserve the continuity of the business, but won't have the money to do it," Grover says.

Barriers to Planning

Why haven't many distributors moved forward with succession planning? Sometimes owner-managers just don't know what is out there, or they can't make up their minds as to what they want. Keep the company or sell it? Are the children smart enough to run the business, and do they want to? Should they sell the company to employees, even if employees can't afford to pay as much as outside buyers?

Grover says owner-managers also sometimes have not invested in a succession plan or in building up a strong management infrastructure because they may

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have a feeling of immortality or invincibility, with the idea that no one else could do as good a job as they have.

On the other hand, some owner-managers just may not know where to start or what is available. They may not know that there are ways to minimize transfer taxes, or that there are ways to give non-owner executives a stake in the business so they won't be easily recruited away by competitors or start their own companies. Rogers has offered some of his top executives phantom stock plans to give them a stake in the future of BW Rogers, for example, which provides Rogers the option that one of them could take over the company when he retires.

Accountants and lawyers often will not bring the subject of succession planning up – though some will. Rogers recommends hiring a consultant who specializes in succession planning; accountants and lawyers should be used as well, but not exclusively.

Also, use resources provided by trade associations. Take advantage of executive education programs and local networking groups. And use other advisors, including insurance agents. A life insurance agent can often be better at getting owners to think about the future of the business than accountants and lawyers. "Life insurance is the only planning tool you can get at a reasonably affordable price to get cash to keep the business from going into another's hands when you die," Grover says. "Sometimes it's the best thing to do, and sometimes it's the only thing to do."

Planning for the Unplanned

In the early 1980s, three brothers were getting into their 60s and decided to sit down and talk about the future of their distributorship. They hired a lawyer to facilitate the discussion about when they would retire, how to pay for the stock, how that would be financed, what positions the kids would be put into and what would happen if someone died.

Not long after, one of the brothers had a heart attack and died, but because of the road-map, the sons knew they would not be kicked out of the organization. They also knew how their father's stock would be handled. All of this had been objectively negotiated by people who were healthy. Not far down the road, a 38-year-old family member had a heart attack, but again the family was prepared.

"The plan kept the business and the family together," Grover says.

Worst-case scenario, without any planning, an owner-manager dies or becomes incapacitated, and the company is left with both management and ownership up in the air. Suppliers may lose confidence and may look to other distributors to serve their needs in that market. They also may get nervous about payment and cut credit.

Key employees may consider leaving for more stable work. "It's a vicious circle," Grover says. "You may then start losing customers."

Create a Timeline

To start thinking about succession, create a

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timeline. Start with things that are known: ages of family members and business principals; likely family and business events such as graduations and marriages. Then look at where the business is likely to be at certain points in the future. Project the cash needs for the business based on growth needs. Project the value of the business and cash flow at certain points in the future.

Now, test different scenarios. What if someone died? What if you want to make an acquisition? Grover says this exercise helps owners get their hands around whether they would need to grow or sell based on their expected circumstances.

Finding a Successor

“Those who have family members in the business have to use extreme caution that any successor they choose wants the responsibility and is capable,” Grover says. There is a difference between ownership succession and management continuity. “You can have people who like to be owners, but don’t want to be part of the management.”

When family is involved, things might get tricky, especially if you have some children involved in the business, and some who are not interested at all. “How do you equalize the value? ... Those are tough choices. No two sets of parents are going to come up with the same answers. Some people feel their children should receive something equal and some people feel that those who have really sacrificed for the business should receive it or the lion’s share.”

Rogers, who has two brothers who weren’t interested in running his father’s business, says he has seen “unhealthy situations” where many family members were involved in businesses and did not work well together. He recommends assigning clear roles to all family members who are involved directly, or keeping the number of family in the business to a minimum.

Another point: Giving stock to non-working family members may not be fair to them or to the company. More than likely, the investment is not liquid, and they are not likely to receive any income from it unless other family members buy their stock, or if the company is sold. Grover recommends providing non-stock assets to non-working family members.

The Details

There are many steps an owner-manager can take to make any transition a little smoother.

Appraisal. One-quarter of Industrial Supply Association members surveyed by Grover

said they had not had an appraisal of their business in the past five years. Most never have. But appraisals can help resolve issues that may arise later on, including buy-sell among owners, Grover says.

It’s also useful to have stock valuation for the purposes of having a gift program. And in domestic disputes, the value of the company may become a factor. In the near future, if someone wanted to buy your company, you would need to know whether you are getting a good offer.

Board of Directors. Less than 30 percent in the ISA survey reported having a “real” board of directors. About one-third has a board made up of insiders, and for 40 percent the board is a legal formality. But Grover says more owner-managed distributors are moving to establish a board of experienced business people. This is important, he says, to hold leadership accountable, validate the company’s strategy and track financial results. Boards also provide an outside perspective.

“I always come out of board meetings with fresh ideas,” Rogers says. BW Rogers has a board of outside advisors, formed 20 years ago, which would take over the company if Rogers were to become disabled.

When it comes to the loss or incapacity of a CEO, a board can be a tool for the owner to implement a CEO’s wishes after he is gone. The owner-manager can do this through a letter of wishes.

Letter of Wishes. The letter of wishes contains instructions to the board on what is to be done when the CEO is gone. (See example at this article online at www.mdm.com.) Include which management should be in charge, what the company is worth, how to dispose of the business, and which investment banker should handle a sale of the business if that’s the chosen route, for a few examples.

In addition, provide details on family members, if you want them to play a part in the future of the business. The document is not legally binding, but should provide a guide for the board to follow. “These are the things that are sometimes thought of, rarely said, and almost never written down,” Grover says.

The letter of wishes can be updated regularly and shared with the board, or sealed until a person’s death. Just less than 20 percent of ISA members surveyed said they had a letter of wishes.

Transfer Taxes. Talk to your accountant and lawyer. They will be able to help you save

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money in this area. Plan as if all taxes currently in effect will continue to be, including estate taxes. "No one has a crystal ball," Grover says. In addition, discuss with your advisors the benefits and drawbacks to being S Corporations or C Corporations. If you are selling your company, an S Corporation may provide more flexibility and incur less taxation on gains.

This article is based on a presentation by Evergreen Consulting President Brent Grover at the Industrial Supply Association's 2006 annual meeting and follow-up conversations between Grover and MDM.

Brent Grover's firm, Evergreen Consulting, LLC, advises owner/managers of closely-held distribution and manufacturing companies about the challenges of strategy and ownership succession. Brent, a former national firm CPA and business school accounting instructor, has published several articles about these topics. He was in the distribution industry for over 25 years, most recently as CEO of National Paper & Packaging Co. Brent can be reached through his Cleveland office at 216-360-4600 or brentgrover@evergreenconsultingllc.com.

Industrial Outlook: Modest Acceleration in '06, Slowing in '07

Moderate acceleration in the manufacturing sector in 2006 will likely be followed by pronounced slowing in 2007, according to the Manufacturers Alliance/MAPI Quarterly Industrial Outlook-Second Quarter 2006, a report that analyzes 27 major industries.

In a sign of consistent strength in manufacturing, second quarter 2006 figures show that 19 of the 27 industries tracked in the report had inflation-adjusted new orders or production above the level of one year ago, thus indicating broad-based growth in the industrial sector.

Top industry performers in the second quarter, recording year-over-year double-digit growth, were mining and oil and gas field machinery (44 percent); communications equipment (34 percent); construction machinery (20 percent); oil and gas well drilling (19 percent); iron and steel products (19 percent); aerospace products and parts (16 percent); electrical equipment (16 percent); navigational, measuring, electromedical, and control instruments (15 percent); material handling equipment (15 percent); and semiconductors (11 percent).

Daniel J. Meckstroth, Manufacturers Alliance/MAPI chief economist and author of the analysis, writes that nine industries are in the accelerating growth (recovery) phase of the business cycle; 11 are in the decelerating growth (expansion) phase; four industries appear to be in the accelerating decline (either early recession or mid-recession) phase; and three are in the decelerating decline (late recession or very mild recession) phase of the cycle.

"Manufacturing has been growing much faster than the general economy since the fourth quarter of 2005," Meckstroth said. "The strength of the expansion in the goods sector created concerns about supply availability within the

manufacturing industry which encouraged inventory rebuilding, adding to the momentum. The industrial rebound in Europe and Japan has improved export demand."

The report also offers economic forecasts for 24 of the 27 industries for 2006 and 2007.

Seven industries are expected to enjoy double-digit growth in 2006, but only one is expected to hit that benchmark in 2007. Mining and oil and gas field machinery is the lone industry expected to enjoy double-digit growth in successive years, 10 percent in 2006 and 17 percent in 2007. In 2006, communications equipment should rise by a robust 27 percent; aircraft and parts is likely to experience 17 percent growth; navigational, measuring, electromedical, and control instruments is expected to gain by 15 percent; construction machinery production should improve by 14 percent; steel production should rise by 13 percent; and electrical equipment is forecast to improve by 12 percent.

One industry is forecast to have negative change in both 2006 and 2007. Housing starts are expected to decline by 8 percent in 2006 and 9 percent in 2007. Manufacturing industrial production grew 3.9 percent in 2005. MAPI forecasts it will grow 5 percent in 2006 before decelerating to 2.5 percent growth in 2007.

"The big-ticket consumer items have already started to falter. Housing starts and motor vehicle sales will decline this year," Meckstroth explained. "Although the production of capital equipment will continue to lead industrial activity, the equipment that uses diesel engines is expected to experience a strong 2006 followed by a decline in production activity next year. New emission control regulations have created an incentive to buy now because the new engines will be more costly."