



Business Insights

Information and analysis from TD Commercial Banking

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Why every business needs a succession plan

Despite the importance of a succession plan, many business owners do not have one: PricewaterhouseCoopers Canada says 54% of Canadian private company business owners do not have a plan outlining future ownership. That figure jumps to 70% among businesses with annual revenues of less than \$10 million.¹

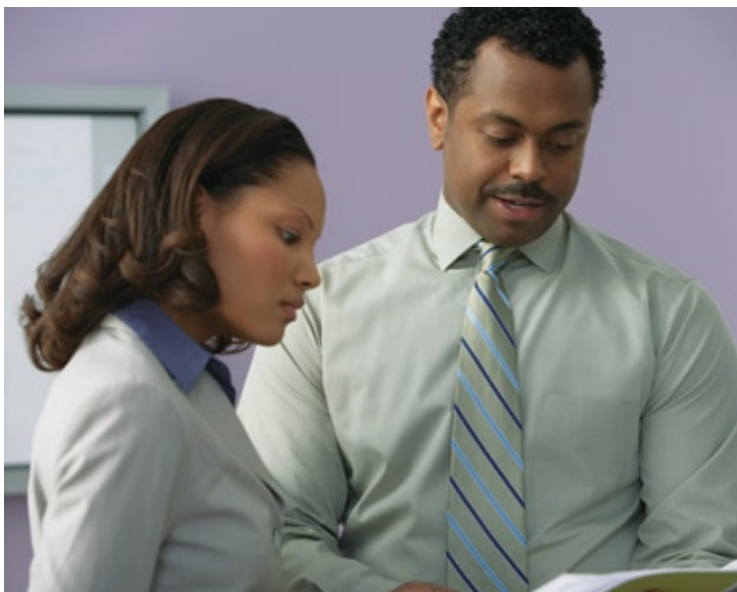
Some business owners postpone this essential task indefinitely, preferring to focus on the immediate needs of their businesses. However, a solid succession plan is an important part of the equity built in a business. Whether for potential buyers down the road, or for current management and employees, a clear plan for the future change in ownership and leadership of any firm enhances its stability and protects its value.

The benefits of good planning

A good succession plan is about maximizing a business's value while securing the future of its owner/manager or partners. This plan is the framework for the transfer of ownership and control of the business.

Here are some of the benefits of proper succession planning:

- ▶ Increased security and stability for the business;



Having a clear plan for the future change in ownership and leadership of a business is an important step in protecting its value.

- ▶ A smooth transition to new owners, free of delays or disputes;
- ▶ Clarification of individual roles and responsibilities during the transition;
- ▶ Opportunity for long-term strategic planning;
- ▶ Protecting and potentially enhancing the payout from the business;
- ▶ Potential tax savings; and
- ▶ Financial security for business owners and their families.

Continued on Page 2

In this issue

3
Rewarding key leaders
Strategies for attracting and keeping the best

5
The flying loonie
Managing today's Canada-U.S. exchange environment

6
Canadian business outlook for 2008
What lies ahead for Canadian businesses

Our goal is to help you achieve yours

Why every business needs a succession plan

Continued from Page 1

Six key questions to ask

While every business requires a unique strategy, all succession plans must address the same concerns:

1 BUSINESS VALUATION. The business must be assessed to determine how its value can be maximized. Business valuation professionals can help with this process.

2 TRANSFERRAL OF OWNERSHIP. The plan will describe the process whereby the business will change hands. Owners must determine:

- a) Whether the business will be sold to a third party or ownership passed on to the owner's family;
- b) Whether shares will be transferred to employees, or if the business will go public; and
- c) Whether potential successors are qualified to run the business, or if training and mentoring will be required.

3 TIMING. Having a clear timeline is important. Owners must decide whether the business will be passed on at retirement, or if it will form part of the owner's estate.

4 OTHER STAKEHOLDERS. If the business has more than one owner, arrangements must be

made between partners and with shareholders. These can include a "buy-sell" agreement governing who takes over the portion of the business to be transferred, and under what conditions.

5 TAX IMPLICATIONS. Tax minimization is a key goal, and a tax specialist can advise you on the best methods. For example, the business may qualify for the capital gains exemption. In some cases, an estate freeze could be appropriate, shifting the tax liability of future growth to the next generation.

6 COMMUNICATION. If the business is to be passed on to family members, current owners must ensure that their successors understand their role in the future success of the business.

Start early

A succession plan should provide direction to navigate through each of these issues and more. Depending on its complexity, business owners should prepare well in advance, to provide time for their succession goals to be realized. Developing the plan in conjunction with your Relationship Manager, as well as your company's accountants, lawyers, and other professionals, is also recommended. ●

A team of professionals — including a tax specialist, lawyer, business valuation expert, financial advisor, and accountant — can ensure that the succession plan minimizes taxes and maximizes profitability.

Cashing out business capital

Here are some key factors to take into consideration when and after selling a business, to make the most of the proceeds:

● **KNOW THE TAX IMPLICATIONS.** The structure of a sale is important. A Canadian-controlled private corporation may be eligible for a \$750,000 lifetime capital gains exemption on the sale of qualified shares. But if a buyer purchases assets of the corporation, rather than shares, there is no exemption.

A tax professional can suggest other ways to minimize or defer tax on the sale of a business. These can include income splitting and setting up trusts for children.

● **MAXIMIZE RETIREMENT SAVINGS.** Business owners may be able to take advantage of a retirement compensation arrangement (RCA) to top up savings before selling or transferring a business. Or they may also maximize Retirement Savings Plan (RSP) contributions with the sale proceeds, making up for missed contributions.

● **INVEST THE PROCEEDS WISELY.** Diversify investments through a range of asset classes. When creditor protection is important, investments that offer potential protection, such as segregated funds, may be advisable.

Rewarding your company's key leaders

A company's leaders are essential to the growth and prosperity of the business. And in today's employment market, where companies are competing for talent, the rewards a business offers are important both for getting and for keeping the best.

Paying for performance

An attractive compensation package is the simplest way to increase an employee's job satisfaction, loyalty, and contribution to the business. Compensation tied to individual, team, or company performance encourages key employees to feel a sense of ownership, with a stake in the business and how it performs.

"It's all tied in with the idea of paying more for performance so employees will

"Compensation packages have to be competitive with what executives might get elsewhere — design compensation so key executives don't want to leave the company."

STEPHEN SAPP
Associate Professor of Finance,
Richard Ivey School of Business

make decisions that benefit the company," says Stephen Sapp, Associate Professor of Finance at the Richard Ivey School of Business at the University of Western Ontario.

Equity rewards for the long term

Increasingly, companies that want the best from their senior employees are opting for solutions that promote long-term

results over shorter-term goals.

While performance-based compensation such as annual cash bonuses is rewarding, it is typically based on shorter-term objectives such as year-over-year profit or sales increases. Other compensation arrangements, particularly those that are equity-related, can produce better long-term results as key employees gain ownership in a company and a direct interest in stock performance.

RESTRICTED STOCK is an increasingly popular equity choice, especially in light of heightened regulatory scrutiny on options as a form of executive compensation.

Restricted stock is time-vested and may not be received for a number of years. As a

Continued on Page 4

Steps for improving the compensation process

Executive compensation can sometimes be a thorny issue, especially when it comes to shareholder interests.

In an era of increased investor and regulatory focus on corporate governance, companies can benefit from guidelines that help ensure fair and transparent compensation practices.

NEW RESEARCH. A report recently issued by The Institute of Corporate Directors Blue Ribbon Commission on the Governance of Executive Compensation in Canada addresses weaknesses in current compensation practices and makes recommendations for improving the process.

The Commission is comprised of leading businesses and organizations working together to provide recommendations on improving the executive compensation process.

Based on research by Stephen Sapp and

Murray Bryant of the Richard Ivey School of Business, the report champions a new standard for transparency and provides a process that companies of any size can use to more closely link executive pay to company performance.

RECOMMENDED PROCESS. The report recommends that companies employ a Compensation Analysis Process (CAP):

- 1 Obtain an in-depth understanding of the business model, strategy, and goals of the firm.
- 2 Develop appropriate executive performance metrics to support the business model, strategy, and goals.
- 3 Determine the appropriate weighting for each performance metric and develop relevant targets.

4 Assess what it takes to motivate an executive with respect to compensation, with consideration given to the mobility of executive talent and other job elements.

5 Evaluate whether the total compensation arrangement is in accordance with performance targets and align executive incentives with the firm's business model and objectives.

6 Objectively stress-test the entire plan to see if it is fair to the chief executive officer, the firm, and investors.

Full copies of the report are available on the Institute of Corporate Directors website at www.icd.ca

Rewarding your company's key leaders

Continued from Page 3

result, company performance is critical to its value at the time the employee receives the shares. And because leaving the company before the vesting date means forfeiting the shares, restricted stock can help retain employees. Performance criteria can be attached to the granting of restricted stock, so shares are received only if objectives are met.

RETIREMENT PACKAGES are also popular. These can also be tied to performance or length of time with a company. They include individual pension plans (IPPs) and retirement compensation arrangements (RCAs). These packages can allow an employee to accumulate more retirement wealth than a typical pension plan or RSP.

Be creative in arrangements

No matter what route a company takes, creative compensation arrangements should be an integral part of its business strategy. An effective business plan recognizes that measuring performance and rewarding key employees based on that performance is critical to long-term results.

This may involve rigorous target setting that takes into account factors such as historical company performance, industry benchmarks, the performance of direct competitors, and shareholder expectations.

“Design it in conjunction with where you want the company to go,” Sapp advises. “Come up with packages where key employees do really well when the company does really well.”



Compensation tied to individual, team, or company performance encourages key employees to feel a sense of ownership, with a stake in the business and how it performs.

Attract and keep talent

It is important to offer packages that are competitive in your industry. The employees that are valuable to one company are often coveted by others.

How much compensation should be performance-related varies from industry to industry, job to job. Some key employee functions are less related to share price. And some companies' performance depends more on economic factors than on strategy. In these cases, bonus rewards or compensation guided by industry benchmarks may be suitable.

Financial rewards are not just for keeping valuable employees satisfied — they attract talent. Creative compensation packages bring in the top-flight employees a company needs, and keep them working towards its success. ●

In Canada's tightening labour market, compensation packages offered to senior executives need to be strong and comprehensive in order to attract and keep the best talent.

Structure compensation to maximize RSP savings

While an RSP is usually only a part of a business owner's retirement planning, it is still prudent to take full advantage of its benefits.

And one way to plan for this is to structure your compensation in a manner favourable to maximizing your RSP contributions. This means that it is important to have your incorporated business pay you and your valued employees enough every year to allow the level of RSP contribution you need to meet your retirement financial goals.

For the 2007 tax year, the maximum contribution is \$19,000, or 18% of the earned income reported on your 2006 tax return (whichever is less). That means your earned income must be at least \$105,556 to qualify for the maximum contribution.

For 2008 the maximum rises to \$20,000, which calls for \$111,112 in earned income the previous year. To be able to make a maximum contribution in 2009 — \$21,000 — you will need to earn \$116,667 this year.

Defend your U.S. market against the flying loonie

Canadian companies that do business with U.S. customers are feeling the pinch of a loonie-greenback relationship that makes Canadian goods more costly.

With the Canadian dollar recently appreciating beyond parity with its U.S. counterpart for the first time in a generation, it is a serious problem that is not about to disappear. Canadian goods and services that cost an American buyer 62 cents four years ago cost about US\$1 today.

Manufacturers whose principal market is the U.S. are especially vulnerable. But businesses ranging from service industries to retail outlets near the U.S. border are also affected.

Here are some ways to manage today's exchange environment.

- ▶ **REPOSITIONING IN THE MARKET.** With less ability to compete on price, the future for many companies lies in selling higher-quality or more sophisticated products, exploiting niche markets, and ensuring customer satisfaction. Products seen as unique by customers are less sensitive to price pressures. Companies may need to consider moving up the value-added chain by identifying niche markets or under-served areas.
- ▶ **INVEST IN NEW TECHNOLOGY.** Updating technology used in a business can help lower costs and increase productivity and efficiency. With U.S.-sourced machinery and equipment now cheaper in Canadian terms, this may be a golden opportunity to modernize.
- ▶ **BUY SUPPLIES AND SERVICES FROM THE U.S.** Supplies, raw materials and services sourced from the U.S. or priced in U.S. currency are now cheaper.
- ▶ **WORK WITH SUPPLIERS TO MANAGE COSTS.** Suppliers want to keep your business. They may be able to offer better prices or other solutions that can contribute to cost management.
- ▶ **CUT NON-LABOUR EXPENSES.** Non-labour costs, such as energy, can be reduced. Devel-



Canadian businesses that rely on the U.S. as their major market are facing a challenging environment, and may need to shift strategies to weather the storm.

oping scale can also lead to cost savings. And explore more cost-efficient ways to access and ship to the U.S. market.

- ▶ **RELOCATE PRODUCTION.** A business may have the option to produce goods in the U.S. or in markets around the world that have lower labour costs, while concentrating on value-added activities in Canada, such as product development and design.
- ▶ **IMPROVE BRANDING AND PROMOTIONAL STRATEGIES.** This is critical to attracting business. It is also an area in which Canadian companies often lag behind their U.S. competitors. With less ability to compete on price, reaching a U.S. audience with a positive message becomes more important. If you are a retailer or service provider who depends on U.S. customers travelling to, or buying from, Canada, focus on the unique benefits and qualities of your products.
- ▶ **MANAGE CURRENCY FLUCTUATIONS.** Hedging strategies may help. For example, a business with substantial U.S. receivables can hedge to provide a buffer against further declines in the U.S. dollar. ●

While the Canadian dollar is likely to continue to fluctuate in a range just above or just below parity, regardless of its value on any given day, it is expected to remain at historically high levels for the foreseeable future.

Canadian business outlook for 2008

BY CRAIG ALEXANDER, DEPUTY CHIEF ECONOMIST, TD BANK FINANCIAL GROUP²



The year ahead should prove to be a decent one for Canadian business, but there will be considerable variation in terms of performance at the industry level and a number of challenges.

Solid domestic demand for sales.

Firms that are focused on selling to domestic markets should generally fare well. Low unemployment and solid real estate markets suggest that consumers will keep their wallets open.

Canadian companies may invest more in 2008. Governments have solid fiscal positions, implying public-sector outlays will advance. Companies that benefit from a high-flying loonie should reap gains from a sustained strong currency. And demand for Canadian wares overseas is projected to be robust.

Exporters will face a strong dollar.

However, businesses adversely affected by a strong Canadian dollar and those heavily leveraged to trade with the United States (or part of a production chain with firms that export to the U.S.) will face a difficult environment. Even if the loonie pulls back, it is likely to remain

remarkably strong. And the housing weakness in the U.S. is expected to persist over much of next year.

Profitability will be impacted by costs.

The sales perspective only tells half of the story for profitability. The other half relates to pricing and costs, and there are a number of challenges on this front.

Competition in local and foreign markets will remain fierce. Businesses are likely to have limited pricing power. Canadians are also likely to pressure firms to pass along savings from the appreciation in the Canadian dollar. The strength in the Canadian dollar will also make imports more competitive in domestic markets.

Tight labour markets to create competition for talent.

Labour markets will remain extremely tight. The pace of employment growth is expected to slow, but the national unemployment rate is only expected to edge up to 6.3%.

Businesses are likely to find staffing problematic and retention an issue. This is expected to create upward pressure on wages, salaries and supplementary income, which are expected to rise at a 4.7% pace in 2008, which is roughly 2.5 percentage points faster than the rate of inflation and approximately in line with business revenue growth.

Costs of energy and materials remain high.

Other input costs are expected to remain elevated. Although oil prices are projected to dip next year, they will remain extremely high. Natural gas prices are forecast to rise moderately and electricity prices could advance at a low single-digit rate. Material costs are also expected to retain much of their past increase.

The bottom line for business. In this environment, business-as-usual strategies won't deliver. Firms will need to find innovative ways to attract talented labour and retain their employees, and non-monetary factors could be particularly important. Ways of reducing energy and non-labour costs need to be identified, as competing on the basis of price or labour costs is a losing cause.

The future is in selling higher-quality or more advanced products. Customer satisfaction and exploiting niche markets are key. Developing scale could also be part of cost saving and greater brand-awareness strategies. Exploring new ways to penetrate foreign markets might also prove profitable.

The bottom line is that creative thinking and flexibility towards new approaches, processes, and strategies are called for. Of course, this is easy to say, and extremely hard to do. ●

UNDERSTANDING - EXPERTISE - SOLUTIONS - COMMITMENT

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The information in this newsletter is current as at December 15, 2007.

¹ Source: PricewaterhouseCoopers August 2007 Pulse Survey

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