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SUCCESSION PLANNING IN SENIOR HOUSING

American Seniors Housing ASSOCIATION

Ferguson Partners

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SUCCESSION PLANNING IN SENIOR HOUSING

INTRODUCTION

As we enter 2022, the seniors housing industry finds itself at an inflection point. On one hand, the sector still faces significant challenges stemming from the COVID-19 pandemic and the lingering impacts felt across the broader economy (e.g., occupancy rates, staffing shortages, new safety protocols, etc.). At the same time, however, there are significant growth opportunities within the space given the aging U.S. population. While these factors push and pull against each other, strong leadership has never been more important and will likely differentiate those that capitalize on the favorable demographics and those that do not.

This also comes at a time when the industry is in the midst of a generational transition, where many of its founders and CEOs are nearing retirement age. Over the next 10 years, the face of senior housing leadership will undoubtably change. It will be the next generation of leaders that will determine how the seniors space evolves. This will require leaders that are capable of executing a strategy, understanding the unique dynamics of the sector, and motivating and leading broad teams. Further, this opportunity opens the door to further explore diversity of thought and background, which can give way to even greater innovation and creativity in solving the industry's greatest challenges.

> **"We are at a point in the maturation of our industry where many founder-led organizations are transitioning leadership to the next generation of executives. We must identify people to lead the businesses that we built."**

Succession planning is a key element of any company's risk management strategy, and focusing on future leaders and the seamless transition for organizations has never been more important. However, this requires resources in time, focus, energy and money, all of which organizations struggle to find in this environment. Therefore, succession planning has not garnered the priority and focus that will be needed moving forward.

On the pages that follow, we will highlight critical considerations and best practices related to succession planning designed to help leaders of seniors housing platforms effectively plan for the future. The commentary herein reflects direct one-on-one conversations that Ferguson Partners ("FP") conducted with industry leaders, as well as our own observations from years of working with clients on developing such programs.

DEFINING SUCCESSION PLANNING

At a high level, a comprehensive succession plan is a multi-faceted, ongoing approach to managing human capital that continuously prepares an organization for changes in leadership. A program should account for both planned and unplanned departures and should extend beyond the CEO to, at a minimum, the core group of functional and/or geographic leaders. Ideally, it would be applied to all levels of the organization to ensure a continuous cultivation of talent. Additionally, an effective succession plan should be monitored and updated regularly to account for organizational changes, skill advancement for key individuals, and other relevant matters that will impact the plan.

With all that said, succession planning includes more than just questions on future leadership (i.e., managerial succession). There can be critical financial/ownership implications as well as governance/decision-making changes that must also be considered. We will cover all these topics in greater detail in this brief.

MANAGERIAL SUCCESSION

Managerial succession at the most basic level focuses on who will run the business (or parts of the business) after a succession event. Planning for such transition is a key facet of prudent human capital management as it prepares an organization for changes in leadership (for both expected retirements and unexpected succession events). At the most fundamental level, effective managerial succession planning should include three primary components:

1. **Identify** - Identify talented individuals that have leadership potential and may be succession candidates
2. **Develop** - Provide candidates with opportunities to develop the necessary experience and skill sets needed to be successful in a leadership role
3. **Communicate** - Inform key stakeholders of the plan

For the purposes of this discussion, we will focus our commentary on CEO succession planning, though similar processes apply for other key senior leadership positions.

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Identify

The first critical step of any succession planning process is to develop a profile for what skill sets and experiences will be required from a future leader. This profile should be based upon the firm's go-forward strategy with a lens toward what competencies will be required to execute the desired plan. Particularly for first generation transitions, the skill sets that were required to found and build a business may not be the same skill sets that are required to operate a scaled enterprise. Recognizing the expertise that will be needed for the future is particularly critical within the seniors housing space given the rapidly evolving landscape. It is important to acknowledge that the optimal profile for a CEO going forward may look different than it has historically.

Once the role profile has been developed, an organization must identify candidates that fit the desired profile. Such candidates may come from within the organization, or they may be sourced externally (either via one-off hire or via strategic platform acquisition).

There are benefits and drawbacks to both internal and external approaches. Internal candidates are familiar with the company's culture, operations, investors, and employees, oftentimes leading to a more seamless transition. External candidates have the benefit of bringing in an objective outside perspective and may offer a particular skill set that internal candidates do not. However, outside candidates also represent a greater risk due to potential cultural fit issues. According to FP analysis studying over 100 CEO transitions over the past 20 years, internal successors have been more common than external hires, representing roughly three-quarters of all CEO replacements. However, there is no consistent performance advantage of one approach over the other. Success is based more upon the caliber of the individual and each organization's unique needs. Ultimately, most organizations prefer to promote from within if there is a suitable candidate in-house.

> **"We don't have the depth in talent to fill the key roles, so it's a fact of life that we will have to go outside the industry."**

Seniors housing firms will not only have to consider the internal versus external approach, but will also need to determine whether their next leader will come from inside or outside the industry. One consistent theme that we heard from sector leaders is that the seniors housing industry lacks the internal talent needed to lead the sector into the future. While some of this is due to training/access to adequately prepare for future roles, it is also due to the changing skill sets required as the sector continues to grow. As a result, many anticipate an influx of senior housing leaders coming from outside the industry. In fact, sectors such as hospitality and technology have already been explored by some organizations. These backgrounds may bring

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unconventional but highly relevant skill sets to the table. While this has the potential to benefit the industry in terms of its ability to innovate, it will also require training and development for leaders that are new to the sector.

"We need to focus on bringing more youth into senior housing sooner. We have to capture the young, bright, best-in-class talent from the business schools."

To prepare the seniors housing sector for the future, both in terms of building a broad talent base and increasing the number of internal CEO succession options, leaders within the space are highly aligned in the desire to spend time and resources bringing fresh new talent into the industry. To execute upon this initiative, the industry will need to consider its training programs, career paths, and compensation/incentive structures to ensure competitiveness with other in-demand sectors. Moreover, it will be important to frame the industry as one with high-growth potential if it wishes to compete for top-tier talent. This is critical but comes at a challenging time when the industry finds itself lacking in time and resources to adequately implement robust human capital management strategies.

To execute an effective succession process, it is critical that organizations begin thinking through the identification step early, particularly for the CEO role. If the company has a clear-cut, long tenured "second in command" succession candidate, 12-24 months may be an appropriate lead time. However, if the company has multiple internal succession candidates, or is considering going external, best practice suggests planning should begin at least three years prior to an intended retirement date. If there are multiple internal succession candidates, they will need time to address skill set gaps and take on greater responsibility and visibility within the organization (more on this in the following section). Through this process, certain individuals will rise to the forefront, at which time the pool of succession candidates can and should be refined. If the organization opts to bring in an external succession candidate, it is important that they are given sufficient lead time to get up to speed on the platform, understand company culture, and build internal and external goodwill.

All told, the identification step is integral to the succession planning process, but it is only the first step.

Develop

Once potential successors are identified, an evaluation of each candidate's strengths and weaknesses must be conducted to identify gaps between the current skill set and the requirements for the elevated job. For the most senior leadership positions, this usually involves broadening one's exposure beyond his/her primary functional area

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of expertise. Several study participants highlighted the need for employees to get broader exposure across the business (e.g, both operational and financial perspectives) as a way to attract talent and prepare employees for more elevated roles.

> **"We do not focus on cross training in our industry – it would be good to change this. This would help in our employee development efforts and would make the industry more appealing for students considering careers in the sector."**

One challenge facing the seniors housing industry with regard to development and succession is the siloed organization model of many firms. The skill sets associated with development and investment roles are distinctly different than those needed for key operations roles. Successful leaders need to have a strong understanding of both areas, but these types of individuals can be hard to find. To address the siloed model, organizations should consider exposure and cross training at the junior levels and internal management committees at the senior levels. Both approaches can provide employees with exposure to different areas of the business, resulting in well-rounded future leaders.

> **"We look at successors and when they will be ready. We utilize various development programs and evaluate progress twice a year."**

While some firms in the space take an informal approach to training and development, there are examples of organizations that utilize a formal development process for their executive and senior tier to plan for succession events.

Once the areas of focus are identified, there are a variety of mechanisms to facilitate greater exposure and training. Development plans typically include some or all of the following dimensions:

1. **"On the job" training/experience** (e.g., participation in management committees or task forces, cross-functional job assignments, increased responsibility/visibility within a function or the organization as a whole)
2. **Formal training/education** (e.g., executive coaching, seminars, conferences, continuing education, etc.)
3. **Learning from others** (e.g., mentorship programs, 360 degree feedback, etc.)

It is important to note that not all development opportunities will be relevant for each employee. The company and employee should work together to identify the opportunities that would be most relevant and valuable.

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Moreover, development should not be viewed as a one-time event; instead, individuals should be continually reassessed. At least once per year, progress should be gauged for each identified individual to determine where gains have been made, and where further training is necessary. Over time, certain individuals may rise to the forefront, while others may fall behind; this is a natural part of the process. A robust development system should build in a continual process of check-ins, re-assessments, and course corrections, as necessary.

While pressing industry challenges have taken priority for many and resources are stretched thin, it is critical that talent development not be overlooked. Identifying and cultivating high potential future leaders is paramount and will impact individual firm performance as well as the evolution of the industry as a whole.

Communicate

Communication represents the last critical element of managerial succession planning. To effectively execute a succession plan, the company must relay the plan (or at least the existence of a plan) to the appropriate internal and external stakeholders. The communication process conveys to employees, investors, and partners that the company is taking a thoughtful approach to risk management and business continuity.

Both implicit and explicit communication is typically used in these situations. Implicit signaling is a critical part of any planned succession event as it gives internal and external stakeholders insights into the long-term plan and provides constituents the opportunity to build comfort with the identified successor. Effective signaling mechanisms include title changes, increased exposure, and shifting responsibilities.

That said, some type of formalized communication is also typical and can occur at one or two points during the process (depending on whether the successor is internal or external). If an external hire is made, formal communication will be made at the time of hire announcing the hire, title, and role/responsibility. This type of communication does not usually explicitly state that the individual has been identified as a successor, in order to maintain flexibility to course-correct if necessary. During the assessment period of the external hire, no explicit communication is necessary. However, if the individual is taking positive steps toward solidifying him/herself as the ultimate successor, the company can utilize new titles and increased responsibilities to signal he/she is on a path toward becoming the company's CEO.

If an internal candidate is identified, the company does not need to formally communicate its intentions initially. However, if the internal candidate is progressing through his/her development plan, the company can use signaling mechanisms to indicate that the individual is viewed as the likely successor. Formal communication will come when the actual departure of the sitting CEO occurs.

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OTHER KEY CONSIDERATIONS: FINANCIAL SUCCESSION AND GOVERNANCE

While the succession planning process tends to focus primarily on identifying the next CEO or President, there are other important considerations that come with a transition in leadership.

Financial succession/ownership transition

Depending on the ownership structure of the company, a CEO succession event may also involve a transition of ownership, especially in the seniors housing industry. If the retiring CEO is the founder and owner of the company, there are generally three options available to him/her regarding the future ownership of the company:

1. **Capital event** - monetize owner interests via a sale/transaction to a 3rd party (partial or full)
2. **Perpetual ownership** - post retirement, founders/majority owners and their families retain ownership indefinitely
3. **Enduring partnership** - ownership is transitioned to the next generation of management so that the business endures as a partnership owned and managed by the principals

The various ownership and financial models in place in the seniors housing industry can be complex and will dictate feasibility of the various financial transition options. In fact, many founders and organizations are considering future ownership options that may not have been considered in the past. However, in general, when considering transitioning ownership to the next generation of management, there are several key questions that must be addressed:

> **"Today, there are many organizations that see opportunities with the seniors housing space. This includes firms outside the US that may want to expand. Some [in our industry] are looking at those opportunities."**

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Who should participate in future ownership?

True equity ownership is typically limited to a fairly select group of individuals. In terms of factors to consider when selecting participants, owners typically look at contribution to the business, retention risk, trust, tenure, prominence with investors/partners, judgement, and raw talent. It is also important to consider the context of future leadership. For example, if an organization will be run by a single leader (not the founder), that individual should be an owner and should have more substantial interests than his/her direct reports. Similarly, the vision for long-term ownership should be considered. Some founders wish to create a more broadly inclusive partnership which in turn calls for a more participatory model than a simple founder-to-successor transition of ownership.

How much ownership should be shared with the team? Over what time period?

The decision of how much equity to share, and over what period of time, is closely related to the current owners' motivations for doing so and how tightly held ownership is currently. Retirements/departures generally lead to greater sharing of ownership over a shorter period of time; if no such departures are anticipated, less may be shared. Moreover, single owners tend to share more equity than in cases where there are already multiple owners.

In cases where there is sufficient time to do so, FP often recommends transitioning equity interests via a phased approach over multiple years to ensure a methodical and gradual approach. This gives all parties involved the chance to get comfortable with the approach and ensure the construct is operating effectively rather than undertaking a single, transformational shift all at once.

Timing is also a key consideration for any company undertaking an ownership transition, particularly given the volatility of the past couple of years (and the potential continued volatility going forward). There are many organizations within the sector that have experienced financial hardships due to the pandemic and other factors. As a result, they may be sitting at materially lower valuations than they would have been several years ago. Owners of these platforms may be reticent to sell at a historically lower value and may wish to instead hold off transitioning ownership until the company has stabilized and regained some of its value. This delay, however, may or may not align with succession timing and must therefore be carefully managed. Conversely, there are some firms that have fared well and have strong future prospects which may command an attractive valuation that encourages existing owners to consider a sale, particularly if it better aligns interests and helps to ensure the platform's long-term viability. All told, timing is undoubtably a factor that owners will have to consider as part of their equity ownership transition.

How should ownership be transitioned to the next generation?

Enterprise ownership interests are often transitioned via one of four approaches (or a combination thereof):

1. Buyout approach

i. Interests are redeemed at the current valuation of the enterprise

ii. Payouts typically made over a multi-year period (3-5 most common)

iii. Valuation may be based upon a formula, appraisal, or negotiation (the latter is the least preferable approach)

iv. Seller financing for incoming "next generation" owners is common

2. Earnings payout (tail share) approach

i. Retiring owner receives cash flow distributions for a fixed period of time or until a fixed dollar-figure is reached

ii. In the fixed duration approach, the departing owner may receive pro rata distributions for the entirety of the tail period or may receive a declining percentage of such distributions but for a correspondingly longer tail

iii. This approach has the benefit of avoiding a valuation exercise; it is also self-funding

3. Recapitalization

i. Preferred stock/common stock approach – utilizes a preferred/common share structure whereby legacy partners' interests are converted to preferred "A" interests

4. Equity grants

ii. In some cases, legacy owners may choose to grant a portion of their interests to incoming partners

iii. In these cases, the approach is usually an acknowledgement of the contributions of long-tenured employees; it can also help to make such transitions financially affordable for incoming partners

iv. Such grants are often used in conjunction with purchased interests to ensure appropriate alignment and "skin in the game"

Determining the go-forward approach to equity interests is a critical component of long-term transition planning and must be carefully integrated into any truly comprehensive succession plan.

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Governance/decision-making

Leadership and ownership are closely tied to governance and decision-making. Therefore, it is also critical to consider if and how decision-making authorities will evolve during any leadership transition.

A Board of Directors is the most common mechanism for addressing a more robust corporate governance framework. In the private company context in particular, Boards can be helpful during generational transitions as they can:

- Give owners comfort that their interests are being protected
- Provide a valuable resource to new leaders by providing mentorship and counsel
- Share their experience and expertise
- Provide a mechanism by which the founder can take a less active day-to-day role while maintaining oversight and ultimate decision-making authority (by serving as Chairman)
- Reduce the risk of reliance on a single individual; represents an enduring structural option for addressing robust governance
- Provide a risk mitigant in the event something happens to the majority shareholder/Chairman

Boards are also viewed favorably by investors and partners and may help to mitigate concerns about a leadership transition.

For private companies, Boards can take many shapes and forms with some adhering to a public company standard and others taking a less robust approach. The most critical elements are ensuring appropriate oversight authorities and populating the Board with individuals who provide diverse and relevant expertise.

“Leaders want to stay involved but protect their organization. Both the governance and ownership process is complex for the seniors housing industry.”

CONCLUSION

While the seniors housing industry will continue to face challenges, it is approaching a time of great opportunity for development, innovation, and growth. The industry's future leaders will have a significant impact on how the industry evolves. As such, it will be critical to ensure a group of experienced and well-rounded next-generation leaders is ready to step in. A broad-based focus on succession planning and leader development should be a prominent component of every seniors housing organization's human capital strategy. Properly addressing this issue will increase the comfort level of investors and employees alike and will help to ensure the health, stability, and longevity of the business.

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