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THE FASTEST ROAD TO OVERPAYMENT

Underestimating the value of the due diligence process

By Kevin W. Smith, CPA

For the past several years, there have been over 200 consummated mergers annually in the insurance industry. Among other factors, the consolidation has been fueled primarily by both the appetite of the national firms as well as the rise of the average age of owners of insurance agencies and brokerages.

While there are several terms out there to describe a “transaction” (e.g. merger, sale, purchase, acquisition of a book of business, etc.), there are two basic forms of deal structure: (1) asset and (2) stock. As an advisor to the insurance industry, I have had the opportunity to speak with many participants in the transaction process. Many of those with whom I have spoken over the years seem to view the due diligence process as either an afterthought or superfluous, especially in an asset purchase. However, overlooking this part of the transaction process, whether the transaction is structured as an asset or a stock purchase, can be quite costly.

Here are two examples of conversations with principals that I have had of late.

Conversation #1: Everyone has executed an employment agreement.

Bill: “I am finalizing my acquisition of XYZ Agency tomorrow.”

Advisor: “Congratulations! I think I am familiar with that company. The principal is close to retirement age, right?”

Bill: “Yes, he has had one foot out the door for several years now. Fortunately, he has Greg and Todd who have handled the lion’s share of production over the last few years.”

Advisor: “I think I have met both of them at a seminar. They seem like good guys. Have they executed employment agreements?”

Bill: “Absolutely! That was the first question I asked as well. I have been through them both, and my attorney is happy with them.”

Advisor: “Great. If I remember correctly, there is an account executive there. Mary is her name, I think. Anyway, she has been instrumental to the owner’s book of business. In fact, I think she has been handling them for several years now. His book was almost half that of the entire agency.”

Bill: “Yeah, I have not spent as much time with Mary, but you are right, she is a critical factor there, and I think she is on board with this.”

Advisor: “Yes, but have you read her agreement as well?”

Bill: “Well, as I understand it, only Greg and Todd have executed agreements.”

Advisor: “Wow. I would suggest you postpone a day or two and spend some time with Mary to make sure she is in fact planning to stay around after the merger. Furthermore, you should make it a condition of closing that Mary execute an employment agreement, and also that the owner use a portion of the proceeds to compensate her for executing the agreement to enhance its enforceability.”

Conversation #2: Paying for something that you do not actually own or control.

Advisor: “Jack, I guess it has been six months now. So how is the integration of ABC Agency going?”

Jack: “Well, I suppose that depends upon what you mean. In so far as systems, culture, etc. goes, it has been like an extension of our current operations. In fact, I have been surprised at how easy it has been.”

Advisor: “That is good news. You sound like there is something else there. Is there something I am missing here?”

Jack: “Well, we took your advice and did our due diligence. However, I guess we were not all that familiar with the process though, as 30% of the book has already left the company.”

Advisor: “What? You are kidding me? What happened?”

Jack: “Well, we made sure everyone had executed an employment agreement, but we forget to check one step. We did not reconcile the production records to the financial records. Had we done that, we would have noticed that there was a sub-producer out there who was responsible for 30% of the total book of business. And to top it off, he has a history with one of our staff, and decided to move his book elsewhere.”

Advisor: “Yikes. Well, you were at least somewhat protected, right? At least a portion of the deal was based upon retention of the book of business, right?”

Jack: “Actually, no. We agreed to pay the entire price up front in exchange for a lower valuation of the company.”

In both situations above, had the proper due diligence been performed prior to the consummation of the transaction, the buyer would not be faced with the difficulties they are now encountering. While it may appear that the buyer in the first situation is simply encountering some "last minute" negotiation headaches. It is just as likely that Mary would not be willing to be a part of the organization on a "go-forward" basis. If that were to occur, Bill would be forced with attempting to renegotiate a lower purchase price to discount the owner's book of business, which may not be received well on the other side of the fence.

In the second situation, Jack has made a poor investment. While this purchase may not sink his ship, it certainly was not the best option for the use of excess capital. If 30% of the firm being acquired were to evaporate overnight, the payback period would significantly increase. Had Jack simply reinvested these excess funds in his own agency or even parked them in a "safe" or risk-free investment, he would most likely have had a better return on his investment.

In either case, however, the issue could have been avoided had the acquirer performed the proper due diligence in the beginning of the process. Once the terms of the deal have been agreed upon in principle, the due diligence process should begin. The results of due diligence would then be used to both ensure the terms which have been agreed upon are fair to both parties based upon their previous agreement, and further, the findings should also be incorporated into the purchase and sale agreement.

An acquisition is deployment of capital, and it should be considered only with an eye towards the future financial reward which will most likely be yielded to the buyer. If the risk outweighs the reward, then one would be ill-advised to make such an investment. Herein lies the basic dilemma, if a buyer does not perform adequate due diligence on the seller, then there is no guarantee that he or she is paying for what they intended to acquire. After all, it is important to remember that sometimes the best deal that you do is the one that you don't do.

The author
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