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AGENCY FINANCIAL MANAGEMENT

SELLER BEWARE – HAVE YOU DONE YOUR DUE DILIGENCE?

Underestimating the value of the due diligence process

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Mergers and acquisitions within the insurance industry over the last few years have been at a peak. The market is flooded with multiple different types of buyers including private equity groups, top brokers, banks, regional and local agencies.

These buyers are usually eager to add revenue to their top line and many are willing to put forth offers at a premium. Upon receipt of a Letter of Intent ("LOI") to purchase your business, a seller may be hypnotized by the fact that their years of hard work are about to be turned into cold, hard cash in the form of a down payment and most likely subsequent earn-out.

The buyer will likely send the seller a request form for a number of documents to be reviewed during due diligence, including corporate records, regulatory, financial, book of business and operations, taxes, insurance, and human resources, to name a few.

In many scenarios, the seller, provides the requested information for the buyer to sift through, and awaits the transaction close. Is that a prudent role for the seller to play?

This is likely the seller's largest investment. A home is also a large investment; however, would a seller go under contract to sell a home without first requesting documentation that the buyer was qualified for financing?

A premium offer from a "smooth talking buyer" doesn't necessarily mean that the buyer has the ability pay now, or in the future.

What is a seller able to do to protect themselves when divesting their business? The due diligence phase of a transaction is the time for both the buyer AND seller to get a peak at the inner-workings of their future partner. Many sellers overlook this opportunity and hang their hat on the LOI and warranties and representations provided in the impending purchase agreement.

With years of transactions experience under our belt, we hear the good, the bad and the ugly from individuals in the industry who have experienced the transaction process first-hand. The following are a few examples of instances where the seller did not perform proper due diligence procedures on the buyer:

Scenario #1: Does the buyer have the money?

Periodically, we will hear a story from a seller who was "left at the alter". Typically, the seller signs a letter of intent with a party who represents themselves as being reputable and having the "financial backing" to consummate the transaction. The seller opens themselves and their office up to the buyers due diligence team to review all of their operations. Meanwhile, attorneys from both sides are in the process of drafting and reviewing purchase agreements and both parties are racking up hefty bills from advisors. However, at the last minute, the buyer walks away.

Typically, this is a classic case where the buyer is unable to come through with the financing. This may occur with private equity groups who are dependent upon investors to approve and fund the transaction as well as insurance agencies who intend to retain bank financing for a transaction.

To prevent such a scenario from occurring, we recommend seller's inquire about the financial backing of the buyer and make sure that the buyer is "qualified" to do the deal and has the funding to close the transaction.

Scenario #2: Where is my earn-out payment?

A typical transaction to purchase an insurance agency involves some amount of a down payment with the remaining portion of the purchase price tied to retained revenues or earnings before interest, taxes amortization and depreciation ("EBITDA") over a specified future period.

Even if a buyer has the financial backing to fund the down payment on a transaction, it is critical to insure that the buyer will be able to fund the earn-out as well. An upfront payment varies for each transaction; however, it is not unusual to have at least 50% of the value connected to an earn-out scenario.

As an initial step, the legal documents need to be specific about how the earn-out is to be calculated, over what time period payments and perhaps most importantly, the seller should make sure that they have control over the components of the earn-out in the post-transaction environment.

In addition to the above, the seller should not only request that the buyer disclose their financial condition upfront during the due diligence phase to determine the financial ability to fund the down payment, but should review historical financial information of the buyer to insure sound financial practices are in place. The seller should be comfortable with the integrity of the buyer's financial managers and gain a conceptual understanding about their financial practices. Does the buyer have an annual audit or review performed? Is there an active board of directors that review the quarterly or annual financial statements and approve transactions?

A buyer which is taking on large amounts of debt to fund multiple acquisitions should be looked at with a higher degree of skepticism. What will happen when all of the earn-out payments are triggered, will the buyer's debt service be too much to handle?

Scenario #3: Is the buyer financially responsible?

Unfortunately, there are many buyers out there who have all of the appearances of financial well-being; however, a good examination of their financial statement indicates otherwise. As a first indicator, the seller should calculate the trust position of the buyer. Do cash and trade receivables sufficiently cover carrier payables? If not, this should be considered a red flag.

An agency which is out of trust is likely to have poor financial management. An out of trust position may mean that they have too many overhead costs and are using policyholder premiums to fund the day to day operations of the company. It may indicate that management or employee compensation is too high, that debt service is unmanageable or that the company is just living outside its means.

The potential result of an out of trust position varies by state as some states do not have laws on the books to set such standards; however, in general, carriers require an in-trust position in their contracts and employment and non-compete agreements typically refer, in general, to the fiduciary responsibilities of the employer. Thus, if an agency is not in-trust, it may result in carriers canceling contracts and producers walking out the door with their book of business in tow, leaving the company with no legal recourse in either case.

Another simple exercise is to compare the buyers financial statements to benchmarks set by industry peers. Compare the percentage of personnel, selling and administrative costs to those incurred by peers. Is the company in-line with such costs? If not, why not?

Scenario #4: How will EBITDA be impacted by hiring new producers?

A seller who agrees to an earn-out scenario will likely go to great lengths to increase their top line revenues. Initially, one might think that they should hire new producers to increase their revenue, which in turn, would increase the earn-out payment.

New producers often take at least two years to validate. Thus, during the earn-out years, new producers may provide a source of new revenue; however, they will likely be compensated via a fixed salary, rather than commission, until the producer validates. Thus, it is extremely likely that during the first few years the producer will make a minimal impact on top line revenues while drawing a comfortable salary and absorbing dollars that would have resulted in a higher earn-out payment under an EBITDA calculation.

We suggest that a seller discuss the buyer’s plan for growth during the due diligence phase and make sure that everyone is on the same page. It is okay to hire new producers, but if this is the case, make sure that they are not included in an EBITDA calculation if the seller is being paid based upon the net return of the agency rather than top line growth.

The author

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