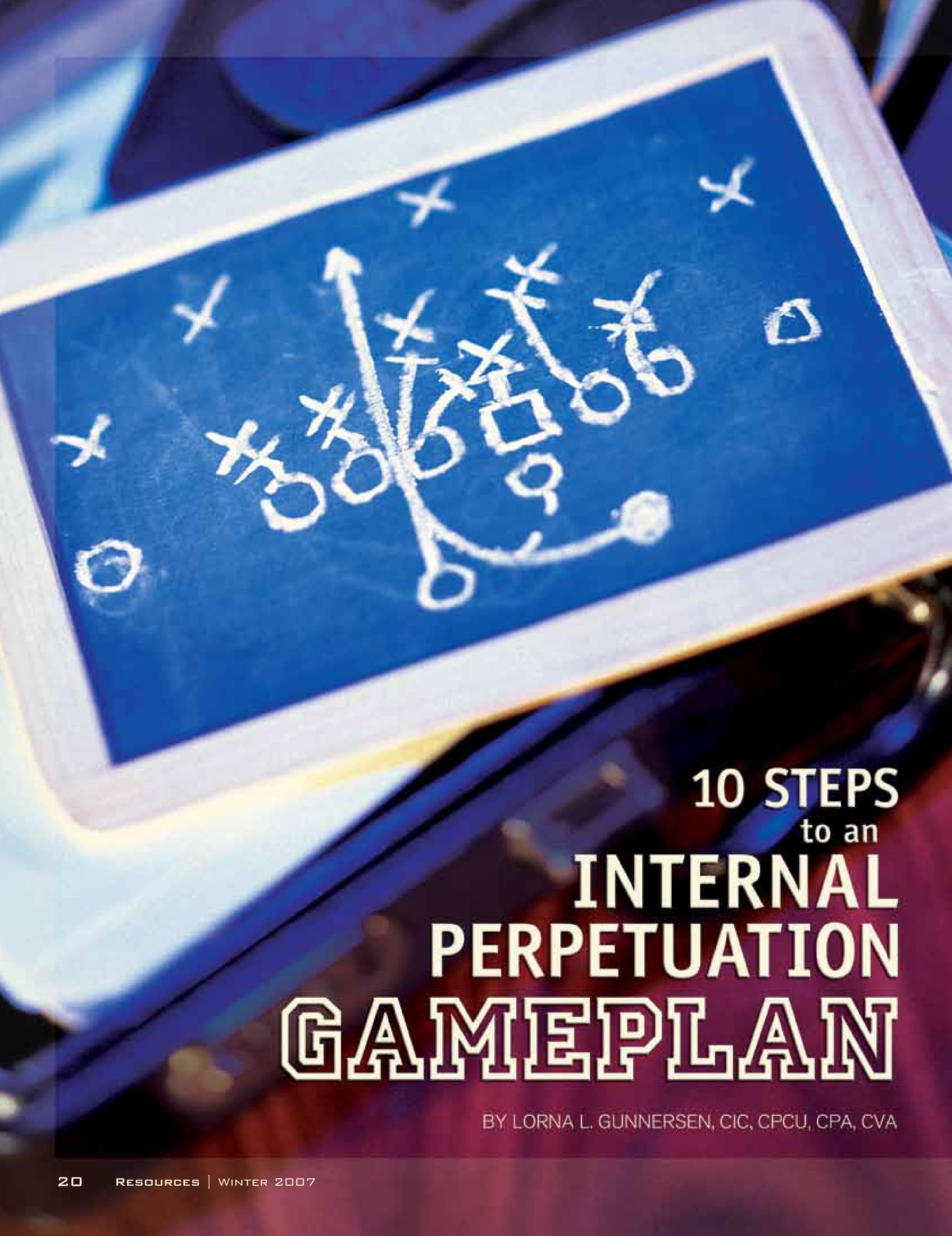

10 STEPS to an INTERNAL PERPETUATION GAMEPLAN

BY LORNA L. GUNNERSEN, CIC, CPCU, CPA, CVA

Generally, a buy/sell agreement does not constitute a perpetuation plan...

One of the goals of many agency owners is to perpetuate the business to their employees. The problem is, with all the struggles of running an agency and maintaining a successful book of business, few agency owners find the time to sit down and put pen to paper to write the perpetuation plan. When the time comes to retire, owners often find they either do not have the employees in place to perform a successful perpetuation or that their retirement needs will require more monetary benefit than an internal perpetuation may offer. A perpetuation plan is an important part of your agency as it enhances your agency's value. A solid perpetuation plan assures that an agency will continue to operate as a going concern should something happen to an agency owner or owners.

Typically, when we meet agency principals we are told that their perpetuation plan is their buy/sell agreement between the principals and the agency. Generally, a buy/sell agreement does not constitute a perpetuation plan, as it does not make a provision for the sale of each owner simultaneously, nor does it address operating issues. Buy/sell agreements rarely specify which individual will be in charge of the agency after the principals are gone, which may lead to tension among the remaining employees.

The first thing agency owners must do when planning an internal perpetuation of their agency is to recognize what a perpetuation truly is—an acquisition. Unlike most agency acquisitions, which are funded by the cash flow streams from both the acquiring and acquired agency, an internal perpetuation is typically funded by the seller. The internal perpetuation team borrows funds from the seller or a third party that will be paid off with the after-tax cash flows generated by the agency. This borrowing of funds is often referred to by a different name: a leveraged buyout ("LBO"). Across all industry barriers, LBOs frequently fail as a result of poor upfront planning. Due to the risks involved with leveraged buyouts, particularly in an industry known for little or no physical assets to use as collateral, it is often difficult to secure outside financing, and the seller usually acts as the lender. In instances where an external party is retained for financing, the borrowed funds are contingent upon a personal guarantee of the buyout group, and the funds borrowed are limited to the personal assets available for collateralization.

Perpetuation can be broken down into a 10-step process as follows:

1) Identification of the buyout group
2) Determination of the owners' needs
3) Data collection
4) Valuation
5) Sensitivity analysis
6) Negotiation
7) Due diligence
8) Legal documentation
9) Closing
10) Integration

While each step is equally important, as you go through the steps, continually focus on integration step #10 and how it will relate to your agency. Integration is the process by which structural and operational changes are "integrated" for the agency to operate on a go-forward basis.

Identification of the Buyout Group

The first thing agency owners must do before embarking down the path of an internal perpetuation is to determine which non-owner employees are capable of participating in the buying group. Typically, the buying group is mainly comprised of producers, as the only way to successfully perpetuate an agency is through sales. It is preferable to have two or three producers for each owner in a perpetuation. The more people in the buyout group, the better the chances of a successful perpetuation.

A retiring principal should be highly concerned with who is managing the agency. Will the buyout group make good managers? Will they be able to manage the agency and fund the perpetuation through sales?

While a top producer might be a great salesperson, this does not guarantee his or her talents will translate to agency management. It is also no guarantee that the top producer should lead the new agency. Remember, the only way to get through a perpetuation plan is through sales, and it may not be a good idea to make the top producer a manager of the agency and divert his focus away from sales.

The retiring principal will often be the lender and note holder for the sale. Thus, it is in their best interest to select a buyout group which is able to fund the perpetuation. Any default on the note returns agency ownership to the selling principal, which results in the selling principal being back to square one at best—assuming the agency isn't a shell of what it used to be. Therefore, it is important that the buyout group not only be able to manage the agency, but sustain profit levels sufficient to complete the purchase.

It is important to be cognizant of the fact that the employees outside of the buyout group might not react well to the new owners' ways of doing business. Make sure that other key staff members will continue on after the sale; or if they are not amenable to the sale, a plan is in place to deal with the potential loss of the employee and business disruption. Also, remember to constantly focus on integration.

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If an agency does not have the staff in place to perpetuate internally, all is not lost. Depending on the time frame, an agency may be able to hire new producers to perpetuate the agency. This becomes a problem as not every producer will be successful, and not every successful producer will want to be an agency owner. An agency owner should be upfront with a new producer about his or her prospects of agency ownership at the time of hiring, so as not to mislead a producer who may be unhappy if the agency ultimately is sold to a third party. Keep in mind that newly hired producers often do not work out and stay with an agency. In some cases, an agency with one owner may need to hire four to six producers in order to find an internal perpetuation team. This is a significant fixed cost to take on as the producers vest, and may be cost-prohibitive for many agencies.

Determine the Owners' Needs

An agency owner might say that he would like to perpetuate internally rather than sell to an outside party. But does he really mean it? If an agency owner wants to sell for the highest price, an internal perpetuation will not achieve that goal. In an internal perpetuation, only the after-tax cash flows of the agency will fund the buyout, so the seller must be lenient in terms of price and length of the loan. This is why the seller's expectation of his agency value is important. Owners going into the perpetuation with the mindset that their agency is worth a specific multiple will often find that the perpetuation team cannot afford the buyout. While it is important that the buyout group be highly motivated to grow revenues and manage expenses in order to fund the acquisition, it is also important at this stage to make sure that owners are familiar with the price differences between asset and stock purchases. Agencies incorporated as a C corporation will need to sell stock to lessen their tax burden, while the buyout group will require some concession on price to make up for the lost amortization benefit of an asset sale.

Data Collection

In this step of the process, the internal buyout group will view financial statements and employee agreements, often for the first time. At first glance, it might not seem that a perpetuation is possible, given the low profitability of the agency. After all, that is how the buyout is funded. Keep in mind that agencies typically maintain low profit margins to minimize taxes; however, there are often several items that may be reduced considerably, or even removed, during the buyout of the agency. While you might not get the membership at the country club like the previous owner, you will get the opportunity to own the agency.

> An agency owner might say that he would like to perpetuate internally rather than sell to an outside party. But does he really mean it?

The review of employee agreements is an often overlooked part of the data collection process. Not only will the buyout group determine if they are in place, but they will be made aware of any inconsistencies within the documents. These inconsistencies can range from vacation policy to new and renewal commission percentages. It is important to realize at this step that employees who have not signed an employment agreement with non-compete, non-solicitation, and non-piracy clauses may choose to leave the firm. If the employee is a producer, there is a risk that such employees will take their book of business with them if they leave the agency.

Valuation

The value of the agency is an important part of the perpetuation plan; after all, the valuation sets the purchase price to be paid by the buyout group. There is no quick and dirty answer to the valuation of an agency. The use of generic multiples is one way to decrease the chances that your perpetuation will be successful. As previously stated, LBOs often fail; improperly valuing your agency may be the fastest way to put you out of business. Clients often say that a friend of theirs sold their agency for three times commissions, or that they read agencies are selling for nine times earnings before interest, taxes, depreciation, and amortization. It is important to realize that someone will never tell you that they sold their agency for what many consider a low price. Furthermore, articles mentioning inflated earnings multiples are often being written as marketing tools for consultants. When it comes to valuing an agency the old adage still holds:

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"If it's too good to be true, it probably isn't." Generic multiples do not take into consideration different risk characteristics among agencies, and often do not mention if the balance sheet was part of the transaction.

The valuation should be performed by someone who knows the intricacies of the retail insurance agent. The balance sheet and income statement will be analyzed to determine what pro forma adjustments need to be made for the buyout group to perpetuate the agency. ***Items such as excessive compensation, unnecessary benefits, and other expenses are removed if they are not vital to the success of the agency.*** The goal of the pro forma adjustments is to adjust the income statement to appropriately reflect costs required to sustain the production level.

Sensitivity Analysis

An often overlooked, but vital part of a perpetuation plan is the sensitivity analysis. The sensitivity analysis matches operating cash flows to financing obligations using various cash flow scenarios. The sensitivity analysis can answer questions about the likelihood of the perpetuation plan succeeding if the cash flows do not grow, are stagnant, or decline over the perpetuation period. While it is unlikely that a perpetuation would be successful if cash flow decreases, the analysis will illustrate to the buyout group the cash flow requirements necessary for the buyout to be successful. Another important aspect of the sensitivity analysis is that it may assist in determining the terms of the note from the seller or lender. A typical perpetuation takes seven to 10 years to complete; as the length of the note increases, the purchase price may be increased. However, the higher price comes with a catch—a longer buyout period will increase the risk associated with the perpetuation.

Negotiation

Recognizing that the needs of the buyer and seller may often differ, it is necessary to negotiate the terms of the buyout. If the buyer requires a larger payout, then they must lengthen the time period of the buyout. Another factor that needs to be negotiated is the down payment. Unless the buyout group has access to a large sum of cash or is able to personally finance a loan, a down payment is typically avoided. One factor to consider when asking for a down payment is that, while few banks will lend the money necessary, a bank will require that its note is senior to the seller's financing. This means that if the note on the down payment is not paid, the seller will not get paid.

Due Diligence

Due diligence is the opportunity for the buyout group to perform an "inspection" of the company being purchased. All too often this step is overlooked in an internal perpetuation, as the buyout group assumes that they have a keen understanding of the operations of the business. However, this is the time for the buyout group to ask questions and obtain supporting documentation, to gain a thorough understanding of the following areas: corporate structure and organization, licensing and regulatory matters, financial statements, book of business, operations, real property, personal property, information technology, debt, insurance, taxes, human resource matters (including compensation and existing employment agreements), and any other items relating to the agency. ***Due diligence is the "safety net" which allows the buyout group to uncover issues and concerns to be addressed in the purchase agreement, or in some cases, decide that they wish to withdraw from the purchase.***

There are several risks for both sides of a leveraged buyout. The buyer is at risk of the retention of books of business and key employees who might leave the firm when new management takes over. The seller has the burden of financing and ultimately collecting cash flows generated from the perpetuation. In order for this to occur, a certain revenue level must be achieved, costs controlled, and sufficient after-tax cash flows used to pay the note. Both parties are concerned that the business will continue to run. Those are the known risks, and due diligence can help reduce these risks. More importantly, due diligence may uncover unknown factors that may increase or decrease the purchase price.

Many agencies feel that due diligence is not necessary during a perpetuation. After all, the parties have worked together for several years. We feel that the buying group should not take for granted that the agency they are buying is clean from a due diligence perspective. A good analogy for the importance of due diligence is a home inspection. You would not purchase a home without an inspection, so why would you purchase a business, which is likely to be more expensive, without one?

Legal Documentation

A perpetuation plan is worthless if it is not legally documented and signed by all parties involved. This is the opportunity for all parties to prepare for the unexpected. "What if…" questions should be answered in legal documents. These questions can include:

What if key personnel leave the agency?

What will the name of the agency be going forward?

What happens if the loan defaults?

Who will keep contingencies earned by the seller?

Will the seller remain as an advisor?

What non-compete provisions need to be in place?

It is important that your perpetuation plan be reviewed by a licensed practicing attorney familiar with business succession. Both buyer and seller should retain separate legal advice.

Closing

After steps 1 through 8 are completed and the final terms are agreed upon, the deal is ready to close. Closing is the time that all parties sign the deal and ownership is transferred. If all the above steps have been addressed, closing should be a painless process.

Integration

Integration is the most complicated step of the perpetuation and, as mentioned, is the process by which structural and operational changes are

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ASK Bettie

Do you have a question to “Ask Bettie?” Bettie Duff, senior vice president of Customer Care for The National Alliance, has been with us for 28 years, and is *the* person to contact for information on just about anything related to operations and procedures. Email your burning questions to: **bduff@scic.com**.

Dear Bettie–

Is it correct that I must be a dues-paid CISR to attend classroom William T. Hold Seminars or take them online?

–A California CISR

Dear California CISR,

We are delighted to be able to offer additional update options via the William T. Hold Seminars and, yes, these programs will be exclusively available to dues-paid CISRs as of January 1, 2008. As a dues-paid CISR, you deserve more update opportunities, and your dues payments make the development of these programs possible. Two 4-hour online Hold Seminars will complete your annual CISR update requirement. The online Hold Seminars give CISRs flexibility in topic selection and the convenience of completing them as their own schedules allow. More new online Hold Seminars are coming soon—visit www.TheNationalAlliance.com.

—Bettie

P.S. By the way…dues-paid CICs, CRMs, and CSRMs are also eligible to attend Hold Seminars for state CE, but not designation update credit.

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“integrated” for the agency to operate on a go-forward basis. Some integration questions include:

What communication to the employees is necessary?

How will the insurance carriers be notified and what impact, if any, does the perpetuation result have on the carrier agreement?

Will the change in ownership be communicated to the agency’s customers?

Is the name of the agency going to change or stay the same?

Are all employees going to be retained or are terminations necessary?

Are there new compensation policies that need to be implemented?

Will there be new automation systems purchased?

Former employees may now be owners. Coworkers are now bosses. Management will now consist of new people who might have a different management style. If integration has been at the forefront of each step of the process, it will proceed with minimal disruptions.

We often hear buyout groups seeking to reward themselves as owners by increasing their salaries. As we have mentioned before, it is important to reduce fixed costs. Rewarding yourself with a raise will increase fixed costs and increase the risk of defaulting on your loan. Increasing production will increase your compensation and the revenue of the agency, resulting in a much better way to reward yourself for ownership. Another comment we often hear from buyout groups is that they will hire new producers to help sell themselves out of debt. New producers take time to vest; during that time you must pay them a salary. Salaries are fixed costs. Hiring producers will not help you pay off your debt.

Insurance for Your Agency

Internal perpetuation planning is not something that can be put off until the last minute. It will take time to identify which personnel can and will help perpetuate an insurance agency. Additionally, parties involved in perpetuating an agency must keep an open mind and make concessions to each other to guarantee that the perpetuation will succeed. A perpetuation plan offers insurance to your clients that the agency will be around after the owners retire. You spend all day selling insurance to your clients. Doesn’t it make sense to offer the insurance that your agency will be there for them after you retire? ■