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AGENCY FINANCIAL MANAGEMENT

PERPETUATING IS EASY — ISN'T IT?

Several factors to consider

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The population is aging and the United States is expecting to see a significant rise in the number of retired people in the coming years, which raises the question: Have you considered your retirement plan lately?

Instead of the infamous "Joe the plumber," let us consider the case of Joe the insurance agent. Joe is 59 years old. He had been planning his retirement well, but lately things have started to look a little dicey. Joe thought his retirement savings were safely invested, but they took a bath during the economic downturn. He is left with less-than-anticipated retirement funds and he is seriously worried about the future. Sound familiar?

So what can Joe do? Perhaps it is time to focus on the one asset that is under his control—his agency. As advisors in the insurance industry, agency owners often ask us what they should be doing to prepare for the perpetuation of their agency. The answer is simple: Start planning now.

Leveraged buyouts

First, let's remember that a perpetuation is a sale of the business. If it is an internal perpetuation, it is the sale to a team of investors who currently work within the agency, which is effectively a leveraged buyout (LBO). It is either funded by a bank loan or, more often than not, via seller financing (i.e., the seller acts as the lender, with the cash flow of the business being tapped to fund the purchase over a period of time). LBOs generally strike fear into most investors, given their high rate of failure, and a perpetuation should be treated with similar caution. Whether the perpetuation is financed by an external group or via the seller, ultimately the agency's cash flow will be the only source for repayment, which adds greater emphasis on ensuring the future success of the company for all parties.

The buyout group

Back to Joe. The first question he needs to ask himself is, "Who is the buyout group?" This is probably the most crucial step in the process. In many cases, it may be clear. In Joe's case, his son, Joe Jr., will eventually take over. Sounds simple, but if Joe is viewing the situation with an objective eye, he has to ask some tough questions, starting with whether his son has the right mix of talents.

Sales talent is always key, but management talent is critical too. Will Joe Jr. have the support of all the staff? Will he be able to retain employees? As was previously mentioned, it is critical to both sides that the new ownership succeeds. The worst-case scenario for a retiring principal who has financed the perpetuation is that the agency fails: the new owner(s) cannot make the purchase payments, and the retired owner regains control of an agency which is a shell of its former self. So, once again, although the buyout group may be obvious, will it actually be able to deliver? If not, should an alternative buyout group be sought?

Valuation

Having considered his strengths and weaknesses, Joe has decided that Joe Jr. is up to the task of running the agency, and that he has a willingness to buy it in the future. The next fundamental question is—what is a fair price for the transfer of ownership?

The fair value for the agency needs to be determined and the valuation method should be part of the perpetuation agreement. Value is often based upon a multiple of earnings, typically based on earnings before interest, taxation, depreciation and amortization (EBITDA), but this valuation may be translated into a multiple of revenues.

Let's consider the case of Joe's agency. Unlike his retirement funds, Joe has managed his agency's balance sheet conservatively, and the company is in solid shape, in an "in trust" position with good liquidity. Chart 1 above summarizes the earnings valuation.

So Joe and Joe Jr. may choose to prescribe a valuation of 6x EBITDA or may prefer 1.67 x revenues. Whichever is agreeable to both, this will add certainty to the valuation and avoid any future argument. However, the downside to this approach may be that the prescribed methodology or multiple that is normal market practice at the time of drawing up the agreement may not be so when the company actually perpetuates.

Retirement needs

The majority of agency sales are structured to include an initial down payment with a schedule of future earnout payments based on meeting certain performance targets. In the case of a perpetuation, significantly more of the purchase price is made via the future earnout payments, usually spread over a longer period to accommodate the new ownership. Joe needs to consider what cash flows from the perpetuation will fit his retirement needs. The critical issue here, though, is taxation.

Joe needs to be aware of what the actual cash receipts will be to him on an after-tax basis. The company may be subject to double taxation on the sale of assets (for example, if it is organized as a Subchapter C corporation, and it sells its assets), which would significantly reduce the actual cash received by Joe. He may need to consider filing an election to convert to a Subchapter S corporation (S Corp), which would remove the double taxation threat; but he should be aware that in most cases there is a 10-year period before the conversion benefits are fully realized, so is Joe happy to wait another 10 years before retiring?

A further issue relates to the timing of the capital gains tax on the earnout payments. Given that the consideration for the agency is spread over time, Joe may simply pay capital gains tax as each payment is received, or alternatively he may prefer to pay the whole amount upfront. You may ask, why on earth would he want to pay the government ahead of time? Well if there are anticipated tax rate changes, it may be beneficial to pay at the lower rate. However, there is a downside to paying the tax upfront, in that if Joe were not to receive the entirety of the consideration upon which his tax estimate was based, his recoupment would be severely limited by capital loss tax regulations.

Sensitivity analysis

So we have considered Joe's needs in structuring the financial terms of the transaction, but we should also consider this from Joe Jr.'s perspective. There is, of course, the issue of whether Joe Jr. can afford to fund any initial down payment that Joe may need. Then looking to the future payout schedule, Joe Jr. will be paying for the acquisition out of the future profits of the agency. Running different scenarios may quickly show that the expected cash flows will not cover the costs.

In the case of Joe, he will need the full value paid at the time of transfer, so Joe Jr. needs to go to the outside credit market to fund the purchase. Joe Jr. is able to borrow funds at 5.5% from the bank, provided he pays the first $500,000, which by itself may be a large stumbling block. In considering the future after-tax cash flows of the agency, Joe Jr. has assumed no growth and a 40% tax rate, which for illustrative purposes here has been reduced to 35% to allow for the deductibility of the interest expense. Chart 2 above shows scenarios for borrowing the money.

So as things stand, Joe Jr. will have a problem. First, he has the significant question as to whether or not he will be able to afford the $500,000 down payment when the agency perpetuates. Then for the earnout payments, the questions that need to be asked include: What level of growth will be enough to cover the shortfall? Will it be possible to meet this shortfall via expense cuts or via growth of the top line? Alternatively, should the valuation be reduced to facilitate the process? As can be seen, the sensitivity analysis from the buyer's side is critical in the whole planning process. What initially seems like a great plan could be worthless if the buying group won't be able to fund it. At the end of day, the ideal perpetuation plan should be challenging to the buyer group but not so challenging as to be unachievable.

Due diligence

A further issue to consider for the future is due diligence. Over these last few years, Joe Jr. has really gotten to know how the company works and by the time it comes to perpetuate, he will know it inside and out, so he suggests that some costs could be saved by not conducting a formal due diligence. Although well intentioned, Joe Jr. could easily be creating future problems for himself.

A third-party view of a company can identify issues which, while known by all parties, had not been considered a risk and that could have an impact on the fair valuation of the company. It can be thought of as analogous to buying your friend's house. Although your friend has maintained the house well and you trust him or her, you would be unlikely to go ahead without an inspection by a qualified individual. The use of an outside professional to review makes all sides feel more comfortable and reduces the possibility of unforeseen problems emerging and causing a strain in the relationship later on.

Conclusion

For any perpetuation agreement to work it must be fair to all sides, and all parties should be involved in the negotiation of the agreement. Once completed, there must be buy-in from all sides for it to succeed. The use of a qualified agency advisor to assist in the perpetuation plan can often facilitate this process, as well as being able to perform the valuation and run the sensitivity testing scenarios to stress the plan and assess whether or not it can be workable.

The author

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