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AGENCY FINANCIAL MANAGEMENT

GET SERIOUS ABOUT YOUR PERPETUATION PLAN

Unrealistic expectations can doom internal perpetuation plan

By Kevin P. Donoghue, CFA, CPA

The 75 million Americans who are part of the Baby Boom generation are now beginning to approach retirement age, and the average age of the United States population is increasing. Likewise, the average age of owners of insurance agencies and brokerages is also on the rise.

As advisors who focus exclusively on the insurance industry, we find that agency perpetuation is a hot topic of conversation for both the current owners who are considering a sale, and the next generation of prospective agency principals. When I take part in conversations about agency perpetuation, I am often surprised by the numbers of misconceptions and the lack of planning relating to the process.

Here are a few examples of recent real conversations I have had with individuals on both sides of the perpetuation transaction—sellers and buyers—with the names of individuals changed.

Conversation #1: The perpetuation plan that appeared to be a "lay-up" may have just bounced off the rim.

Advisor: "Hey, Tom, how is everything going with the perpetuation of your agency?"

Tom (current agency principal): "Great. My daughter, Emily, is really doing well as a producer and is firmly positioned to be my perpetuation for ownership of the agency."

Advisor: "She must be excited. I hope she is ready to take on the financial burden of buying you out."

Tom: "What burden? My agency makes a lot of pre-tax money. This will be a lay-up for her."

Advisor: "That's great, Tom, but since you are a C-Corporation, she will likely be paying the obligation with after-tax dollars. Have you and Emily done any after-tax financial scenario analyses to determine how she will be able to purchase your agency?"

Tom: “No, we didn’t get that far; we just decided that she should be able to purchase the agency at a fair price because it is very profitable.”

Advisor: “Tom, for your sake and your daughter’s sake, you need to take a close look at the process. She needs to plan ahead and know that if the business doesn’t grow, she may have to take a pay cut to stay current with any note obligation.”

Tom: “She has three kids getting close to college; I’m not sure she can afford that.”

Advisor: “Well, Tom, it sounds like you and Emily need to consult with an advisor on how to make the deal work, and you need to consider what happens if revenues don’t continue to grow or expenses are not properly managed.”

Conversation #2: The inexperienced business appraiser creates unrealistic valuation expectations.

Steve: “Can I talk to you about the MGA (managing general agency) I work for?”

Advisor: “Sure Steve; what’s on your mind?”

Steve: “Well, I am currently a 10% owner in the business, and my partner wants to retire at the end of the year. He hired a local business valuation firm to appraise the business, and they said our agency was worth about 1.5x gross commissions. Our agency is quite profitable, but I am not sure whether the cash flows produced could pay off a perpetuation loan.”

Advisor: “On the surface the valuation seems high. Assuming that your net revenues are about 50% of your gross commissions, this would imply a 3x net revenue valuation. What is your EBITA (earnings before interest, taxes, and amortization) margin off net revenues?”

Steve: “Before dividends and personal expenses, we produce about 30% pro forma margins.”

Advisor: “That implies a 10x EBITA multiple, which is totally unrealistic. How did the appraiser justify the valuation?”

Steve: “The appraiser said that he was involved in a couple of retail agency deals in the past few years and both sold for about 1.5x gross commissions. As a rule of thumb, he assumed we would too. My partner knew the guy from his golf club and he barely charged us for the work.”

Advisor: “As you know, there are huge differences between a retail agency and an MGA. For an MGA the key revenue figure is net revenue, which is defined as revenue after outside brokerage expense. Comparing gross commissions of a retail agency to gross commissions of an MGA is like comparing apples to hubcaps. It sounds as though the appraiser wasn’t familiar with MGAs. Also, any time we hear that someone is using a ‘rule of thumb’ approach, we get concerned.”

Steve: “Well, what do you suggest?”

Advisor: “Your instincts about the valuation being too high are most likely right. The problem now is that it may be difficult for you to convince your partner otherwise. I would suggest you get a second valuation opinion from a qualified advisor who understands your business model and can help you and your partner put a realistic perpetuation plan in place. Unless your partner is realistic about the true valuation, the perpetuation is almost surely doomed to fail.”

In both of these scenarios, the parties tried to shortcut the perpetuation process. Without solid perpetuation planning, the risk of failure dramatically increases. You should be aware that an “in-house” perpetuation is a really a leveraged buyout (LBO). The inside team borrows the money to purchase the agency and uses the future cash flows of the business to pay off the note(s).

There have been numerous studies produced on LBOs over the years, and the conclusions always seem to say that approximately 75% of them fail to achieve their objective. The most common reason given is failure to plan appropriately for risk. Optimism abounds in buyout plans. Risk associated with failure to grow (or even revenue contraction) is rarely assessed. This is especially of concern in a market with softening prices.

When you go to purchase a house, do you assess how you will make the monthly mortgage payments? What happens if you lose your job? What happens if your Adjusted Rate Mortgage (ARM) causes your payments to skyrocket? Understanding the upside of an opportunity is one thing; not planning for the downside is completely another.

Let’s discuss a fundamental valuation example for the retail agency discussed in Conversation #1 (above). Assume the following:

Now let’s assume the money can be borrowed over 5, 7 and 10 years:

As you can see, absent of growth, the business will not generate enough cash flow to pay the annual payments, no matter what terms are used for the note. Therefore, in order to succeed: (1) Selling Agency Owner (Tom) will have to sell the business for a much lower price than Fair Value, or (2) The In-house Buyer (Emily) will have to either cut expenses (often by taking a major pay cut), and/or grow the operation significantly. Any loss of revenue will dramatically increase the chances of default.

Running some basic scenarios will quickly force Tom and Emily to come to grips with the challenges of a successful perpetuation. From here, a real perpetuation plan can start to emerge.

How can an agency get serious about developing a perpetuation plan?

Step 1: Identify individuals who should be considered to be on a perpetuation team.

Step 2: Ask the individuals if they have an interest in becoming an owner.

Step 3: Engage an experienced industry advisor to prepare an agency valuation and financial perpetuation plan.

Step 4: Include all parties in the review of the valuation and plan. This includes all existing principals and all potential principals.

Step 5: Run various scenarios for all participants so that each individual understands the risks of the deal and can assess his or her true willingness and capability to become an owner.

Step 6: Implement a perpetuation plan that is achievable, but not easily achievable.

Keeping the kite in the air

What is the secret to keeping a kite in the air? The answer is keeping the correct amount of tension on the string. A successful perpetuation plan should also have the correct amount of "tension on the string." Any member of the buying group who is not losing sleep worrying about the success of the buyout will likely fail to put forth the effort needed to avoid default on the obligation.

Requiring the buying group to borrow money with personal liability exposure creates tension. Another tension-creating truth is knowing that if they don't grow the firm, they will likely take cuts in compensation. Knowing that the firm is focused on the success of the buyout and the fear of letting down the other members of the buyer group, creates tension.

Ultimately, the reward of ownership is great, but the risk of failure is high. If you take your perpetuation lightly, you greatly increase the risk. Agency principals and potential buyers need to get serious about a perpetuation plan. *

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