MYSTIC CAPITAL ADVISORS GROUP, LLC

Quit Taking Perpetuation Planning Lightly!

By Jim Bethea

We live in a world of procrastinators. We all remember last minute test cramming, last minute trip packing, and last minute sales budget preparations. It is just the reality of the situation, not many of us plan well in advance. But when it comes to your retirement, you had better buck the last minute trend. Perpetuation is a serious event, quit taking it lightly!

The average age of agency principals is approaching 60 years old and many are finding themselves forced to sell to an outside firm. Having waited until past the twelfth hour, they find internal perpetuation options expire. If you need to sell your business, the more options you have, both internally and externally, the better chance you have of realizing a fair price for your agency.

At Mystic Capital, we find great reward in helping younger producers and managers develop a plan to purchase the stake of retiring owners. When these perpetuations succeed, millionaires are created. But the key to success lies as much in the preparation as it does in the execution. The primary reason for failure is the lack of detail planning and analysis. The buying and selling parties waited until the last minute to put together a plan and never understood the true after tax cash flow scenarios required to make the perpetuations successful.

Not all principals can perpetuate their agencies internally. If the in house group (1) is not focused on growth, (2) lacks sufficient financing or (3) is nearing retirement themselves, their undertaking of a perpetuation is a wasted effort. The exiting principal is financially at risk if the individuals purchasing the business are unable to successfully execute the plan of transitioning the business. Remember, Perpetuation is a serious event, quit taking it lightly!

Items that need to be addressed prior to any perpetuation implementation include:

1. What is a perpetuation? Seems basic, but few recognize it for its true risk.
2. Is there a group of capable inside producers and managers that can successfully run and grow the agency? If so, do these individuals want to be owners?
3. What is the valuation of the Agency? Do the Buyer and Seller agree on it?
4. What are the post transaction risks of the business?
5. What is the structure and terms that the perpetuation should take?

What is a perpetuation and a perpetuation plan and why should my agency have one? A perpetuation is a sale of an ownership stake to an inside group. It is most often paid for with a Seller financed note, which makes it a leverage buyout (LBO). Leverage buyouts have historically failed 3 out of 4 times across all industry barriers. The failure of most is the lack of realistic planning and valuation up front. A perpetuation plan is a detail planning document that incorporates a valuation, post transaction risks, analysis of perpetuation options, and a future after tax cash flow sensitivity analysis. Any perpetuation plan which does not incorporate these elements is a fake.

Is there an in house group capable of perpetuating the owner? It generally takes more than one producer to perpetuate an owner. Recognizing that the agency needs to continue to grow in order to pay off the acquisition, the more active the producers are in participating in the buyout, the greater the chance of success. But being capable of being an owner is not enough; individuals must want to be an owner.

Although a group may look good on paper and have a strong affinity felt by the current owner(s), it does not mean they should be allowed to purchase the owners interest. Each member needs to be analyzed on their own merits and capabilities of contributing to the long term growth of the agency. The group as a whole needs to be analyzed and assessed whether they can be an effective partnership. Furthermore, the current owners need to be patient with their payments terms to allow for some leeway in the plan. It takes a capable and willing buyer along with a patient and willing seller to make a perpetuation work.

How much is my agency worth? Several articles in today's press quote multiples of revenues or EBITDA or pre tax earnings to determine agency value. But be careful what you are reading. There are several factors that these articles fail to take into account, including corporate structure of the business, whether the quoted multiple was based on pro forma or actual figures, whether the composites are asset or stock transactions, and whether or not the balance sheet was included in said valuations. Not mentioning these factors make such figures virtually worthless.

We have witnessed too many Agencies that have put together buy sell agreements and perpetuation plans based upon a figure quoted in an article only to find out they have drastically overvalued the business and are unable to fund the buyout obligations.

Since the accurate determination of your agency's value is vital, it should be prepared by a professional. Such professional should thoroughly understand the industry as well as the tax issues associated with all parties. They should be capable and experienced in structuring present value buyouts that achieve the ultimate objective for all. Such a third party professional will usually act as the buffer between the buyer and seller to ensure fair play in the negotiations.

What are the post transaction risks of the business? Items such as retention of key accounts, key employees and key markets are all vital in considering buying out an owner. Additionally, to protect the acquired investment, it is essential that the perpetuating group ensure that employment agreements, including non-compete, non-solicitation and non-piracy provisions are in place. Furthermore, adequate life insurance must be retained on the principals of the business. Whatever the risks perceived, they must be addressed prior to the purchase to ensure the proper protections are put into the agreement for both the buyer and seller.

How should I structure the sale of my business? Since a perpetuation plan ultimately involves selling your interest in the agency, the owner must think about how the deal will be structured and what type of transaction it will be. Based upon the corporate structure of the Agency (C Corporation, S Corporation, etc.) and the interest for sale, the optimal purchase structure (stock versus asset) of the transaction should be determined. Additionally, based on the after tax cash flow projections of the business, the time required to fund the buyout should be agreed upon as well. Where as the typical funding required by an external buyer is 5 to 7 years, a perpetuation generally takes 7 to 10 years to payoff the purchase obligation.

Designing and implementing a successful perpetuation plan is one of the hardest aspects of running a business. Planning for one's exit is exceptionally hard and easy to put off. But with your retirement on the line, you can not afford to wait until the last minute. Perpetuation Planning is a serious strategic event, quit taking it lightly!

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