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How to avoid the need to sell

Consider the people, agency valuation, capital and time

By Tim Cunningham and Dan Menzer

Estimates vary somewhat, but most put the estimated number of independent insurance agents in the U.S. somewhere around 35,000—down from the 40,000. Where did these agents go and why? It's not like we make buggy whips or another product for which demand has dwindled. A need for the traditional insurance agent still exists in our marketplace. And, for those of us in the business, we know it can be rewarding financially. So, why aren't more agencies perpetuating their businesses successfully?

Part of the problem is perspective. Too many agency owners view their ultimate exit strategy as an event they make happen when they're ready to retire. But in reality, perpetuation is a long-term process that forces many agency owners to sell if not properly designed and executed. It doesn't have to happen this way for most firms, but avoiding the issue isn't going to make it go away. Your best chance for successful perpetuation lies in careful planning of the process over years—not months—before you want to retire.

Before we explore the success factors related to perpetuation, it's important to understand why so many agency principals sell their businesses instead of keeping them in the family, or at least within the existing corporate structure. Most reasons we hear ultimately fall into one of the following categories:

1.) **Expedience.** Selling the agency can be much less time consuming than the long-term process required to transition its ownership and leadership. If the agency principal waits too long to initiate a viable perpetuation plan,

selling likely will be the only means of capitalizing on the value of his or her life's work.

2.) **Financial gain.** Selling the agency to an outside party almost always results in a greater financial reward than selling to a team of inside people. Outside buyers may be willing to pay a premium if the agency fits their strategic plan.

3.) **Strategy.** Some owners sell their businesses not because they want to retire to the lake house, but because they want access to additional resources, such as markets, ancillary services or personnel, which they can't access by themselves due to agency size and revenues.

Excluding a strategic sale, which is a decision more about growth than about selling a business, how can agency owners improve their chances of achieving successful perpetuation if that's the route they choose?

We believe there are four critical components to agency succession plans, and we refer to them as "PACT." When agency principals build a plan focused on these concepts, we've found they're more likely to control their exit strategy and to succeed. The concepts in PACT are:

- **P**eople
- **A**gency valuation
- **C**apital
- **T**ime

People

The most important aspect of any ownership perpetuation process is the people to whom the current owner will sell the business. These professionals will:

1.) Assume responsibility for leading the agency into the future.

2.) Manage day-to-day operations as well as the strategic goals and accomplishments of the agency.

3.) Potentially replace the lead sales person to ensure that business continues to grow.

Whether one person or several takes on these responsibilities, together they form a daunting task that should not be taken lightly.

When considering your agency's perpetuation candidates, a number of issues should be addressed whether or not they are current employees. In a small agency with one or two lead producers and related support staff, the candidates should be able to wear all hats: one for management; one for sales; another for leadership; another for product knowledge; and one for the culture of the firm. In larger agencies, these responsibilities are distributed across the management team, but each one still must be addressed in the perpetuation process.

A popular assumption about perpetuation is that the candidate is working already for the company and simply must be led like a horse to water. But if it were that easy, it wouldn't be called "work." For a small firm that hasn't invested already in a viable succession candidate, the recruiting process can be a significant drain on the organization. The time and money required to identify the needs of the agency and the most appropriate person to lead it can be significant. And, if the first person chosen doesn't have the strength and breadth of skill sets as originally believed, you'll have to replace him or her and start the process all over again.

Leaders of family firms often assume their children can be developed into leaders, managers and sales executives with the same level of success as their predecessors. Unfortunately, business genes don't pass automatically from one generation to the next, and not everyone is destined for insurance greatness due to heritage alone.

Another problem family-owned firms may encounter when recruiting future leaders: The potential glass ceiling faced by prospective employees who have a different last name. Every effort needs to be made to place your most qualified people—and these qualities include cultural, ethical, personal and philosophical views as well as their professional capabilities—into the perpetuation strategy. Once you've chosen, let these employees know they have a future in the agency's leadership, then groom them over a period of years to expose them to the rigors and realities of agency management fully. We say "years," because these things take time and capital, and must be planned and implemented well in advance of any retirement considerations.

Agency value

A second key to building a successful perpetuation plan is realism about the value of the agency and how that value is calculated. Sellers who set an unrealistically high purchase price for their agency, possibly because of inaccurate anecdotal data or information on what a third party offered for another agency, may get a big surprise upon returning from vacationing in the Caribbean only to find out the agency is unable to make this year's promissory note payment. Clearly, such mistakes can lead to fiascos for all parties involved.

There are many different definitions of value, and it's critical that parties to a perpetuation plan use the right approach when establishing a basis for the purchase. As much as we'd like to refer to an agency's value as a multiple of revenues, we must remember that true value lies only in the future profitability of the business.

When determining the value of an agency for sale to the next generation of owners, we strongly recommend that agency principals avail themselves of independent counsel. Ask an objective insurance professional that is not associated with your agency to perform a risk assessment and an analysis of historical and projected sustainable profitability. The outcomes will determine the appropriate valuation model, and it must include an evaluation of the firm's balance sheet.

In an internal ownership perpetuation process plan, it's key to remember that the buyer, who for all practical purposes is the agency itself, can pay only what can generated by the business or resides in cash reserves. Outside buyers are different, and they may have strategic reasons for executing a purchase, including the ability to combine the business with another and generate efficiencies due to size and duplicate personnel. Thus, an outside buyer may acquire a 25 percent-margin business and generate 30 percent or more incremental margin, allowing the buyer to pay more, all other facts being the same. In an internal perpetuation strategy, these efficiencies and overlapping personnel don't exist.

The value of an agency under an internal perpetuation strategy is based completely on the cash flow that can be generated by the agency, as we said above. If owners wish to continue drawing big salaries and taking profit out of the company, the value of the future profits will be minimal. Instead, if the buyer(s) and seller(s) treat themselves like employees and maximize long-term profitability and efficiencies, both parties should be satisfied with the value paid and received for the business.

One other comment on value: Purchase prices (of 100 percent ownership transitions) that cannot be supported by projected agency cash flow over a period of six to eight years likely indicate that the agency's value has been set too high. Stretching payments over a longer period of time would ease the cash burden, but think about it: Would you pay for a car for more than eight years, or a house for 50 years?

Capital

Many perpetuation plans involving the buy-out of a significant owner require more cash in the early years than the agency can generate through normal operations. Unless the agency or its buyers want to borrow money or contribute capital to meet the excess cash demands, management will need to have built up a level of cash to cover these shortfalls sufficiently.

Generally, agency perpetuation plans are not tax-efficient, meaning it's going to require more cash to meet the cash demands of the plan. In a stock redemption, the purchase of agency stock is made with after-tax dollars. In a transaction between shareholders, the buyer generally requires enough after-tax compensation funding from the company to generate the cash necessary to meet the purchase price payment obligations. In either event, the Internal Revenue Service is party to the transaction.

However, regardless of the form of the transaction, the only way owners can increase an agency's capital base for supporting the future ownership transition is to build up liquid assets through retention of earnings over time. Doing so will impact the agency's tax burden or cash position of agency owners negatively. But, building up a rainy-day fund for perpetuation needs or other capital requirements of the agency such as producer recruiting, infrastructure development or as a backstop in case the economy and/or insurance market soften (like that ever happens at the same time) has never created a problem for any agency we've ever worked with in the past.

Time

The one factor shared by all successful perpetuation strategies is sufficient time to plan and implement each of the perpetuation components. From recruiting and grooming potential candidates to building a capital base to support the ownership transition, agency principals need to accept that perpetuation is a long-term planning and implementation process.

Without qualified candidates, a reasonable agency value and capital in place, you'll need a minimum of five years to set up and implement a workable plan, even if all goes smoothly. Should perpetuation candidates leave, agency value slump, or capital be redirected, you may need as long as 10 years to complete your plan.

Summary

Agency perpetuation is not the goal for every agency principal, but it is for those who wish to see their legacy carried on to the next generation of owners. Usually, agency principals seek outside expertise when planning for perpetuation, since it requires input from tax, legal and financial professionals who are familiar with the brokerage industry. These consultants can ensure that everything is being done to build and support a successful plan. Following the "PACT" approach helps identify the key attributes of a successful plan, but ultimately you need to take the following actions to make it work:

- Define your time horizon;
- Work with professional advisors to develop a viable plan from all perspectives; and
- Pull the trigger and put the plan into action.

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