Be Prepared

Steps to take before selling your agency.

by Timothy J. Cunningham and Daniel P. Menzer

Clients frequently ask, "What do we need to do to prepare the agency for a sale to maximize the transaction value?" In the same context, a frequent mistake is not to ask the question.

To arrive at an answer, it's helpful to think about what should be done before a home is sold. Nonessential items are eliminated and some cleaning and painting are done to spruce things up. For an agency, it's much the same—and now is an ideal time to remove clutter and spruce up the agency if you're thinking of going to market.

These three critical areas of financial management should be addressed before putting the agency in play:

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▶ **The Big Picture:** Many agents don't know how to go about getting their business ready for sale.

▶ **What Needs to Happen:** Agency owners should address revenue and expenses, balance sheets and financial controls before putting a business in play.

▶ **The Payoff:** When an agency's financial house is in order, buyers perceive fewer risks, resulting in higher value to the seller.

1. Revenue and Expenses

The objective is to present a clear picture of historical results, which will be used to establish an accurate and meaningful projection of revenue and expenses by having an in-depth knowledge of the agency's revenue drivers. This is accomplished by developing protocols that monitor changes in customer revenue within the budgeting and monthly variance-reporting processes. These include:

• Expected renewal revenue in total and by producer.

• New-new business in total and by producer.

• Lost business in total and by producer.

• Changes in renewal revenue due to rate (i.e., hard or soft market) and/or exposure variances.

This information can play a powerful role in managing the agency's revenue and producer performance. Having this data, for example, removes uncertainties about why revenue is up or down this year versus last year, or which product line segments and producers are growing despite the difficult market.

Having this data also shows a buyer that you understand the dynamics of these revenue sources, including historical trends. What's more, projecting future agency revenue will be greatly enhanced through an understanding of what already has occurred and what could still happen in the form of new and lost business, renewal pricing, and other variances. Buyers can then focus on the future, knowing that past performance is the best predictor of future performance.

The only cleanup in revenue that may be required is elimination of non-owned books of business or vesting rights in producer books. Buyers typically purchase 100% of an agency's revenue stream without expecting to share a portion of future growth with producers or managers. Executing the buyout of non-owned business in advance of selling the agency will facilitate the transaction.

Additionally, it will likely prevent any partial owner of the book from feeling as though they have some control if these negotiations are done as part of the agency sale.

To motivate partial owners to act in the best interest of the agency, exchanging their book ownership or vesting rights with ownership in the agency may be the best solution.

The purpose of reviewing and eliminating unnecessary expenses now is to begin operating the agency prior to a sale in the same manner as after the sale. Doing so will instill in both principals and employees the need to constantly look for opportunities to improve efficiency, work flow and value.

Personnel costs, including employee benefits, often represent up to 60% of revenue. Thus, the salary line is most likely to contain excess costs. Buyers will seldom give full value for savings to be derived from future payroll cuts. But if the savings already have been reflected in the seller's operations, the buyer doesn't have to worry whether the current expense level is attainable and sustainable; it's already in place.

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Some of the more common situations seen in many agencies are:

• Not adequately capturing staff savings from technology and other process or efficiency initiatives.

• Retaining marginal staff in hopes they will be transformed into productive employees.

• Not replacing a "C" performer or two marginally performing employees with one strong employee.

• Retaining producers who aren't reaching their production goals, but are viewed as not really hurting the agency.

In reality, these books of business could be distributed among other producers and account managers without skipping a beat, other than saving the salary, car, expense account and office space of the producer in question.

At many agencies, revenue and profit growth are not in sync with compensation. Producer compensation tied to sales and revenue growth, along with a properly structured salary administration program for support staff, provides the incentive-based framework correlating compensation to performance with a corresponding impact on growth in revenue and profit margin. This presents a platform that is extremely attractive to buyers.

Outside of personnel costs, other discretionary and operational costs should be scrutinized to determine those that are necessary and critical to the long-term growth of the firm, and those that are luxuries or owner perquisites. Perks for owners are fine, as long as they can be easily identified and will go away following the sale. The problem is that perks can become entitlements that are next to impossible to reduce or eliminate.

Don't get caught in that trap. Set a threshold for owner perks based on ownership levels, and then allow people to use them as long as the agency's profitability warrants it. Then stick to the plan.

Other items that may deserve review include:

• Advertising, promotions and charitable giving. Are you getting the requisite "bang for your buck" based on new revenue opportunities?

• Vendor and purchasing management. If you haven't tested the market and pressed vendors for pricing terms and volume incentives, you may be leaving money on the table, both in current profitability and the resultant purchase-price value.

• Staff training and education. These should be at a reasonable level; otherwise, they may be viewed as a short-term profit enhancement that could act as a longer-term detriment to value.

There will almost always be expenses incurred by a privately owned company that will be seen as unnecessary by a third-party buyer. Discretionary compensation and ownership perks such as cars, club dues and travel are normal pro-forma adjustments that will be made to convert a seller's earnings into a meaningful picture of potential profitability. Take action before marketing the agency to minimize the number of pro-forma adjustments—especially those unrelated to ownership rewards. You will present a more credible earnings picture to prospective buyers.

2. Balance Sheet

Management should consider steps to eliminate noncritical items on the balance sheet and make sure all other assets and liabilities are properly stated or disclosed in notes to the financial statements.

Non-operating assets should not reside on the balance sheet, because they will likely not be part of any sale. Ownership of the building occupied by the agency is generally problematic, and should be transferred outside the agency. Most buyers do not want to be property owners; including building ownership in the transaction can be a deal-breaker, or at least delay closing.

Similarly, other noncritical assets belonging to the agency, including automobiles, artwork, marketable securities and other investments, should be transferred out. Buyers don't need or want assets not related to the core business.

Whenever possible, remove contingent obligations such as future purchase-price payments, deferred compensation, stock-appreciation rights, vesting commitments in ownership, books of business and branch revenue. Some may not be able to be cleared, due to the long-term nature of the obligation. Nevertheless, all pertinent and relevant facts about those obligations need to be disclosed.

Build up working capital to at least one to two months' worth of operating expenses. If you have excess working capital, use it to pay down any debt or unrecorded obligations. Buyers typically will require 30 to 60 days of working capital at closing. Anything less will be funded through a reduction in the purchase price. Any excess will be distributed to owners prior to closing.

Customer premiums receivable should be current, with limited or no balances outstanding over 60 days unless the situation is well-documented. Additionally, all customer credits should be processed and returned as soon as possible. Company payables should be current and reconciled with follow-up and research on any stale payables or return premium items due back to the agency. Customer receivables and company payables are scrutinized closely by buyers, even though they remain the seller's responsibility subsequent to the closing.

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Management should thoroughly review all asset and liability general ledger account reconciliations. Many times this simple oversight step is bypassed—only to find surprises, seldom good, at a later date. Buyers conduct a thorough review in due diligence, so a seller should be prepared for whatever they might find.

In particular, attention should be paid to:

- Monthly bank reconciliations with all reconciling items cleared in a timely fashion.
- Stale unreconciled items or balances with poor or no documentation or explanation.
- Aged customer receivables and premiums payable should reconcile directly to the general ledger. Any variances need to be researched and resolved.
- A fixed asset review to ensure all owned items are identified and reconciled to the ledger.
- If direct bill revenue is accrued, it must be reconciled and reviewed to be certain it is accurate.

3. Financial Controls

Management needs to be certain a robust set of internal financial controls exists to enhance the integrity of the financial statements. There should be a well-defined purchase and disbursement review and authorization guidelines, along with adequate segregation of duties within the financial or accounting area.

Controls should exist to avoid potential conflicts, whereby one person has the ability to initiate, approve and complete any form of a transaction. Even the most trustworthy employees have been known to improperly divert company resources for personal gain.

A senior manager must review and approve key financial information, including the reconciliations referenced above, and critical variance analysis, to ensure the accuracy of the financial information and related reports.

Steps to Take

Unfortunately, there is no common set of tasks every agency will need to complete before going to market. But these steps can serve as a guide to make sure the financial house is in order.

The impact of these steps on transaction value will vary from modest to significant. Just as important, however, a broader range of prospective buyers will be impressed, influenced and have a greater comfort level, resulting in less perceived risk in the transaction.

A final note: Although these steps are presented as preparation for going to market, they are also sound operating strategies that should be part of the agency's everyday operating plan. Operating at a high level of efficiency, maintaining an uncluttered balance sheet and having proper internal financial controls are good habits for every agency. BR