

Building Agency Value Through Perpetuation

By John Wepler

Editor's note: Agency perpetuation, or ownership succession for an agency, seems to be on the minds of many agency owners today. To address issues involved in planning for the transfer of agency ownership, the Independent Insurance Agents of Texas, through its annual Joe E. Vincent Management Seminar—to be held Jan. 25 – 27, 2004 in Austin—is hosting several special sessions that focus on agency perpetuation.

The following series of articles, written by consultants and agency principals, are presented in conjunction with the IIAT to help you get a jumpstart on a plan to keep your agency working for you if or when you decide to, well, retire ...

The number of independent insurance agencies with revenue greater than \$250,000 dwindled to 20,066 in 2000, from 35,000 in 1990. By 2010, the number of agencies will decline to less than 12,000. While some portion of consolidation reflects agencies taking advantage of the valuation premium in the market today, most deals stem from an inability to perpetuate ownership internally. It is estimated that 75 percent of agencies with revenue greater than \$2,500,000 will not perpetuate as no process has been implemented to drive agency value by recruiting, retaining and rewarding high performing producers and reinvesting in the balance sheet. This column will review concepts that should be embraced to build

agency value and make perpetuation a reality.

Recruiting to replace talent

While perpetuation is often perceived as a transaction, perpetuation is in reality a continuous process with neither a beginning nor an end. The most important ingredient in the process is people. Recruiting must be taken seriously as it typically requires at least two quality producers to buy out one shareholder. Unfortunately, only one in three producers succeed and even fewer achieve performance that justifies ownership. As a result, a typical agency must hire more than six producers before it can develop a staff capable of retiring the shares held by one agency principal.

To develop a staff capable of supporting perpetuation, agency owners must continuously evaluate the importance and age of each staff member and customize recruiting to perpetuate talent and key relationships long before an ownership transfer takes place. Furthermore, there must be a concerted effort to stagger the ages of shareholders to prevent an agency from being saddled with too much debt as buy-outs occur.

Producer retention through ownership

It is difficult to locate, hire and train producers that will perform. It is even more challenging to execute a process that will weed out non-performers and provide enough incentive to retain those that do perform. Agencies that attract producers with drive and entrepreneurial spirit have a process to clearly communicate expectations, hold producers accountable and reward performance through ownership. These agencies spend less time recruiting due to better success in creating and retaining a quality production staff.

Many agency owners feel that producers can be recruited and retained without providing an ownership incentive. Rewarding performance through commission splits, perks or book equity seldom attracts the type of teamwork and talent required to grow at an organic growth rate required for survival. The fastest growing agencies in the country offer agency ownership incentives and the slowest growing agencies do not. Agencies without ownership incentives typically attract producers satisfied knowing that they will never be an agency owner, the result of which is paltry organic growth insufficient to fund perpetuation.

Most producers leave an agency because of a perception that greater opportunity is available elsewhere. Producers lobby for higher commission splits because they attach security to their compensation as no retirement asset is being built through agency ownership. And, producers justifiably have little confidence that owners will eventually broaden ownership. In most agencies, ownership is stuck in a perpetual filibuster where promises made are not kept. Agency owners should clearly define the criteria and process to become an owner to prevent resentment and loss of perpetuation talent.

Perpetuation stock incentive plan

A perpetuation stock incentive plan can help turn producers into leaders. Perpetuation candidates with leadership capabilities are made, not born. Good producers have egos, are self centered, have a short attention span and seldom understand the big picture without proper guidance and leadership training. To help producers develop leadership attributes and work toward becoming shareholders, agency owners

should implement a process to track and communicate each producer's progress relative to stated objective and subjective criteria on a quarterly basis.

The best plans include a mechanism to help producers become comfortable with perpetuation debt and a financial incentive to maintain employment. The plan outlined in this column includes a stock bonus, subject to five-year vesting, equivalent to 30 percent of the value of a producer's book of business above a 15 percent net growth goal. Vesting ties producers to the agency, as unvested shares are subject to forfeiture if employment is terminated. To ensure that producers have skin in the game and to teach producers to become comfortable with perpetuation debt, producers must purchase stock from treasury to receive earned stock bonuses. Those producers that choose to forgo stock bonuses because of the resulting tax liability or the requirement to take on debt to purchase stock send a clear signal that they will not be willing to sign a note to buy out a primary shareholder when the day comes for a large ownership transfer.

Producers that take on and retire debt over a prolonged period of time learn to keep their lifestyles in balance to maintain their capacity to retire debt and to build personal net worth. Debt to the agency also helps build and test producer debt tolerance, which will enable agency owners to eventually become comfortable with accepting a large note versus forcing a sale. Such a plan takes the mystery out of a very important question: "Will our producers be willing to pull a dime out of their pocket when it is time for my buyout?" Such a plan turns the table on the production staff. Instead of pleading to participate in ownership, producers will be responsible for driving ownership opportunity. Independence will be "theirs to lose" as perpetuation will only occur if producers rise to the challenge and demonstrate that they are leaders capable of managing debt service, and are therefore worthy of the seller financed credit risk.

While such a plan will not suffice as a complete perpetuation plan, it does tie ownership to performance, provide a coherent definition of what it takes to become an owner and put an agency in a position to attract and retain a production staff capable and willing to take risk to make perpetuation a reality. Existing owners benefit financially from the plan as the dollar increase in their value more than offsets the resulting percentage dilution in ownership.

As illustrated in the following table, if such a plan motivates one producer to



improve net growth from 15 percent to 25 percent during the first three years, the existing owners drive their value by \$295,000 in return for sharing \$158,000 in value with the producer. While such an increase in value may appear modest, the true benefit comes from multiple producers stepping up performance, attracting additional entrepreneurial talent and driving the number of viable perpetuation candidates. It should be noted that the table does not illustrate the required stock purchases by producers in order to illustrate the value trade off driven by the plan.

PSIP Plan Overview

- Stock bonus: 30 percent of the value of the book in excess of 15 percent net growth
- Bonus shares subject to a five-year vesting
- Producer responsible for the taxes associated with the stock bonus
- Prerequisite to stock bonus - purchase equivalent number of shares from treasury at appraised value
- Agency to hold five-year note for the purchase of shares from treasury
- Unvested bonus shares to be held as collateral and released as debt is retired
- To be eligible, producer must attain a set of objective and subjective performance criteria.

Example Objective Criteria

- 3+ years experience in industry
- 3+ years experience with agency
- Individually develop commission book

of \$400,000

- Net new business production goal of 15 percent during prior year
- Attainment of cross-referral goals during the prior year
- At least one professional industry designation
- Involved in at least two community organizations
- Signed agreement with non-solicitation language
- Satisfy employee survey of leadership/management skills
- Achieve aged receivables minimum target during the year

Example Subjective Criteria

- Ability to communicate with others in agency
- Skills include new business, account handling, management, leadership
- Committed to the future of the industry
- Self-starter regularly demonstrating initiative
- Personal confidence
- Willingness to delegate and annually trade down bottom 20 percent of accounts to house
- Opinion of agency principals
- Positive attitude
- Demonstrated willingness to mentor young producers
- Field underwriting that demonstrates diligence and integrity

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Strength through retained earnings

Few agencies have enough capital to perpetuate. An undercapitalized agency cannot secure financing from a bank without requiring the departing principal to provide collateral for the note. If an agency does not have a strong balance sheet, a bank will not perceive the agency as a good credit risk. And if a bank does not have confidence that an agency can service perpetuation debt, why should a retiring agency principal? Faced with the decision to sell or perpetuate the agency, most aging owners choose a sale.

To be a good credit risk for a lender or a departing principal, an agency must have sufficient cash flow to support perpetuation, reinvest in the production staff and cover any future difficulties. Furthermore, an agency with a strong balance sheet can make a large down payment so that less of the future cash flow will need to be diverted to service the

remainder of the perpetuation debt. To build a base of capital sufficient for perpetuation, an agency should build and maintain a strong balance sheet by retaining earnings. A good indicator of balance-sheet strength is tangible net worth. Tangible net worth is the amount by which an agency's tangible assets (assets excluding covenants, goodwill, expiration lists) exceed liabilities. An agency with tangible net worth less than 12 percent of revenue will find it virtually impossible to perpetuate, especially if a sizable portion of the net worth is concentrated in fixed assets. Agencies serious about perpetuation should strive to maintain a tangible net worth ratio of 25 percent.

Securing independence

To perpetuate, agencies should implement a process to enable best of breed producers to participate in the risks and returns

of private ownership and to build personal wealth. A perpetuation stock incentive can help agencies attract entrepreneurial self-starters, drive production and create leaders that are capable of managing perpetuation debt. While breeding the next generation of leadership, the agency should build tangible net worth to provide the agency with sufficient cash flow after debt retirement obligations are covered for departing shareholders. Agencies that embrace such concepts will drive agency value by recruiting, retaining and rewarding high performing producers and will succeed in securing independence. ■

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PSIP Growth/Value Comparison Table

	Base	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7
Without Plan - Growth & Value								
Revenue - other producers (15% growth)	3,000	3,450	3,968	4,563	5,247	6,034	6,939	7,980
Example producer (15% growth)	400	460	529	608	700	805	925	1,064
Total revenue - w/o plan	3,400	3,910	4,497	5,171	5,947	6,839	7,864	9,044
Value - w/o plan (1.5 times)	5,100	5,865	6,745	7,756	8,920	10,258	11,797	13,566
Number shares outstanding	250	250	250	250	250	250	250	250
Per-share value	\$20.40	\$23.46	\$26.98	\$31.03	\$35.68	\$41.03	\$47.19	\$54.26
With Plan - Growth & Value								
Revenue - other producers (15% growth)	3,000	3,450	3,968	4,563	5,247	6,034	6,939	7,980
Example producer (25% growth yr. 1, 2 & 3)	400	500	625	781	898	1,033	1,188	1,366
Total revenue - with plan	3,400	3,950	4,593	5,344	6,145	7,067	8,127	9,346
Value - with plan (1.5 times)	5,100	5,925	6,889	8,016	9,218	10,601	12,191	14,020
Number shares outstanding (see below)	250	250.18	250.54	251.11	251.69	252.26	252.65	252.86
Per-share value	\$20.40	\$23.68	\$27.50	\$31.92	\$36.63	\$42.02	\$48.25	\$55.45
Stock Earned by Producer								
Example producer (25% growth yr. 1, 2 & 3)	400	500	625	781	898	1,033	1,188	1,366
Less: target (115% of prior year book)	400	460	575	719	898	1,033	1,188	1,366
Excess book	0	40	50	63	0	0	0	0
Agency value	1.5	1.5	1.5	1.5	1.5	1.5	1.5	1.5
Value of excess book	0	60	75	94	0	0	0	0
Sharing of excess	30%	30%	30%	30%	30%	30%	30%	30%
Value of bonus shares	0	18	23	28	0	0	0	0
Divide: prior year stock value	N/A	\$20.40	\$23.68	\$27.50	\$31.92	\$36.63	\$42.02	\$48.25
Fully vested number of shares bonused	0	0.9	1	1	0	0	0	0
Producer Share Vesting Schedule								
Year 1	0	0.18	0.18	0.18	0.18	0.18	0	0
Year 2	0	0	0.19	0.19	0.19	0.19	0.19	0
Year 3	0	0	0	0.2	0.2	0.2	0.2	0.2
Annual vested shares	0	0.18	0.37	0.57	0.57	0.57	0.39	0.2
Shares outstanding beginning of year	250	250	250.18	250.54	251.11	251.69	252.26	252.65
Total shares outstanding end of year	250	250.18	250.54	251.11	251.69	252.26	252.65	252.86
Leverage in Agency Value								
With plan - value current shareholders	5,100	5,921	6,874	7,980	9,156	10,506	12,063	13,861
With plan - example producer value	0	4	15	36	62	95	128	158
Total agency value	5,100	5,925	6,889	8,016	9,218	10,601	12,191	14,020
Without plan - value current shareholders	5,100	5,921	6,874	7,980	9,156	10,506	12,063	13,861
Without plan - value current shareholders	5,100	5,865	6,745	7,756	8,920	10,258	11,797	13,566
Current shareholders - increase in value	0	56	129	224	237	248	267	295

*Numbers have not been rounded so totals may not directly reconcile