



# The Private Ownership Study

*Successfully Navigating the Maze of Alternatives Available  
to Agents and Brokers Committed to Private Ownership*



# About The Private Ownership Study

With the first of the Baby Boomers turning 65 in 2010, the ownership landscape of the insurance brokerage business is entering a transitional phase. Agency principals are increasingly seeking liquidity for their agency investments. For some, it will mean a sale of their agency to a third-party. For others, it will mean remaining privately-held – an internal ownership transfer to one or more employees.

Many agency owners view “remaining privately-held” as a top business goal. Their agency ownership is their biggest and best-performing investment, and the ability to call the shots and control their own destiny is part of what makes the business fun. Further, they believe that the ability to offer ownership gives them a crucial edge in attracting and retaining talented employees. The commitment they have made to their employees is that they intend, one day, to transfer their ownership internally to the next generation.

While internal perpetuation has always been a challenge, today’s soft P&C market, weak economy, and changing healthcare landscape are making things even more difficult. Many of the perpetuation plans that were developed during better times are now under severe stress. With agency growth at a standstill and profit levels falling, the margin for error in these plans has

shrunk dramatically. Both buyers and sellers are wondering if their plans need to be adjusted.

Unfortunately, though, the information available to them can be confusing at best. A wide variety of outside professionals – financial advisors, lawyers, lenders, tax specialists and consultants – frequently provide conflicting and, in some instances, self-serving advice to agency owners and those that desire to be agency owners. What agency principals need is *not* more information. Agency principals need to start with a clear understanding of where they are and where they want to go. They need to be provided with a clear picture of the various ways that ownership can be successfully transitioned. Most importantly, they need to have access to tools and resources that can help them sort out which of those ways will work best for them and to ensure that all of the pieces are in place to successfully execute that ownership transition plan.

Our purpose for developing The Private Ownership Study is to help agency principals navigate the maze of perpetuation alternatives and create effective strategies to remain privately-held, if it is their desire to do so.

# Table of Contents

- ABOUT THE PRIVATE OWNERSHIP STUDY ..... 2
- THE FOUR PILLARS OF PERPETUATION ..... 6
  - What is Effective Perpetuation Planning? ..... 6
  - The Four Pillars – A Framework for Understanding Perpetuation ..... 7
- THE FIRST PILLAR: HEALTHY OPERATION ..... 10
  - The Perpetuation-Driven Profit Imperative ..... 10
  - The Perpetuation-Driven Growth Imperative ..... 12
  - Perpetuation and The Rule of 20 ..... 12
  - The Role of Risk ..... 14
  - The Balance Sheet ..... 14
- THE SECOND PILLAR: REASONABLE SELLERS ..... 16
  - Valuation ..... 17
  - Financing Terms ..... 19
  - Timing ..... 22
- THE THIRD PILLAR: ABLE BUYERS ..... 26
  - Financial Ability ..... 26

What Else Does the Buying Group Need? .....31

**THE FOURTH PILLAR: EFFECTIVE TRANSFER MECHANISM ..... 34**

Selecting the Right Transfer Mechanism.....37

Determining the Value of the Agency .....39

**CONCLUSION: PULLING IT ALL TOGETHER ..... 42**

Where Do You Begin?.....43

**ACKNOWLEDGMENTS ..... 46**

**APPENDIX A: NOTE ON ESOPS..... 48**

**APPENDIX B: NOTE ON VALUATION ..... 52**

**APPENDIX C: VIABILITY CHECKLIST ..... 56**

**APPENDIX D: SAMPLE MODEL..... 60**

# The Four Pillars of Perpetuation

There are tens of thousands of insurance agencies in the U.S. Reagan Consulting estimates the number to be approximately 37,500, but nobody really knows the exact number. Most are privately-held, local businesses.

Each year a small number of these agencies (approximately 200 – 300) sell to third-party buyers. On the other hand, the vast majority march on as independent firms and most intend to remain that way. Maintaining their privately-held status is important to many of them.

But transferring ownership in a privately-held business can be extremely complicated. When done correctly, the business can transition from one generation to the next even while continuing to prosper in the marketplace. When done incorrectly, however, it can mean financial and operational disaster. The difference between success and failure often comes down to effective planning.

## **What is Effective Perpetuation Planning?**

The goal of “remaining privately-held” seems pretty straightforward. But for purposes of this study, we would like to define perpetuation planning with real clarity. An effective perpetuation plan is an ownership transition program that will work not just for the “next transaction” but instead will work indefinitely.

Many agency principals focus entirely on the “next transaction.” They work hard to bring all of the pieces together – buyer and seller, valuation, timing, financing, etc. – but fail to build a more comprehensive approach that will work for subsequent transactions. In the worst of cases, in their fervor to consummate today’s deal, they actually end up doing things that doom their long-term goal of remaining private.

The purpose of this study is therefore to assist agency owners in understanding how to set up a perpetuation plan that will work not just for the next transaction, but for multiple generations of ownership transfers. In doing so, we are not assuming that those desiring to remain independent now have a goal to remain independent for eternity – not many of us think that way. We are assuming, however, that agency owners always want to have internal perpetuation as an option. Our intent is to explore plans that will, if adopted, help agency principals avoid a situation where they are forced down an ownership path against their wishes.

Ultimately, successful agency perpetuation – whether it is a sale to a third-party or an internal transaction – is about protecting the owners’ ability to choose their direction, without having their range of choices limited by factors or circumstances that could have been prevented.

### **The Four Pillars – A Framework for Understanding Perpetuation**

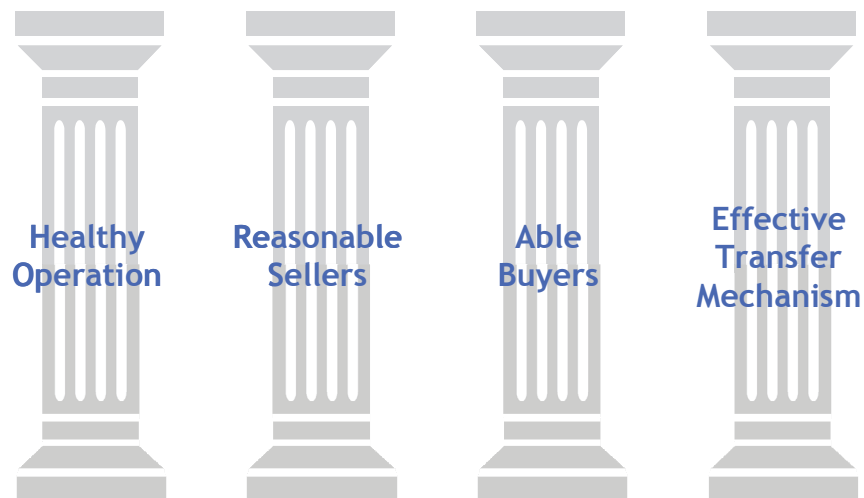
Maintaining a wide range of options requires balancing a dizzying array of intertwined variables. Indeed, the complexity of perpetuation planning can seem overwhelming. It is intimidating in a way similar to walking past the cockpit of a passenger jet and wondering – does anybody really know what all of those switches and buttons are for?

A key goal of this study is to demystify perpetuation. Can it be simplified? What are its essential parts? If it can be broken down, it can be better understood. In our experience, gained by working with hundreds of agencies to help them plan for perpetuation, it has become clear that there are four key elements of any successful perpetuation plan: A Healthy Operation, Reasonable Sellers, Able Buyers, and an Effective Transfer Mechanism. If any of these four elements are missing, the perpetuation plan will collapse. As such, we have labeled these the Four Pillars of Perpetuation.



We then set out to canvas the industry, aiming to better understand the pillars and to see which pillars were giving agencies the most difficulty. Our initial source for data was a 12 question survey that we have called the *Baseline Perpetuation Survey*. This survey was distributed to agencies across North America. It was designed to assess an agency's commitment to private ownership and the challenges faced in remaining private.

#### The Four Pillars of Internal Perpetuation

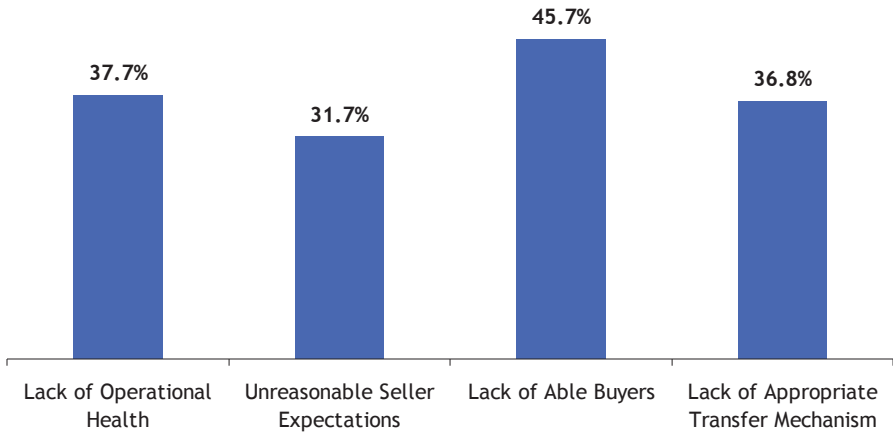


We anticipated 250 responses but instead received close to 900, which validated the importance of this topic to firms across the continent. The interest was especially high among larger firms. Nearly 25% of all firms in the industry with revenues of \$5 million or more participated: 205 out of Reagan Consulting's estimate of 900 firms nationwide. In the *Baseline Perpetuation Survey*, we asked participants to identify the three biggest challenges to perpetuating internally. The challenges identified came from each of the Four Pillars.

Our next step was to dive deeper into the actual perpetuation activities in the marketplace, exploring the dynamics within each of the Four Pillars and understanding what agencies are doing in each area. Exactly what steps are they taking and what techniques are they deploying to achieve their perpetuation goals? We invited the firms from the *Baseline Perpetuation Survey* that had expressed a strong commitment to internal perpetuation to complete a second survey, which consisted of 24 detailed internal perpetuation questions. 146 firms completed the second survey, which we

have called the *In-Depth Perpetuation Survey*. The bulk of this study will provide our findings for each of the Four Pillars of Perpetuation.

What are the Biggest Challenges to Perpetuating Internally?



Source: Reagan Consulting Baseline Perpetuation Survey

# The First Pillar: Healthy Operation

The ability to perpetuate any business begins with the operational health of the business. For an insurance brokerage, operational health encompasses a wide variety of factors including the quality of the sales force, the strength of the client support team, the carriers represented, the products and services offered, the types of clients served and a host of other factors. An agency should be strong in all of these areas while at the same time being diversified enough to avoid being too dependent on any one employee, carrier, product or client.

Ultimately, all of these raw ingredients of operational health are then integrated by an agency's leadership team to produce a stream of profits – hopefully one that is strong and consistently growing.

The value of an insurance agency can be derived by answering three basic questions about the profit stream and one about the balance sheet: How much profit margin is generated from the firm's revenues? How fast are the profits growing? How risky is the profit stream? How healthy is the balance sheet? Balancing these four indicators – profit margin, growth, risk and financial stability – is the key to a solid first pillar.

## The Perpetuation-Driven Profit Imperative

Agency leaders sometimes underestimate the importance of high profit margins. If asked, they would certainly agree that profits are important, but when operating their businesses, as long as they are “reasonably” profitable, they prefer to focus on other matters. At the same time, within many of these

Driving Profits - and  
Value - in the  
Insurance Distribution  
Industry



firms, the owners closest to retirement are expecting to receive a value for their shares that lines up with historical industry revenue multiples – frequently 1.5 times revenue.

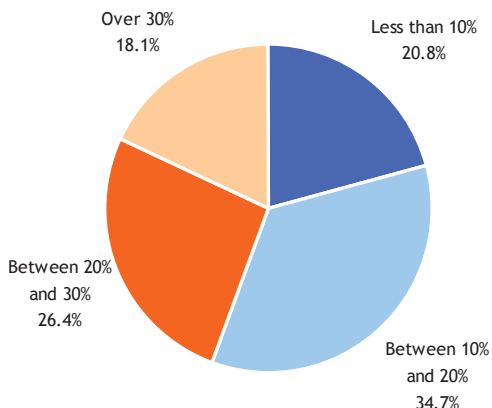
The problem with this, of course, is that today’s profit margins often cannot come close to justifying a valuation of 1.5 times revenue. For most agencies, an appropriate valuation multiple for internal ownership transfers falls within a range of 5 to 7 times EBITDA (see sidebar for an explanation of EBITDA.) In order to understand what EBITDA margin is required to justify a revenue multiple of 1.5, we can simply divide 1.5 by our 5 and 7 EBITDA multiples. The resulting range is 21% to 30%, with a midpoint of approximately 25%. Few firms are generating EBITDA margins this high in today’s market. As the table below indicates, 20.8% report they are earning less than 10%, with another 34.7% reporting they are earning between 10% and 20%. The bottom line is that today’s low profit margins are making it hard to justify valuations that satisfy seller expectations.

**EBITDA**

EBITDA stands for Earnings Before Interest, Taxes, Depreciation and Amortization.

When we discuss EBITDA in this study, we will be referring to what is known as “pro-forma” EBITDA. Pro-forma EBITDA is EBITDA prior to any extraordinary, non-recurring expenses and prior to ownership rewards.

**EBITDA Margins in the *In-Depth Perpetuation Survey***



Second, profit margins do not just validate value, they fund perpetuation. As we will see in detail later in the study, buyers rely on the profit dollars generated by the firm in order to finance their ownership purchases. Without these profit dollars, agencies will find that there are not many buyers lining up to purchase shares. After all, a buyer cannot fund ownership purchases with agency revenue – ownership purchases must be funded with agency profits.

### **The Perpetuation-Driven Growth Imperative**

Agencies must also grow in order to perpetuate, and this growth imperative is rooted in three realities:

- *Growth can provide purchasing power.* Growth in revenue will typically fuel growth in distributable profits, which will enable those who recently bought shares in the company to retire their ownership purchase notes over a reasonable time period.
- *Tomorrow's expected growth impacts today's EBITDA multiple.* The most important factor that influences where an agency falls within the typical 5 to 7 times EBITDA range is expected future growth. The higher the expected growth, the higher the multiple. In fact, mathematically speaking, the appropriate EBITDA multiple for an agency grows by 10% for every 2.5 additional percentage points of sustained future growth that is realistically expected. So an agency expecting to grow its profit stream by 7.5% per year going forward is worth 10% more than the same agency with a 5% growth rate.
- *Growth means viability.* An agency that does not grow loses its ability to compete. Its best people leave for greater opportunities. Its carriers leave in their search for agencies that can help them grow. Its clients leave because they are sought after by growing, more innovative brokers. And then, to top it all off, as the agency's ownership team advances toward retirement, there is no younger generation to purchase the agency's equity.

The truth is that an agency must be both growing and profitable – and in order to perpetuate there must be a healthy balance between the two. Is there an optimal balance?

### **Perpetuation and The Rule of 20**

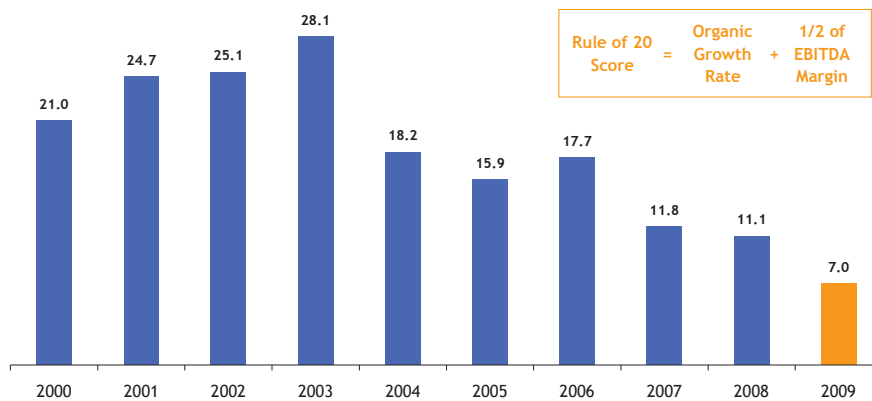
Reagan Consulting has developed a simple growth and profitability balancing equation that we call “The Rule of 20.” The Rule of 20 states that an agency will drive industry-standard shareholder returns if the sum of (a) its organic growth rate and (b) ½ of its EBITDA margin equals or exceeds 20.

We have examined the cost of capital in the industry and estimated that an industry-standard return for privately-held agencies and brokerages is approximately 15% - 17%. In other words, shareholders who are investing in

these businesses expect to earn 15% - 17% per year through stock price appreciation and / or shareholder distributions. When we have tested the annual returns generated by different combinations of growth and profitability, we have found that any time The Rule of 20 is met (any time organic growth plus ½ of EBITDA margin equals 20) industry-standard returns are achieved.

Because organic growth is such a key input into the Rule of 20, the persisting soft market and the current depressed economic environment have made it very difficult to obtain a Rule of 20 score of 20. During the hard market years of 2000 – 2003, the average agency in the Reagan Value Index (a portfolio of approximately 30 firms appraised annually by Reagan Consulting) easily exceeded a score of 20. From 2004 on, however, it has gotten progressively harder to achieve a score of 20. With 2009 characterized by negative growth and the lowest margins of the decade, the average score was a depressingly low 7.0.

Historical Rule of 20 Scores



Source: Reagan Consulting Research, Reagan Value Index, Organic Growth & Profitability Survey

For an agency to perpetuate, not only does it need to score well in terms of the Rule of 20, but ideally it will also have a good balance between growth and profitability. From a perpetuation perspective, abnormally high EBITDA margins cannot overcome the stagnation that results from poor growth. Likewise, exponential growth is useless without the bottom line to show for it.

A good rule of thumb is that an agency, while always striving for a Rule of 20 score as high as possible, will combine solid organic growth with an EBITDA

margin that is at least twice as high as its growth rate. There are some limitations to this rule (for example, an organic growth rate of 20% does not require a 40% EBITDA margin), but these parameters will ensure that an agency does not get out of balance with regard to internal perpetuation.

**Using the Rule of 20 to Balance Growth & Profitability**

The High Growth, Low Margin Firm		The Low Growth, High Margin Firm		The Balanced Firm	
Organic Growth	10%	Organic Growth	0%	Organic Growth	5%
EBITDA Margin	10%	EBITDA Margin	30%	EBITDA Margin	20%
Rule of 20 Score	15%	Rule of 20 Score	15%	Rule of 20 Score	15%
<p>Though growth and the Rule of 20 score are strong (for today's market), EBITDA margin is not twice organic growth, indicating insufficient profits. This firm may have trouble funding perpetuation to meet seller valuation expectations.</p>		<p>Though profitability and the Rule of 20 score are strong (for today's market), organic growth is weak. This firm may have trouble remaining competitive and attracting talent.</p>		<p>The Rule of 20 score is strong (for today's market), organic growth is healthy and EBITDA is at least twice the growth rate. This firm's performance should allow for successful internal perpetuation.</p>	

**The Role of Risk**

Risk is manifested in multiple ways in the insurance distribution system. Concentration issues (client, industry, producer or carrier concentration), a lack of producer restrictive covenants or high employee turnover can all increase the risk of deterioration of an agency's profit stream. Though not reflected in the Rule of 20, this risk can still affect value and internal perpetuation.

Agencies that have not appropriately diversified their profit stream – mitigating the concentration issues and other risk issues – may find that buyers (both internal and external) have a hard time reaching market valuation ranges in the purchase of equity. When market ranges cannot be achieved, meeting seller expectations can also be difficult.

**The Balance Sheet**

An unhealthy balance sheet can cause significant perpetuation problems. When examining the balance sheet in the context of internal perpetuation, the key question is: Is the agency's balance sheet a source or use of cash flow? If

an agency's balance sheet is loaded with excess cash, this cash can be used to fund perpetuation, shoring up a firm's prospects for success. However, when a balance sheet contains more uses of cash – long-term debt, working capital deficiencies, a non-compliant trust ratio – these items can compete for perpetuation funding, making completing an internal transaction more difficult.

Defining a benchmark for a healthy balance sheet is difficult, due to the typical ebb and flow of capital needs as respects perpetuation funding. Generally speaking, an agency should strive to have working capital equal to at least 30 days of cash expenses, a trust ratio of a least 1:1, and ideally a tangible net worth of at least 25% of any impending stock redemptions.



# The Second Pillar: Reasonable Sellers

The word “reasonable” is defined, according to Webster, as “not extreme or excessive.” Synonyms include words like “moderate” and “fair.” It is one of those words frequently used to try to grab the moral high-ground in an argument. As such, it is the sort of word people frequently apply to themselves, but rarely to others – especially in a negotiation!

So we will admit that the word “reasonable” comes with some baggage. Nevertheless, the purpose of this section is to attempt to define what truly represents “reasonable” when applied to sellers of agency equity, focusing on (a) what sellers are actually doing in the marketplace and (b) what types of actions genuinely support, rather than undermine, a commitment to remain privately-held.

So how does one define a reasonable seller? Our research indicates that a reasonable seller possesses three key characteristics.

- *Valuation.* A reasonable seller is willing to sell his or her shares internally at a value reflecting a multiple generally ranging between 5 and 7 times EBITDA.
- *Financing.* A reasonable seller either personally finances the sale of his or her ownership stake, participates in agency financing or assists in arranging suitable third-party financing for buyers.
- *Timing.* A reasonable seller is willing to sell his or her shares in order to make them available to the next generation when the next

generation is ready to buy into the firm. Further, a reasonable seller is willing to time his or share sales to avoid redemption logjams – situations where one or several large shareholders need to be redeemed simultaneously.

## Valuation

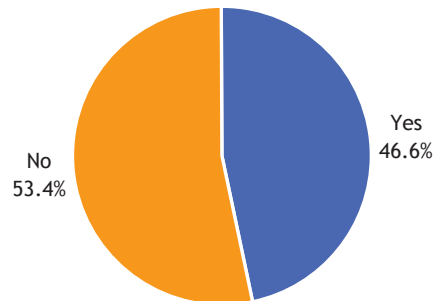
For many agency owners, the value of their agency investment is their single greatest asset. As such, the concept of leaving significant money on the table when transferring that asset to others can cause real heartburn. It is widely understood that selling shares to insiders will typically fetch a lower overall valuation than would a third-party sale of the entire firm – but it is not all because of higher EBITDA multiples. In reality, third-party buyers can rarely deliver a guaranteed multiple dramatically higher than the 5 to 7 times EBITDA that insiders can pay. So where does the third-party premium come from?

- *Higher EBITDA.* It is not uncommon for a firm's EBITDA margin to go up by 5 percentage points or more due to changes that occur in tandem with the change of ownership. The biggest changes typically include reductions to owner compensation and perks, adjusting producer commission splits, elimination of non-performing employees and consolidation savings.
- *The Earn-Out.* In addition to the guaranteed multiple, buyers will generally offer an upside that can be earned based on performance post-close. This is not a typical feature of internal deals where you typically have a fixed price.

But regardless of where it comes from, the third-party premium exists. Further, reasonable sellers must be willing to give it up. Internal buyers cannot often match a third-party offer, because they are not as well capitalized as third-party buyers and they are rarely going to realize the EBITDA increase expected by third-party buyers.

Yet even in our *In-Depth Perpetuation Survey*, which included only firms expressing a strong commitment to internal perpetuation, less than half of responding agencies reported that their selling shareholders were willing to take a discount to third-party valuations. Simply put, if sellers are not willing to sell internally for less than what a third-party buyer would pay, they are undermining the commitment to remain privately-held.

Are Sellers in Your Firm Willing to Take a Discount to Third-Party Values?



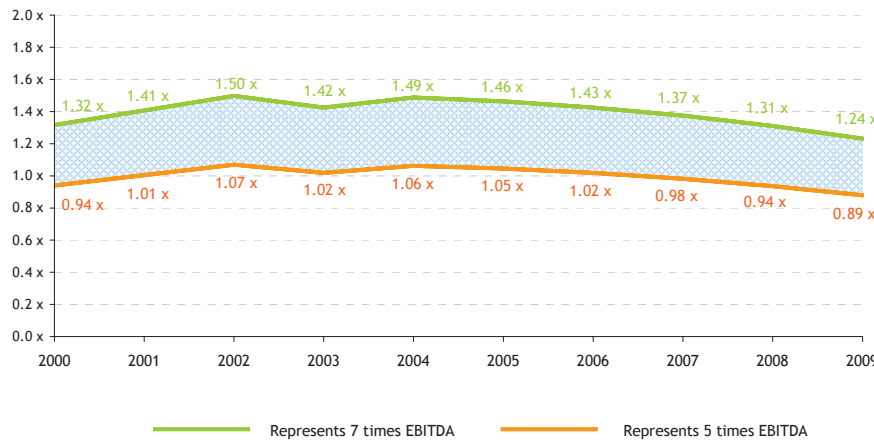
Source: Reagan Consulting In-Depth Perpetuation Survey

But valuation issues extend beyond a comparison of internal and external figures. One of the toughest challenges in the marketplace today is that many agencies have had their EBITDA margins fall well below the range that validates their historical valuation. However, many selling shareholders have hung on to the notion that the value of their shares needs to remain at historical multiples of revenue. As a result, these agencies are having a difficult time financing major shareholder buyouts. The following table provides a look at the typical agency’s internal perpetuation value as a multiple of revenue over the past nine years, based on the application of the 5 to 7 times EBITDA internal valuation range discussed earlier and the actual average profit levels achieved by privately-held firms.

For those agencies committed to remaining privately-held but whose profits have plummeted while shareholder valuation expectations have not, there are some tough choices to be made. They can:

- Abandon valuation principles and overpay the departing shareholder for his or her shares, hoping that future appreciation will bail out the remaining shareholders.
- Delay ownership buyouts until conditions improve.
- Negotiate a lower redemption value for those going out, reflecting today’s lower margin realities.
- Make operational changes to generate enough additional profitability to deliver an acceptable price to the departing shareholder.

Internal Perpetuation Values Expressed as a Multiple of Revenue (2000 - 2009)



Source: Reagan Value Index, Reagan Consulting Organic Growth & Profitability Survey

Most agencies today are choosing a combination of these options, but there are additional alternatives to consider. One way to alleviate either the pain of the internal discount versus a third-party or today’s depressed internal valuations is for selling shareholders to sell their ownership in pieces, rather than all at once. In a growing agency, this type of staged sale allows for growth in the value of the remaining shares to offset any discount the sellers end up taking.

Additionally, agencies can use a clawback approach specifically to address the third-party valuation premium. A factor that contributes to reluctance by sellers to sell to insiders at a discount is the retiring owners’ fear that shortly after they sell, those they sold it to will turn around and sell the business to outsiders for a premium. A mechanism that is commonly used to address this concern is called a clawback provision. Under this technique, for a period of time typically ranging between one and five years, sellers retain a contractual right to participate in any premium if the agency is sold to a third-party.

**Financing Terms**

From a seller’s perspective, valuation tends to get first priority, but financing terms run a close second. In fact, less than a third of all sellers get paid 100% cash at closing – the rest are financing the transaction themselves and collecting the purchase price for their shares over time.

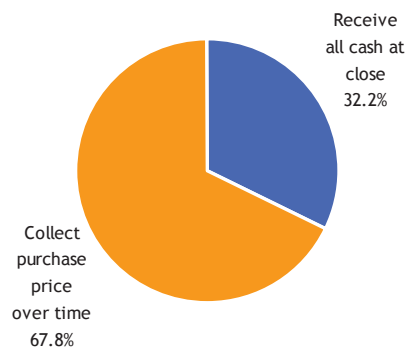
Reasonable Sellers

If a seller finances the deal it does not necessarily mean that the seller is taking payment directly from the buyer. It simply means that the seller takes payment over time – usually from the agency or the buyer – in order to facilitate the transaction. This partly explains why the median length of financing and the down payment requirements are different for buyers and sellers. As we will discuss shortly, there are several mechanisms in use by agencies today to finance internal perpetuation transactions, and most require sellers to receive their payments over time. The chart below identifies typical terms for sellers as reported in the *In-Depth Perpetuation Study*.

**Seller Financing for Internal Perpetuation Transactions**

Do sellers receive all cash at close or do they finance the deal, collecting their purchase price over time?

For sellers financing the transaction, what are typical down payments and length of financing?



Median down payment

**12.5%**

Median financing period

**7 years**

Source: Reagan Consulting In-Depth Perpetuation Survey

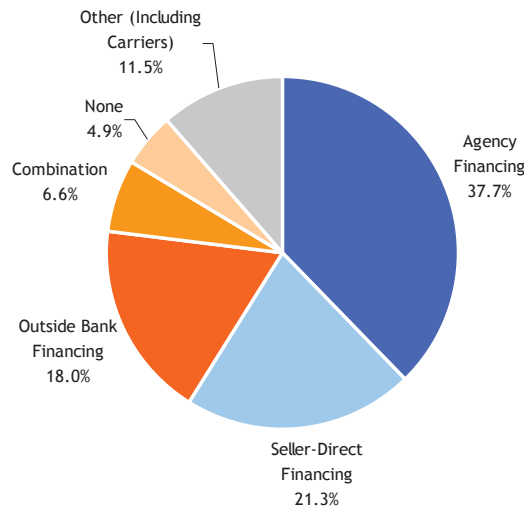
The source of the financing creates different dynamics for buyer and seller. The most common source of financing among firms in the *In-Depth Perpetuation Survey* is agency financing, where the firm stands between buyer and seller, receiving payments from the buyer and making payments to the seller. The second most common source of financing is seller-direct financing, where the seller receives payment directly from the buyer – the agency is not used as a conduit. In these situations, the seller may not have the security of the agency’s size and cash flow in securing his or her payments. Sellers must rely more on the personal cash flow of the buyer, which generally includes profit distributions or ownership bonuses from the agency.

When examining the sources of financing, it becomes clear that it is relatively rare to get outside financing – banks, insurance companies or other lenders are

brought in on roughly one out of three internal perpetuation transactions. When it is used, external financing arrangements can help accelerate the seller’s receipt of funds. In seller-direct financing situations, the terms for sellers necessarily mirror the terms for buyers. And in agency financing situations, the terms are often equivalent as well, as the agency is rarely prepared to bridge the cash flow gap created by a large disparity in buyer and seller financing terms.

However, if a bank or other lenders are used, they can bridge the gap – allowing buyers to borrow from the bank instead of the seller or the agency. In this situation, a seller can receive 100% cash at close and the buyer can pay the bank back over time. These external financing methods also explain why, in our survey, the median buyer financing length (8 years) is longer than the median seller financing length (7 years).

Sources of Financing for Internal Perpetuation Transactions



Source: Reagan Consulting In-Depth Perpetuation Survey

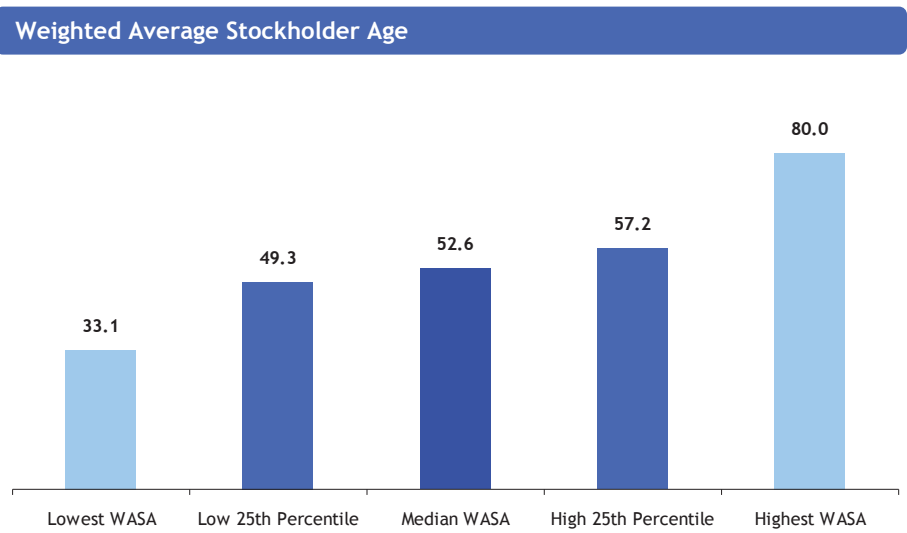
For a seller, there can be risk in financing an internal deal. Typically, the buyer gets to vote the shares and receive the related profit distributions on the shares as long as the buyer is current on the note payments. Often, the only remedy that a seller has in the event of default is to reclaim the shares that were sold. The problem with this is that if the seller has retired and left the business, he or she might not want the shares back, or be in a position to convert them into cash.

### Timing

An agency’s cash flow is its lifeblood. Without strong cash flow, investments in future growth get squeezed and shareholder redemptions become difficult. Yet if an agency desires to remain private, its cash flow must be able to cover both its growth investments and shareholder redemptions. Borrowing money can help fill in temporary gaps in which the current cash flow plus the retained earnings do not cover the obligations, but borrowed money must be paid back too – which simply means the demands on cash flow are extended.

A real challenge occurs when a high percentage of an agency’s shareholders need to get redeemed at the same time. In theory, even 100% of a properly valued agency should be redeemable at any one time, yet it rarely happens. Major redemptions put an incredible amount of pressure on agency perpetuation plans – exposing any cracks.

Thus a key to a healthy perpetuation plan is spreading shareholder redemptions out over time – which means spreading shares among owners of different ages and even generations. If an agency’s ownership is spread among both old and young, that agency should be able to more consistently invest in future growth, even while a portion of its cash flow is used for retiring shareholder redemptions.



Source: Reagan Consulting In-Depth Perpetuation Survey

Reagan Consulting has developed a benchmark to measure the age of an agency's shareholder base – the Weighted Average Shareholder Age (“WASA”). It is calculated by taking the product of each shareholder's age times their percentage ownership and then adding them together. In our experience, when an agency's WASA gets above 55, the pressure on internal perpetuation intensifies and the likelihood of a third-party sale increases. In these instances, near-term redemptions loom as a larger and larger claim on future cash flow. The healthiest agencies tend to have WASAs below 50, and most firms have WASAs that fall between 50 and 55.

The key to optimizing the timing of share sales is to lower the WASA while ensuring that no one age range has an outsized portion of ownership that will need to be redeemed at once. The solution to both of these problems often involves getting shares into the hands of the next generation. To illustrate this point, we have drawn a composite sketch of the average actual current ownership distribution by age of the firms in the *In-Depth Perpetuation Survey*. Then, taking this average firm, we have shown two perpetuation scenarios, one with a focus on the next generation and one without.

In both of the following charts, the firm, which starts with our survey's average ownership age distribution and WASA, is successfully purchasing the interests of selling shareholders as they retire. However, the redemption methodologies – and the results – differ.

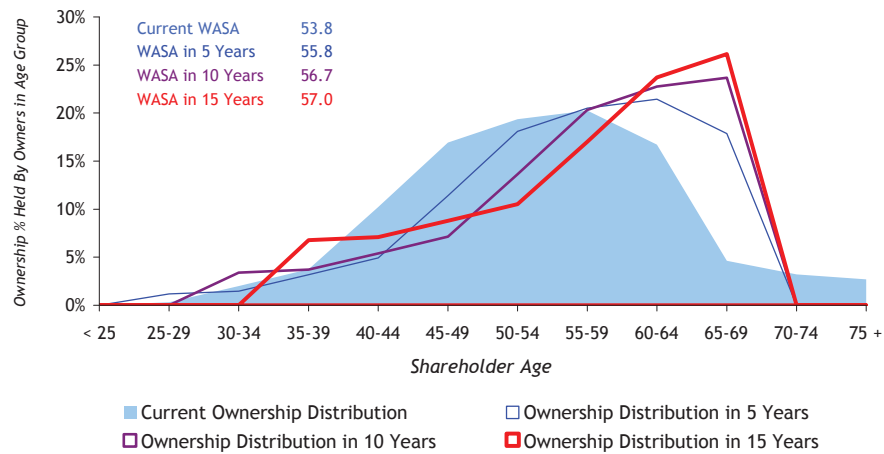
- *No focus on the next generation.* In the first chart, the existing ownership group simply absorbs the shares from selling shareholders when they sell at age 65. New owners are not brought in, either because of the reluctance of the current group to share ownership or because the next generation of Able Buyers does not exist. However, for a time, the firm continues to perpetuate. But as can be seen in the chart, the wave of perpetuation trouble is building. Without an explicit focus on the development and buy-in of a younger generation, the firm's WASA rises and the perpetuation pressure intensifies. The firm is experiencing a situation where the number of shares that needs to be redeemed is increasing and the number of buyers is decreasing.
- *A focus on the next generation.* In the second chart, the existing ownership group makes a couple of deliberate directional changes in their perpetuation plan. First, the firm's owners begin selling shares at age 60 and conclude their share sales at age 65. Second, the shares sold by selling shareholders are made available to the younger generation, which has been cultivated by the firm for this very



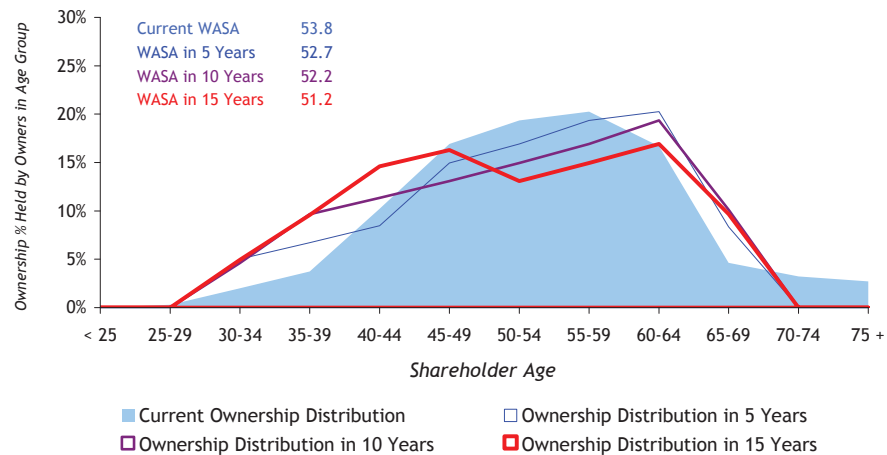
purpose. This type of plan provides stability to the share ownership distribution and can even lower the WASA over time. However, it depends on reasonable sellers who see the value in beginning to sell shares when the younger generation is ready to purchase them.

**WASA and Distribution of Share Ownership by Age**

**Perpetuating without a focus on the next generation**



**Perpetuating with a focus on the next generation**



Source: Reagan Consulting In-Depth Perpetuation Survey

Some agencies have forced the issue by mandating an age at which sellers must sell – or begin to sell – their shares. This can be a useful tool for imposing a well-rounded shareholder age distribution, but can also be

misunderstood as a statement that older shareholders cannot perform at the same level as younger shareholders. As such, only 23% of the firms in the *In-Depth Perpetuation Survey* have adopted such a policy. A closer look at the data, however, reveals that the more shareholders a firm has, the more likely it is to adopt a specific mandatory redemption age. Nearly half (45%) of the firms in the study with 10 or more shareholders have adopted a required selling age. For those who have adopted a required selling age, the median age is 65. We would note, however, that a mandatory sale of stock does not mean mandatory retirement for the selling shareholder.

# The Third Pillar: Able Buyers

As identified in the introduction to this study, finding Able Buyers is the biggest challenge to internal perpetuation. It is the pillar most likely to crumble. But what is an Able Buyer? “Able” is one of those words like “reasonable,” where the definition tends to vary based on what side of the table you are on. Therefore, we will take a similar approach as the previous section, and focus our analysis of “Able Buyers” on what is happening in the industry and what supports, and not undermines, internal perpetuation.

## **Financial Ability**

First and foremost, an Able Buyer must be financially capable of purchasing equity in the firm, and the issue of buyer financial capability can generally be boiled down to one question: How much must buyers come “out-of-pocket” in order to purchase equity in the firm? In other words, what portion of the buyer’s payments should be covered by new sources of income available to the buyer (dividends, distributions, shareholder bonuses, etc.) after he or she purchases shares – and how much should come from a buyer’s personal resources (salary, commissions, savings, etc.)?

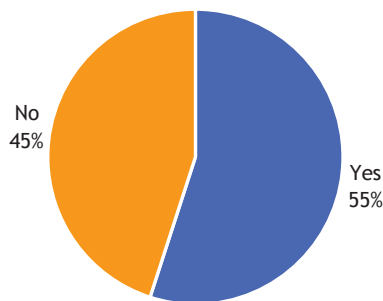
To evaluate this question, we have looked at what we call the *Buyer Coverage Ratio*. The Buyer Coverage Ratio is the percent of a buyer’s first annual payment (principal and interest for the purchase of equity) that is covered by shareholder distributions or bonuses that the buyer receives. For example, if a buyer’s first year payment is \$100,000 in principal and interest but he or she receives shareholder bonuses or distributions of \$70,000, the Buyer Coverage Ratio is 70%. A firm with a Buyer Coverage Ratio of 100% has a perpetuation plan that is designed to provide the buyer with enough shareholder bonuses and / or distributions to cover the buyer’s principal and

interest payments. (Please see the note on the calculation of the Buyer Coverage Ratio.)

We explored the Buyer Coverage Ratio of the firms that participated in the *In-Depth Perpetuation Survey*, focusing on the approximately 90 firms whose main method of internal perpetuation was ownership purchases. Firms that use stock grants or that are ESOP-driven, for example, were excluded. We then tested the responses of these firms in our own perpetuation model to validate the data.

We found that the Buyer Coverage Ratios for this group covered a wide range of possibilities. Some – for firms that do not distribute profits – were 0%, meaning that buyers are responsible for funding the entirety of their purchase price obligations from their personal resources. Others were well over 100%, meaning that buyers receive shareholder distributions or bonuses that cover not only their principal and interest obligations but also some or all of the tax liability created by the distributions they receive. The most common Buyer Coverage Ratio in the survey is 100%. This means that over half of the firms structure their perpetuation plans to ensure that a buyer’s principal and interest payments are entirely covered by the buyer’s shareholder distributions or bonuses.

Is the Buyer Coverage Ratio for your Firm 100% or Higher?



Source: Reagan Consulting In-Depth Perpetuation Survey

There are a few obvious reactions – particularly from sellers – after learning that it is common for firms to design their plan to cover a buyer’s note payments in full.

**Buyer Coverage Ratio**

The Buyer Coverage Ratio is calculated by dividing the Buyer’s ownership distributions or bonuses by the annual principal and interest payments on their ownership purchase notes.

The Buyer Coverage Ratio is a pre-tax calculation, using shareholder distributions and bonuses prior to buyer income taxes. Some firms have buyer coverage ratios over 100% in order to cover some or all of the buyer’s tax obligations in addition to principal and interest payments.

The Buyer Coverage Ratio does not take into account the down payment made by the buyer. The typical buyer down payment in the industry is 10%.

The Buyer Coverage Ratio is a *first-year* metric. If a firm does not grow cash flow, the Buyer Coverage Ratio will remain consistent across the term of the buyer notes. If a firm grows cash flow, the Buyer Coverage Ratio should increase over time as shareholder bonuses or distributions increase.

Able Buyers

- *Are not those sellers just giving their shares away?* No. Every buyer – even third-party buyers – ultimately uses the profits of the acquired entity to fund the transaction. For internal buyers, the explicit connection between distributions and purchase price is a recognition of the limited financial ability of the typical buyer – a producer in his or her mid-to-late thirties. Further, buyers, as owners of the shares, are entitled to their pro-rata portion of profit distributions.
- *Shouldn't there be some "pain" for buyers in purchasing agency equity?* Not necessarily. Based on the *In-Depth Perpetuation Survey*, agencies are structuring their plans to minimize the out-of-pocket obligations of buyers. Further, though, even a Buyer Coverage Ratio of 100% does not cover a buyer's down payment (typically 10%) or taxes due on shareholder bonuses or distributions. The typical buyer of a 5% interest in a \$10 million dollar agency that has a Buyer Coverage Ratio of 100% and a 10% down payment still has to come up with anywhere from \$100,000 – \$200,000 out-of-pocket over the financing period depending on the growth rate of the agency.
- *Does a Buyer Coverage Ratio of 100% mean that buyers do not have any skin in the game?* No. Aside from the out-of-pocket costs that are discussed above, buyers have the risk of default and the risk of an under-performing agency. The note payments will still need to be paid – even if shareholder distributions and bonuses decline.

The Buyer Coverage Ratio is ultimately a function of three variables: length of financing, level of distributions and valuation. The following chart looks at how the Buyer Coverage Ratio varies for the typical firm when valuation, distributions and financing length changes.

The chart, though, merges two of the variables into one: it takes valuation as a multiple of EBITDA and distributions or bonuses as a % of EBITDA and uses *valuation as a multiple of distributed EBITDA*. Expressing valuation as a multiple of distributed profit is useful in modeling the Buyer Coverage Ratio, as distributed profit is what buyers use to fund purchases. The median firm using ownership purchases as the primary means to perpetuate shares distributes approximately 80% of EBITDA, using the remaining profit for investments in growth or to shore up the balance sheet. Therefore, a 5 to 7 times EBITDA multiple equates to a multiple of 6.25 to 8.75 of distributed profit (80% of 6.25 is 5 and 80% of 8.75 is 7).

This connection between distributions and value is critical in perpetuation, as even firms with high margins must ensure that they are distributing enough of that profit to sufficiently fund internal share purchases. As can be seen in the following chart, letting the agency’s valuation rise, relative to distributions, reduces the Buyer Coverage Ratio – putting pressure on an agency’s buying group. Shortening the financing period has the same effect.

Modeling the Buyer Coverage Ratio

		Length of Financing for Purchases (Years)							
		5	6	7	8	9	10	11	12
Valuation as a Multiple of Shareholder Distributions	5.0 x	96%	113%	129%	144%	158%	172%	185%	197%
	6.0 x	80%	94%	107%	120%	132%	143%	154%	164%
	7.0 x	69%	81%	92%	103%	113%	123%	132%	141%
	8.0 x	60%	71%	80%	90%	99%	107%	115%	123%
	9.0 x	54%	63%	71%	80%	88%	95%	103%	109%
	10.0 x	48%	56%	64%	72%	79%	86%	92%	99%
	11.0 x	44%	51%	58%	65%	72%	78%	84%	90%
	12.0 x	40%	47%	54%	60%	66%	72%	77%	82%

Source: Reagan Consulting Analysis. Assumes a 10% down payment and 5% interest. An increase or decrease in interest rate of 1% will have an effect of approximately 2% - 5% on the Buyer Coverage Ratio. In the chart above, Buyer Coverage Ratios above the median of 100% are in green, those below are in orange.

While the median Buyer Coverage ratio is 100%, almost 45% of the firms in the *In-Depth Perpetuation Survey* that are using ownership purchases as the primary means to perpetuate internally have lower Buyer Coverage Ratios. Among these firms, the median Buyer Coverage Ratio is 50%.

Some of these firms likely have dynamics that allow them to get away with a lower Buyer Coverage Ratio than their peers. These dynamics can include:

- *Perpetuating smaller dollar amounts.* Smaller firms that are perpetuating smaller “chunks” of value can afford to have a lower coverage ratio, because the out-of-pocket dollars will be smaller. A similar coverage ratio for a \$2.5 million agency and a \$25 million firm will result in a buyer coming out-of-pocket for significantly more dollars in the larger firm – and this is ultimately a dollar issue.
- *Selling control.* Perpetuating a controlling interest or a substantial interest in the firm can also make a lower Buyer Coverage Ratio more

palatable. A buying group knowing it is gaining control may be willing to invest more out-of-pocket, knowing that control enables a buyer to make operational changes necessary to ensure profits cover note payments.

- *Understanding duration.* The duration of the out-of-pocket costs may also contribute to the acceptability of the Buyer Coverage Ratio. A buyer who needs to come out-of-pocket for 50% of his or her principal and interest payments may be more likely to accept the arrangement if the principal and interest payments only last five years as opposed to ten.
- *Expecting growth.* A firm with a high organic growth rate may be able to perpetuate with a lower Buyer Coverage Ratio, as the Buyer Coverage Ratio will increase quickly over time as revenues and distributions rise.

All of these features can make a lower Buyer Coverage Ratio more palatable to buyers. But beyond that, some firms simply are not in a position to provide a high Buyer Coverage Ratio – even if they wanted to. Most notably, when a firm has recently bought out a large ownership block or borrowed money for some other use (such as an acquisition), the payback of the existing debt can temporarily reduce distributable cash. In addition, agencies that reinvest aggressively in future growth opportunities might find their distributable cash – and thus their Buyer Coverage Ratio – under significant strain. Finally, in recent times many firms have seen their profits drop – which has reduced expected Buyer Coverage Ratios for all buyers that recently executed purchases.

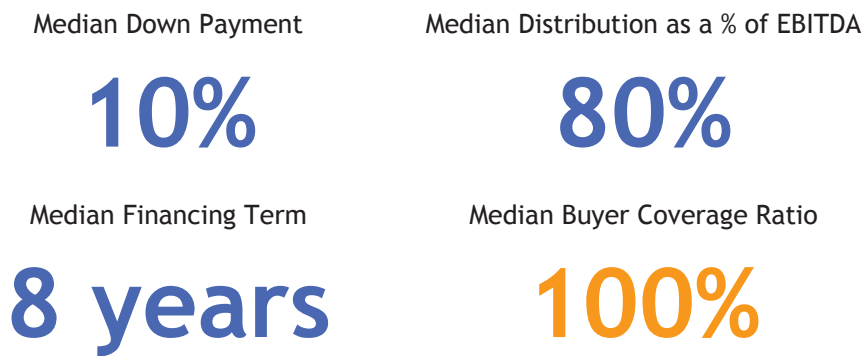
In each of these situations, the existing agency owners might be frustrated to find the next generation reluctant to buy shares until the situation improves. However, this does not necessarily spell perpetuation disaster. Rather, it simply means that these firms will have to find creative alternatives to address the challenge of transitioning ownership during these periods. For firms that expect significant or long-enduring Buyer Coverage Ratio shortfalls, these alternatives may need to include moving away from or heavily supplementing ownership purchases as the primary method of perpetuating equity.

While there is not a “correct” Buyer Coverage Ratio, determining whether or not your firm has able buyers is impossible without considering the Buyer Coverage Ratio and the resulting out-of-pocket requirements for the buying

group. Firms with Buyer Coverage Ratios that are materially below industry norms will likely experience low buyer interest.

The chart below summarizes the typical buyer transaction in the industry from a financial perspective, and presents the circumstances that generate the median Buyer Coverage Ratio of 100%.

Looking at the Typical Buyer Transaction in the Industry



Source: Reagan Consulting In-Depth Perpetuation Survey. Focuses on agencies using ownership perpetuation as the primary method of transferring shares.

**What Else Does the Buying Group Need?**

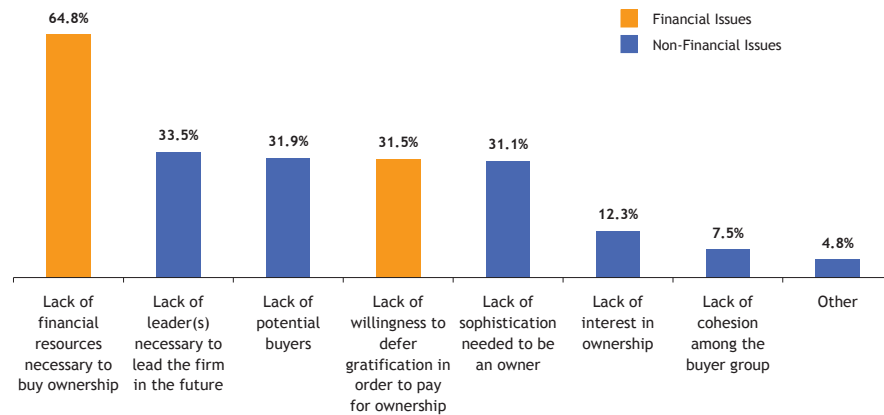
On a parallel path to evaluating the financial affordability aspect of internal perpetuation, agencies must also assess the ability of their buying group to lead and grow the firm. After all, it is not just the equity that the sellers are transitioning; it is also the responsibility for the firm’s employees, books of business, carrier relationships, earnings, reputation and culture. The ability to maintain health in all of these areas is not necessarily a given just because the buyer has the ability to purchase the shares.

In the *Baseline Perpetuation Survey*, almost 900 firms were asked about buying group challenges. As discussed earlier, financial affordability was the primary challenge, cited by almost two-thirds of surveyed firms. However, following that were several other non-financial challenges.

Three non-financial issues figured most prominently. For each issue, we have provided some perspectives, based on our consulting experience.



What are the Biggest Challenges to Finding Able Buyers?



Source: Reagan Consulting Baseline Perpetuation Survey

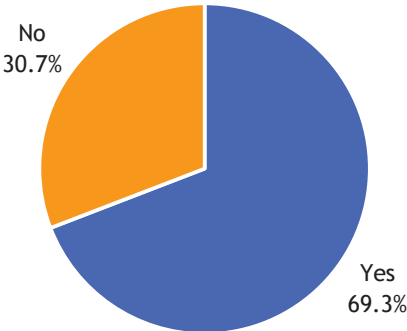
- 33.5% of firms cited a lack of leadership among the buying group. The bottom line is that even agencies that have solid young talent can lack the next generation of leadership. In order for perpetuation to work, there must be one or more leaders who focus beyond simply personal production into such areas as recruiting sales people, motivating support teams, serving as the “face” of the organization in the community and determining the firm’s strategic direction.
- 31.9% of firms reported that they simply do not have the next generation of agency principals in the firm. Regardless of the Buyer Coverage Ratio in place or the down payment required, there are not enough buyers around to make the deal work. This frequently is the result of hiring the wrong people, or neglecting next-generation recruiting efforts until it is too late.
- 31.1% of firms have buying groups that lack the sophistication required to be an owner. Being an agency owner requires a certain level of sophistication. It requires a basic understanding of sales, operational and financial management that comes naturally for some, but certainly not all. Agency principals must often invest time and money in the development of the next-generation to ensure it is ready to effectively operate the business going forward.

A simple lack of interest and a buying group not operating cohesively round out the non-financial buying group challenges. As firms evaluate internal perpetuation, and specifically the Able Buyers Pillar, it is perhaps the non-

financial challenges that are more difficult to address than the financial challenges. After all, a firm can adjust its valuation or its financing length or its down payment or its distribution to make the stock more or less affordable – and it can make these changes quickly. But how quickly can an agency adjust to a buying group that does not have the skill set required to take the mantle of ownership? How fast can a firm fill a leadership void in the next generation?

Satisfying the financial and non-financial conditions necessary for a strong Able Buyers Pillar has not been easy for all of the firms in our study. Almost 31% of the firms in the *In-Depth Perpetuation Survey* reported that they do not have the next generation of buyers in place. Developing that buying group and constructing an effective buyer plan will be critical if these firms want to fulfill their commitment to remaining privately-held.

**Do You Have the Next Generation of Buyers in Place?**



Source: Reagan Consulting *In-Depth Perpetuation Survey*

Able  
Buyers

# The Fourth Pillar: Effective Transfer Mechanism

Even when the first three Perpetuation Pillars are solid – a Healthy Operation with Able Buyers and Willing Sellers – a perpetuation plan can still be doomed to failure without the final pillar. The fourth pillar is critical – there must be an effective mechanism in place to facilitate the transfer of ownership from one generation of owners to the next.

We have used the term “mechanism” to mean a method or process for transferring ownership. In reviewing the transfer mechanisms used by agencies, two things are clear:

1. A wide variety of mechanisms are used across the industry
2. Many firms use more than one transfer mechanism

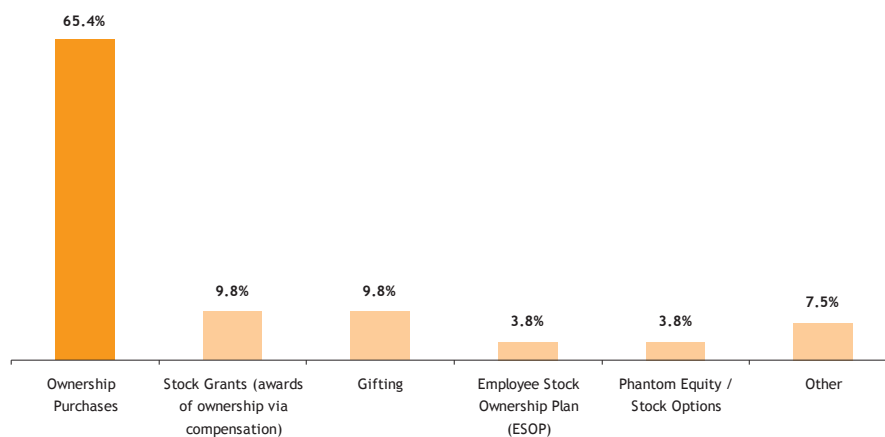
In light of these realities, we asked agency owners to list their “primary” method of transferring ownership in order to understand what firms are doing. Of the 146 firms that completed the *In-Depth Perpetuation Survey*, nearly two-thirds reported their primary method of transfer is ownership purchases whereby an individual buys ownership shares either from another shareholder or from the company. In fact no other method comes close to matching it – none represents even 10% of the agencies in the study.

A brief description of each method is as follows:

**Ownership Purchase** – the purchase of stock or ownership units by an individual, either directly from a selling shareholder, or from the company. To finance the purchase, the buyer can either use cash or borrow the funds, or both. Ownership purchases frequently occur under one of two different models:

- *Rolling or Incremental purchases*, whereby one or more buyers acquire ownership in multiple transactions over a period of several years, from owners that divest of their shares in stages. Rolling or incremental purchases are best used when there is a generation of new buyers in place and where a strong, growing profit stream exists to provide funding for internal transactions.
- *Single-event purchases*, whereby one or more buyers acquire most or all of an agency’s ownership in a single transaction, typically involving a large amount of debt. The single-event transfer is best used when a majority of the ownership needs to be redeemed at once and when the corporate structure of the agency allows for potentially favorable tax treatment.

What is Your Primary Method of Transferring Agency Ownership?



Source: Reagan Consulting In-Depth Perpetuation Survey

**Stock Grants** – awards of ownership that are delivered to an employee in the form of compensation. Stock grants are frequently delivered to key employees and are delivered as a reward for performance. One of the most common

situations involving stock grants occurs when stock is granted in exchange for value built under a producer book-equity program. As compensation, stock grants are deductible to the company when paid, and are taxable as ordinary income to the recipient. Stock grants are often best used to drive internal perpetuation in situations where a firm does not make significant profit distributions.

**Giftng** – ownership that is directed from one individual to another at no cost to the recipient. Most commonly, gifting is used as a technique to transfer assets between generations while taking advantage of certain elements of the tax code to minimize estate and income taxes among members of the same family. This mechanism is often well-suited for a situation where the next generation of the family is in place and performing and where the selling generation does not require a material purchase price to fund its retirement. One disadvantage of this mechanism is the impact it can have on non-family employees in the agency.

**Employee Stock Ownership Plan (ESOP)** – a tax qualified, defined contribution ERISA-governed employee benefit plan designed to invest primarily in the stock of a sponsoring employer. The various parties to the ESOP – the sponsoring company, the selling shareholders and the participants each receive various tax benefits. ESOPs often work best in larger agencies where the administrative cost and complexity can be better leveraged. (For more information about ESOPs, refer to “Appendix A: A Note on ESOPs.”)

**Phantom Equity** – a plan for key employees whereby they receive many of the benefits of ownership without actually owning company stock. Employees may be granted “phantom” equity which rises and falls according to the value of the firm’s real shares but never possesses any voting rights or claim to profits. Frequently phantom stock benefits are delivered in the form of deferred compensation at termination of employment, or at the time of some other triggering event. Payouts under phantom stock plans are typically taxed as ordinary income to the recipient. Phantom stock is generally used as a complementary transfer mechanism and is often best suited to situations where agencies want to reward key individuals for growth in the firm.

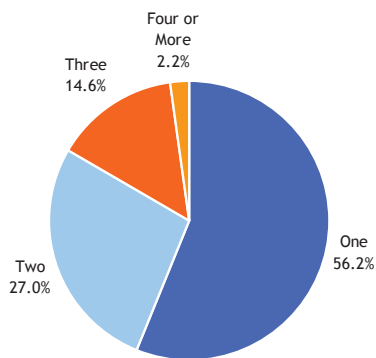
**Stock Options** – shares of stock made available for purchase by individuals at a fixed “exercise” price over an extended period of time. They allow for individuals to receive the economic benefits of the increase in an agency’s share price without having to purchase the shares until the window for

exercising the options (which is frequently 10 years) expires. Until options are actually exercised, the option-holder does not receive any of the rights or benefits of actual stockholders. The options will likely require cash from the option-holder upon exercise, but the option-holder will then be a true equity partner in the firm. Options have ordinary income and capital gains tax implications for the option-holder but are often tax deductible to the firm.

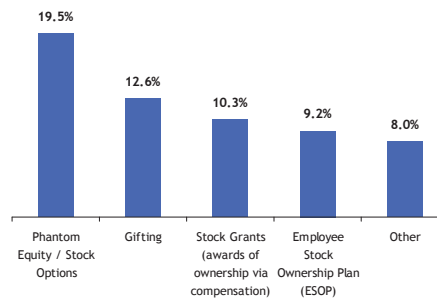
Ownership purchases – whether rolling or single-event – are the most prevalent transfer mechanism and most firms have geared their perpetuation plans around making ownership purchases work. Even the ESOP and family-held firms in our surveys use ownership purchases more frequently than ESOPs and gifting, respectively, as the primary method of transferring equity.

**Using Complementary Transfer Mechanisms**

**How many transfer mechanisms is your firm using?**



**What are you using to complement ownership purchases?**



Source: Reagan Consulting In-Depth Perpetuation Survey

But while the ownership purchase is the most common *primary* method of transfer, it is common for firms to employ other methods as a complement to the ownership purchase. In fact, as indicated in the chart above, over 40% of the firms in the survey use at least two mechanisms for transferring ownership. Many firms have found that using complementary transfer mechanisms can take the pressure off of exclusive use of ownership purchases.

**Selecting the Right Transfer Mechanism**

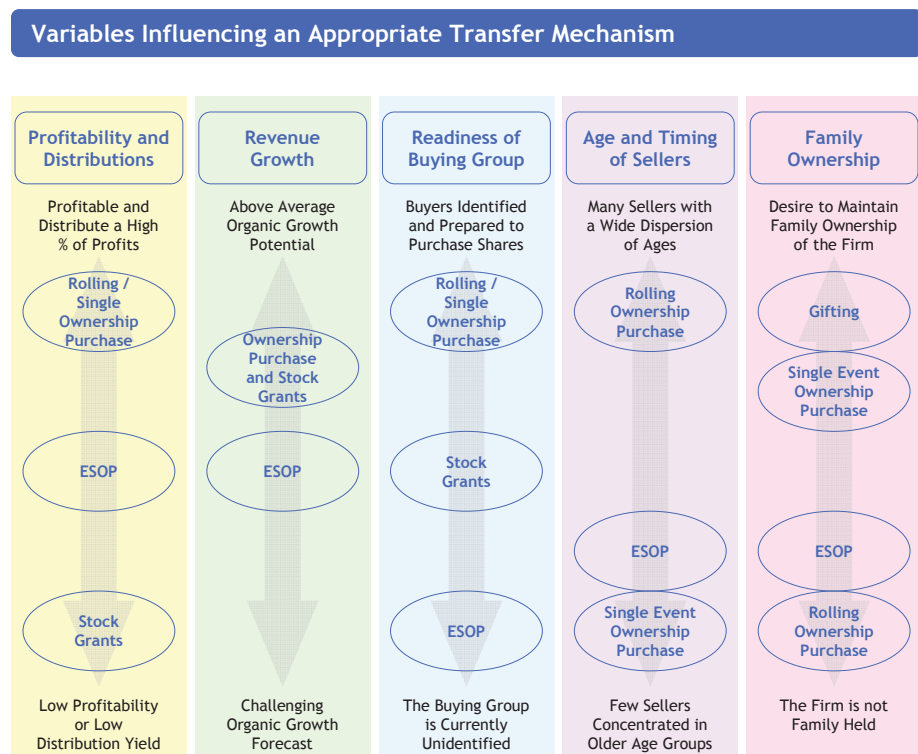
In determining which Transfer Mechanism is right for an agency, the owners must match the Transfer Mechanism with the agency’s unique DNA and

Transfer Mechanism

circumstances. This is a critical process, because not all transfer mechanisms will work for every agency. The agency’s distribution philosophy, shareholder distribution, growth prospects and other attributes will influence the appropriateness of any given transfer mechanism.

This is a complicated area, and there is not a simple checklist that will determine the perfect primary transfer mechanism for an agency. Many variables need to be considered before making that choice. Further, even when a primary transfer mechanism is selected, there are further decisions to be made on the best complementary transfer methods – if any.

There is, however, some guidance that can be provided. In the following chart, we have outlined a few of the key variables that will influence the effectiveness of different transfer mechanisms within an agency. This is not a comprehensive list, and does not include all of the questions agencies should ask themselves before devising their perpetuation plans. However, we believe that these are the key areas, and this chart aims to provide some guidance in how these key areas influence the effectiveness of a particular transfer mechanism.

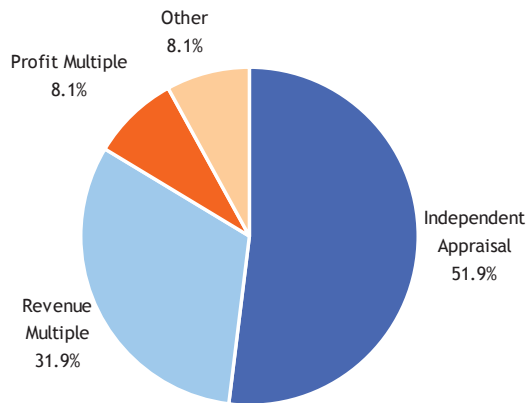


Please note that in the previous chart we have not discussed phantom stock or stock options, as these programs are rarely used as primary transfer methods – but are commonly used as complementary transfer mechanisms. The chart deals solely with an agency’s primary transfer mechanism, and we have focused on ownership purchases (single and rolling), ESOPs, stock grants and gifting.

**Determining the Value of the Agency**

A critical part of the transfer mechanism is the determination of value. We have discussed value at several points throughout this study, but now we will focus on the *method* that firms in the industry are using to establish the value of their shares. After all, an improper valuation *methodology* is unlikely to produce a proper agency value, except by accident. And internal perpetuation cannot work without appropriate valuations.

**How is Your Firm Valuing its Shares for Internal Perpetuation?**



Source: Reagan Consulting In-Depth Perpetuation Survey

Over half of the firms in the *In-Depth Perpetuation Survey* are using independent appraisals to establish value. This process involves working with an experienced independent valuation firm to use accepted tests of value to arrive at an objective valuation conclusion. This approach is the most comprehensive and is generally the only approach that can consistently take into account all of the variables that determine agency value: growth, profitability, risk and financial stability.

Transfer Mechanism



Approximately 40% of the surveyed firms, however, are using a predetermined formula approach to determine agency value. This approach, while still somewhat common in the industry, is fraught with peril. Agencies using a formula approach apply a predetermined multiple to the firm's revenue or earnings to arrive at agency value. In some instances, they use multiple year results. In some instances, they factor in the condition of the balance sheet, but in many instances it is ignored. While multiples can be helpful as rules of thumb, they are best used as an *expression* of agency value, rather than as a *determinant* of agency value.

Let us illustrate a couple of common problems associated with the use of formula approach:

- *Ignoring growth.* Multiple formulas do not often have the capacity to incorporate future growth into an agency's valuation. If two \$5 million agencies use a 1.5 x revenue multiple to determine value, they will both determine that the agency is worth \$7.5 million. But what if one agency is expected to grow to \$6 million in revenue in the next year, while the other is expected to lose a large account and shrink to \$4 million? A simple formula does not normally factor in growth – even growth that can be anticipated.
- *Ignoring cash flow.* If a firm's shareholders insist on using a formula multiple, it is better to use a profit multiple than a revenue multiple. Unfortunately, despite the greater accuracy of a profit multiple in tying value to profits, revenue multiples are almost four times more likely to be used than profit multiples in the *In-Depth Perpetuation Survey*. Revenue formulas ignore the true cash flow generated by the firm – and cash flow is generally what enables internal perpetuation. Let us take the same two \$5 million firms we discussed above and assume that growth is the same and that they are both using the same 1.5 x revenue valuation multiple. Suppose one firm generates a 25% EBITDA margin and the other a 10% EBITDA margin. For a valuation to be accurate, profit margins must be accounted for.
- *Ignoring the balance sheet.* Over 60% of the firms surveyed that are not using independent appraisals are not taking into account the agency's balance sheet in their formula valuation approach. Let us go back to our two \$5 million firms, assuming the same growth and profitability and valuation multiple of 1.5 x revenue. Now suppose that the revenue formula does not take into account the balance sheet. One firm has a million dollars in debt and the other a million dollar

portfolio of marketable securities and no debt. Ignoring the impact of the balance sheet can lead to real trouble.

If perpetuating internally is the goal, the valuation methodology of the firm should be set up to support that goal. Rarely can a formula approach give assurance to both sellers and buyers that the value is being properly established. Sooner or later, the predetermined multiple will result in a valuation that is either too high or too low – upsetting the delicate balance between buyers and sellers and jeopardizing the firm’s ability to remain privately-held.

# Conclusion: Pulling it All Together

The decision was made to perform this study based on the simple fact that many agents and brokers desire to remain privately-held but are finding internal perpetuation increasingly difficult. The results of our research have confirmed the broad desire for continued private ownership. The research has also confirmed that there are many challenges being faced in four key areas (the Four Pillars) needed for internal perpetuation to be successful.

We did not begin this study with a premise that it is better for firms to remain privately-held as opposed to selling to a third-party or merging into a larger firm. We have supported and represented many firms that have sold to or merged with a third-party and have seen these transactions fully accomplish the seller's desired objectives. At the same time, there are many firms that recognize that their objectives can be best accomplished by remaining privately-held. Some of these firms have recognized that if they sell and get a premium price and terms and then need to find a place to reinvest the money they get, there is not a better place to invest it than in their own agencies. We have supported and helped many firms effectively put in place all of the key elements needed (the Four Pillars) and have seen them successfully perpetuate their ownership and operations internally. Internal perpetuation can and does still work.

If done properly, internal perpetuation and the willingness to sell the ownership of the firm to the next generation can be a great tool to attract talented young employees to the organization. The willingness to share ownership with those employees can help motivate and retain them. With talented and motivated employees, the firm is better positioned to achieve

strong operating results. Strong operating results greatly aid the ability to successfully perpetuate and improve the returns for those that are now owners, which further enhances the ability to attract and reward talented employees. As such, if done properly, internal perpetuation can be a key “cylinder” in the growth engine of a firm.

In addition, there is one other key point to keep in mind. The purpose of this study is to help those that desire to remain privately-held position themselves to perpetuate internally. Our objective is to expand the range of perpetuation options available to agents and brokers, not limit them. If your firm’s desire at this point is to remain privately-held, and if the firm takes the steps and measures to prepare itself accordingly, the firm will simultaneously increase its value to third parties. Agencies that improve operating results, attract an outstanding group of young people to the organization and begin sharing ownership with the next generation will increase the marketability of the firm to third-party buyers. Our recommendation to firms that desire to remain privately-held is to leave that third-party option open as a safety net or fall back position if something changes and it is necessary to consider “plan B.”

### **Where Do You Begin?**

If it is your desire to remain privately-held, you can never get started too early. We would recommend that you consider the following:

1. Take a look at the Internal Perpetuation Viability Checklist that is included as an addendum to this report. It provides a summary of the components needed for internal perpetuation to work. Use this checklist to better understand your current situation.
2. Honestly assess your commitment level to internal perpetuation based on (a) the goals and objectives of the current owners, (b) the depth, capabilities and desire of the next generation of owners, and (c) the operating health of the organization.
3. If the commitment level is still there for internal perpetuation, go back to the checklist and consider each of the items that are in place and each of the required elements that are not currently in place. For each that is not in place, develop a plan or strategy for “correcting” that deficiency or finding a solution to that problem. It is our hope

that this study will help with your ability to understand the problems and identify solutions.

4. As you look for the missing pieces, particularly the “Transfer Mechanisms,” we would encourage you to draw on resources available to you. The best resource will be other agents and brokers within the industry that have already been down this path and that have experience with the various options and alternatives. We would also encourage you to get professional assistance from accountants, business and tax lawyers and consultants. These issues and options can be complex. The tax and legal variables can be difficult and can dramatically affect the transfers of ownership. The expenses incurred to get the right advice and find the right solutions will most likely save you a lot of money and problems in the long run.
5. As you look for solutions, particularly as respects finding sources for the funding of ownership transfers, be sure to talk with your key insurance carrier partners. Some carriers have demonstrated a willingness to help their key agents by providing funding and financing for ownership transitions.
6. Because of uncertainty and how rapidly things change, it is rare to see strategic plans that are developed for much longer than 3-5 years. However, perpetuation planning can be more predictable. We would recommend that you establish a potential or intended ownership transition plan that goes out for 10 to 15 years. We have included an example of one in the addendum to this report. As you will see, based on the assumptions included, it shows when the selling and buying will take place, how it will impact the value of the firm and how the money will flow. This type of planning is extremely valuable in setting expectations and providing an understanding of how the perpetuation process can and should work.
7. Once you have established how your ownership will be transitioned, we recommend that you put your plan in writing and that you make certain that it is aligned with and supported by all of the other related documents and agreements, including:
  - a. The by-laws of the firm
  - b. The shareholder or partnership agreement

- c. The employment agreements (including a restrictive covenant)
  - d. Life insurance contracts on the lives of the firm's owners
  - e. Disability buy-out insurance on the firm's owners (if this is carried)
  - f. Agreements and covenants with the firm's bank(s)
  - g. The wills or trust agreements of the firm's owners
8. Once your ownership perpetuation plan is developed, summarize it in a high-level overview that can be shared with others. The key elements of your plan can be shared with:
- a. Employees, as a means to motivate them and to attract new ones.
  - b. Clients, in order to assure them of your firm's long-term stability.
  - c. Carriers, to give them a greater understanding of your future intentions and how you are positioned to remain a trading partner for them.
9. Because things constantly change, review your perpetuation plan periodically in order to make any necessary modifications. A wide range of factors might significantly alter your circumstances. The desired timing of owners' retirements, changes in the your firm's operating performance, new employee hires or terminations, regulatory or tax law changes – all are issues that might affect your perpetuation plan. A plan needs to be dynamic in order to properly function and achieve your ownership team's objectives.

# Acknowledgments

The Private Ownership Study was conceived, conducted, written and produced by Reagan Consulting in an effort to respond to the desire of many agents and brokers to remain privately-held and their need to have more tools and resources to help them do so. It would not have been possible for us to have conducted and produced this study without the backing of four insurance companies. These companies, through their financial commitment to this study, have tangibly demonstrated their support for the agents and brokers they serve, and for the industry as a whole.



Liberty Mutual **Agency Markets**



The Advantage of Partnership

We also want to express our thanks and appreciation to The Council of Insurance Agents & Brokers for their sponsorship and support of this study.



**THE COUNCIL**  
of INSURANCE  
AGENTS & BROKERS

Finally, we want to thank the almost 900 agents and brokers who were willing to participate in the Baseline Perpetuation Survey, the 146 agents and brokers who were willing to take additional time to also participate in the In-Depth Perpetuation Survey and the numerous firms that have provided to us additional information, input and observations. The number of agents participating is a testimony to the importance of this topic to them and their desire to be better equipped to accomplish their desired perpetuation objectives. For their participation we will be sending a copy of the study in thanks and appreciation. We do offer our sincere thanks and appreciation to each and every one of them and trust that with this study and the information that has come from this study they, and their peers within the industry, will be better positioned to accomplish their perpetuation objectives.



# Appendix A: Note on ESOPs

While the vast majority of insurance agencies are “employee-owned,” very few have actually implemented an ESOP. In fact, only 5% of the almost 900 firms that completed the *Baseline Perpetuation Survey* have an ESOP as part of their ownership structure. Nevertheless, curiosity about ESOPs abounds among agency principals looking for an edge in their quest to perpetuate internally.

## **What exactly is an ESOP?**

An ESOP is a tax qualified, defined contribution, employee benefit (ERISA) plan designed to invest primarily in the stock of the sponsoring employer. It can either complement a company’s existing retirement plan (such as a 401(k) or profit sharing plan) or can be used exclusively as the company’s sole retirement plan. It is a flexible corporate finance tool that takes advantage of numerous tax incentives by allowing a company’s employees to own the stock of their employer. The ESOP purchases shares from either the company or its shareholders and those shares then get allocated to the all of the company’s employees in amounts proportional to each employee’s W-2 wages relative to the entire company’s wage pool (subject to certain limitations.)

## **Why do agencies adopt ESOPs?**

In our experience, agency principals that adopt ESOPs do so to obtain a handful of key benefits. The list of benefits shown below is not all-inclusive, but represents the key motivations of those who adopt ESOPs.

- An ESOP captures a myriad of tax benefits available for multiple parties – the company, employees and stockholders.
- Shareholders who sell shares to the ESOP can, if certain qualifications are met, defer capital gains taxes on the sale, until the point that the replacement securities are sold.
- Contributions of either cash or company stock to the ESOP are tax-deductible to the company and, like other qualifying pension contributions, are non-taxable to the employees when received.
- Debt payments – both principal and interest - that are made for the purchase of shares by the ESOP are tax deductible.
- Liquidity for departing shareholders can be created, even in the absence of a clearly-defined “next generation” of Able Buyers.
- It enables the spreading of stock ownership redemption obligations over a wide number of individuals of various ages in order to avoid major concentrations of ownership being redeemed all at once.
- It potentially enhances morale by providing all employees with the sense of stewardship that accompanies actual ownership in their employer.
- It allows the current leadership of the company to retain control.

While these benefits can be compelling, agency owners need to do extensive homework before adopting an ESOP. There are some potential drawbacks, including:

- Administration requirements are significant – both at start-up as well as annually. Implementation requires an initial feasibility study, an independent valuation, a repurchase liability study and the development of the ESOP plan document. Then, the plan must be regularly monitored and managed, which requires an independent annual valuation of the company’s stock as well as a third-party administrator’s preparation of the employees’ annual benefit statements.
- Fiduciary obligations are real. When an ESOP is put in place and purchases shares, the ESOP becomes a shareholder of the firm and generally possesses the rights afforded to other similarly situated shareholders. An agency’s board of directors must appoint a trustee for the ESOP (usually one or more members of the management team) and that trustee is charged with taking actions on the ESOP’s behalf. The trustee’s fiduciary duty is to act solely for the benefit of the ESOP participants.

- The positive cultural impact that agencies expect when adopting ESOPs sometimes does not materialize. This can occur for a variety of reasons – most notably a combination of poor stock price performance and ineffective communication.

We have seen agencies where ESOPs have served the firm well as a primary or, in more instances, secondary transfer mechanism. In light of the information gathered in this study, here are some observations about ESOPs and their usefulness in helping agencies remain privately-held:

- Except in rare cases, ESOPs are most often used as a complementary tool supporting other transfer mechanisms, most often ownership purchases.
- An ESOP is similar to an ownership purchase with a Buyer Coverage Ratio well in excess of 100%. The typical firm has a buyer coverage ratio of 100%, so an ESOP is more generous to buyers than the typical firm. The reason is that taxes and down payments are not applicable in an ESOP.
- The typical agency spends approximately 2.5% of its revenue on retirement contributions for its employees. If that same money is “captured” by re-directing it into ESOP contributions that fund the acquisition of the agency’s stock, it could afford to annually purchase approximately 2% of that firm’s shares – perpetually. If the average ESOP participant spends 10 years with the agency, this potentially means that roughly 20% of an agency’s stock can be recycled through its ESOP at no additional cost over what is currently spent on retirement contributions in a 401(k) or other retirement plan.
- A common concern about ESOPs is that they are “socialistic” in nature. Since all employees participate, rather than only those key employees who can demonstrably drive the value of the company, the rewards of ownership get spread too widely. This is not totally true because participation is based on payroll which does favor the higher paid employees, but the cap on eligible payroll does hurt the highest performers. In a professional services industry like insurance brokerage, where ownership is typically reserved for high performing impact players, this represents a real philosophical hurdle that keeps some firms from adopting ESOPs.
- The tax benefits are compelling. With state and federal income tax rates commonly approaching or exceeding 40%, the value of a tax deductible component of a perpetuation plan is enormous – and will

only grow in future years if tax rates increase to cover government deficits.

- It seems that the key trade-off in considering an ESOP is whether or not the value of the tax benefits and the generational spread of ownership exceed the costs of administration and compliance, as well as the philosophical hurdle of spreading ownership out to all of any agency's employees.

# Appendix B: Note on Valuation

One of the biggest challenges to successful internal perpetuation is the ability of the agency principals, both current and future, to properly understand valuation as it applies to internal ownership transfers. Even a seemingly minor deviation from the appropriate value can jeopardize an agency's perpetuation plan. It all begins with a proper understanding between various *types* of valuations. The two most prevalent are (1) "Third-party" valuations and (2) Internal or "Going Concern" valuations. Below we will explain each.

## **Third-party Valuations**

A Third-party valuation is what a buyer (whether an insurance broker, bank, private equity firm or other outside investor) is willing to pay for 100% of an insurance agency. There are three ways beyond simply a higher EBITDA multiple that a Third-party valuation might exceed an Internal valuation.

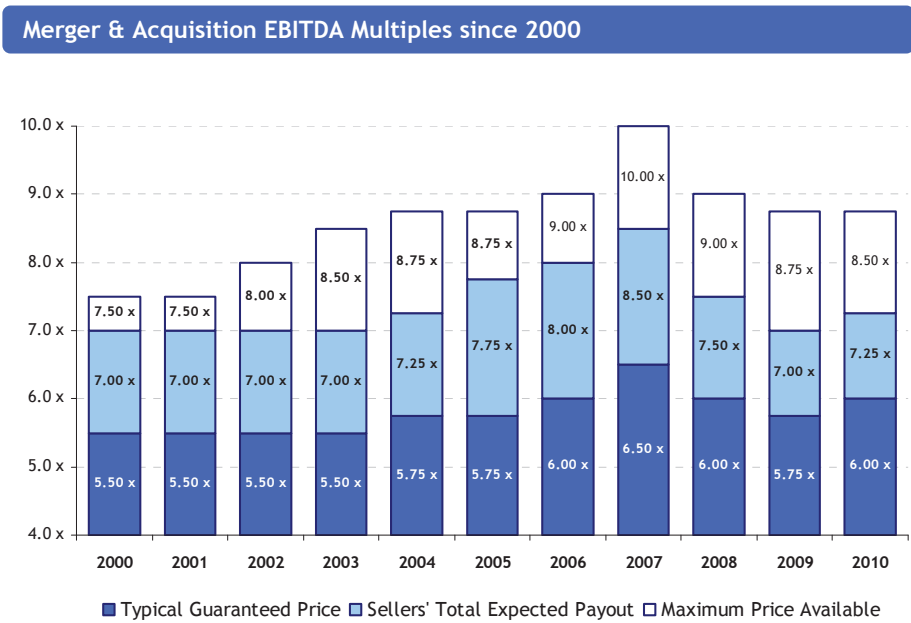
First, as discussed earlier in the study, when such a transaction is consummated, there are often several adjustments to the expense structure (reducing owner compensation, eliminating non-recurring or redundant expenses, eliminating non-performing employees, etc.) that enable the buyer to pay a higher price. While these savings do not always get fully paid to the seller, a portion of them often does.

Second, most transactions reported within our industry are not fully guaranteed, but instead offer an incentive payment that is only paid if certain results are achieved (the "earn-out"). Especially with market conditions as

they are, many of today’s earn-outs will ultimately pay only a fraction of the potential maximum payout.

Third, many agency acquirers are in a position to pay a higher multiple based on issues that they, as outsiders, bring to the table. For example, their own stock price might be trading at a materially higher value than the acquisition multiple they pay. Or they might achieve certain tax benefits from a particular deal. Or they might benefit from economies of consolidation that they can achieve after the transaction.

For each of these reasons, it is common for outside buyers to be in a position to pay a higher price than insiders. Shown below is a table of third-party valuations over the last ten years.



Source: Reagan Consulting Analysis

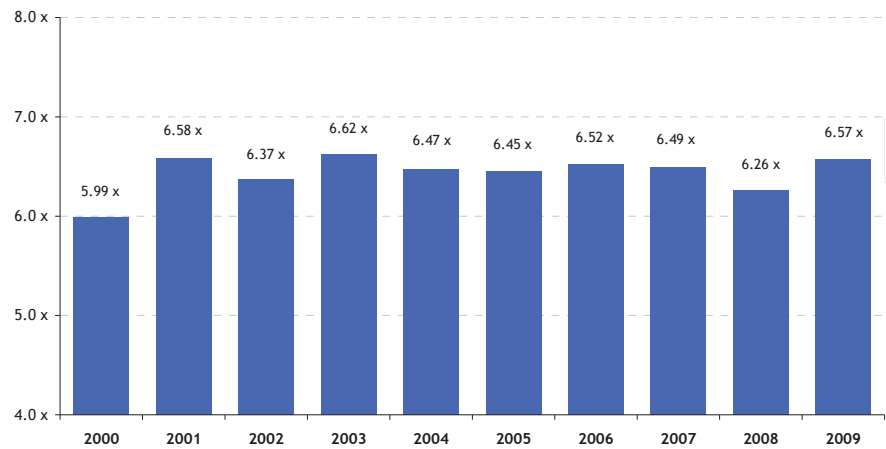
### Internal or Going Concern Valuations

Many of the most common drivers of valuation advantages for third-party buyers simply do not apply for internal transfers. They tend to be more straightforward transactions that are based simply on the actual earnings that can be expected based on the operation as it exists today, along with what is actually expected to happen in the future. The Internal Valuation is primarily based on a projection of actual future anticipated earnings, discounted back to

a present value based on current interest rates, the actual risk inherent in the agency and the agency’s ability to achieve its projected earnings. In addition, the valuation considers the health and strength of the agency’s balance sheet. Stated another way, this valuation establishes the value that an internal buyer (whether an individual, an ESOP or the agency itself) can afford to pay for a share of stock. In virtually every instance, the value established in an Internal Valuation is a fixed specific figure that has no earn-out or variable component. As such, a buyer pays a fixed price that is fully guaranteed to the seller.

With the value of privately-held insurance agencies not being publicly available, there is limited data on where these values typically fall. From the numerous privately-held firms that Reagan Consulting annually appraise, we have compiled averages of these firm’s Internal Valuations, stated as a multiple of EBITDA (pre-tax cash flow). Our experience has shown that on average, the Internal Valuations of privately-held insurance agencies generally falls within a range of 5 to 7 times EBITDA. However, as these are averages of firms that would fairly be considered as performance leaders within the industry, they tend to fall toward the upper end. The data for the past 10 years is shown below.

**Internal Perpetuation EBITDA Multiples Since 2000**



Source: Reagan Consulting Analysis

### **Internal Perpetuation**

For internal buying and selling of stock, the values that should be used should be established using Internal Valuations rather than Third-party Valuations. As is discussed earlier in this study, there are different ways to establish the Internal Value of an agency. Some firms use formulas, but formulas can lead to understated or overstated values that neither buyers nor sellers have much confidence in. The best way to establish an Internal Valuation is by obtaining an independent appraisal through the services of a competent, knowledgeable appraiser.



# Appendix C: Viability Checklist

The following brief checklist, separated into items relating to each of the Four Pillars, can be used by agency owners to assess internal perpetuation viability.

## Healthy Operations

- Are you generating the profits needed to create value and support ownership transfers?
- Are you achieving sufficient growth to create value and support ownership transfers?
- Do you have a healthy balance between profit and growth?
- Are you aware of the factors impacting the risk inherent in your firm and have you done (or are you doing) what can be done to eliminate or reduce the risk?
- Do you have a healthy balance sheet (i.e., receivables management, liquidity, net worth)?

## Reasonable Sellers

- Are sellers willing to accept a valuation for their interests that the internal buyers can afford to pay?
- Is the basis for valuing the stock/ownership interests fair, reasonable and appropriate?
- Are the sellers willing to provide or arrange financing for the purchase of their ownership interests that will work for the buyers?
- Will the valuation, distributions and financing terms result in a Buyer Coverage Ratio that will work for the buyers?

- Are the sellers willing to sell ownership interests to the younger key employees and willing to begin reducing ownership percentages so as not to create an unworkable burden on the buyers?
- Is the firm's WASA (Weighted Average Shareholder Age) at a healthy level?

#### Able Buyers

- Are there enough potential buyers that will have the desire to be future owners?
- Do you have people capable of being the future leaders of the firm? Will the employees support the next generation leadership?
- Do the potential buyers have the personal discipline, financial sophistication, people skills and unity needed to own and run the firm?
- Do you have the people in the organization that can fill the key future management, sales and operations roles?
- Do the potential buyers have the personal financial resources to purchase ownership or will they be provided with the financing and distributions needed to purchase their ownership interest?

#### Effective Transfer Mechanisms

- Do you have in place the means and timetable for transferring ownership between buyers and sellers?
- Is the plan that you have for buying and selling supported by the current and anticipated operating results of the firm (i.e., profits, growth and balance sheet strength)?
- Does the plan that you have in place provide the most favorable tax consequences for sellers and buyers?
- Is the plan that you have in place understood and embraced by the current and anticipated future owners of the firm?
- Have you positioned your perpetuation plan such that it will support your efforts to attract, retain and motivate talented employees?
- Do you have a written perpetuation plan and do you have all of the other supporting pieces in place (i.e., employment agreements, shareholder agreements, life insurance, disability buy-out insurance, etc.)?

If the answer to any of these questions is “no,” in most instances, this represents an issue or factor that will limit your ability to effectively perpetuate the ownership of the firm internally. In those areas where you fall short, efforts should be made to begin understanding why there is a “no” and considering what can be done to address that particular issue. Experience has shown that, with the exception of the expectations of the sellers (current owners), most any problem can be addressed and rectified if there is sufficient time and the desire to do so. There are even ways to creatively address the expectations of the owners but in those instances where the seller wants the highest third-party valuation available and wants to assume no risk, a third-party sale may be the only option. Poor planning and anticipation can limit the options particularly as respects having in place the next generation of owners and leaders of the firm. This is not a problem that can be solved at the 11th hour.



# Appendix D: Sample Model

This section provides an illustration of a forecasting model that can be used to help develop and validate an agency's perpetuation plan. Some models are simpler, while others are significantly more complicated. This illustration covers some of the most important issues that must be considered by firms planning for internal perpetuation. For presentation purposes, we have shown the model over seven years, but typically a longer horizon – 10 to 15 years – should be considered. The illustration involves a \$10 million firm, and we have presented the data in thousands.

## **Share Ownership**

In the top section of the model, we have projected the share ownership of the firm over seven years. The current owners of the firm have an agreement to sell 20% of their stock per year starting at age 61. In this illustration, both Joe Smith and Bill Jones reach age 61 and begin selling shares. The stock sold by these senior owners is purchased by the younger owners, including several that have not been identified (the “Future Owners”). Red numbers indicate years where owners are selling shares, while blue numbers indicate years where owners are buying shares.

At the bottom of this section, we have shown the annual percentage of the company's stock to be bought and sold and we have presented the firm's WASA. We have estimated that the Future Owners are age 30 currently and purchase stock for the first time at age 35.

## Perpetuation Model Illustration (data in thousands)

Share Ownership	Current Age	% Owned Year 1	% Owned Year 2	% Owned Year 3	% Owned Year 4	% Owned Year 5	% Owned Year 6	% Owned Year 7
JOE SMITH	56	20.0%	20.0%	20.0%	20.0%	20.0%	16.0%	12.0%
BILL JONES	59	37.5%	37.5%	30.0%	22.5%	15.0%	7.5%	0.0%
WALTER BROWN	46	16.5%	16.5%	19.0%	21.5%	24.0%	26.9%	29.8%
MARY HARDY	41	15.0%	15.0%	17.5%	20.0%	22.5%	25.4%	28.3%
PETER HOLIDAY	34	11.0%	11.0%	13.5%	16.0%	18.5%	21.4%	24.3%
FUTURE OWNERS	30	0.0%	0.0%	0.0%	0.0%	0.0%	2.9%	5.8%
Total		100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
% of Equity Transferred		0.0%	0.0%	7.5%	7.5%	7.5%	11.5%	11.5%
WASA		50.8	51.8	51.4	51.0	50.6	49.3	48.0

Financial Performance / Valuation	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7
Net Revenues	\$10,000	\$10,300	\$10,609	\$10,927	\$11,255	\$11,593	\$11,941
Growth		3.0%	3.0%	3.0%	3.0%	3.0%	3.0%
EBITDA	\$2,000	\$2,060	\$2,122	\$2,185	\$2,251	\$2,319	\$2,388
EBITDA Margin	20.0%	20.0%	20.0%	20.0%	20.0%	20.0%	20.0%
EBITDA Valuation Multiple	6.0 x	6.0 x	6.0 x	6.0 x	6.0 x	6.0 x	6.0 x
Value of Earnings	\$12,000	\$12,360	\$12,731	\$13,113	\$13,506	\$13,911	\$14,329
Balance Sheet Adjustment	\$250	\$250	\$250	\$250	\$250	\$250	\$250
Equity Value	\$12,250	\$12,610	\$12,981	\$13,363	\$13,756	\$14,161	\$14,579
Total Distributions	\$1,600	\$1,648	\$1,697	\$1,748	\$1,801	\$1,855	\$1,910
% of EBITDA	80.0%	80.0%	80.0%	80.0%	80.0%	80.0%	80.0%
Value as a Multiple of Distributions	7.7 x	7.7 x	7.6 x	7.6 x	7.6 x	7.6 x	7.6 x

Perpetuation Calculations	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7
Equity Value Sold / Purchased	-	-	\$946	\$974	\$1,002	\$1,582	\$1,629
Total Down Payment (10%)	-	-	95	97	100	158	163
Amount Financed	-	-	851	876	902	1,424	1,466

## Year 3 Purchases

Buyer Principal and Interest Payments	\$110	\$110	\$110	\$110	\$110
Buyer Distributions	127	131	135	139	143
Buyer Coverage Ratio	115.5%	119.0%	122.5%	126.2%	130.0%

## Year 4 Purchases

Buyer Principal and Interest Payments	\$113	\$113	\$113	\$113
Buyer Distributions	131	135	139	143
Buyer Coverage Ratio	115.6%	119.0%	122.6%	126.3%

## Year 5 Purchases

Buyer Principal and Interest Payments	\$117	\$117	\$117
Buyer Distributions	135	139	143
Buyer Coverage Ratio	115.6%	119.1%	122.7%

## Year 6 Purchases

Buyer Principal and Interest Payments	\$184	\$184
Buyer Distributions	213	220
Buyer Coverage Ratio	115.7%	119.2%

## Year 7 Purchases

Buyer Principal and Interest Payments	\$190
Buyer Distributions	220
Buyer Coverage Ratio	115.7%

Source: Reagan Consulting Analysis

### **Financial Performance / Valuation**

In the middle section of the model, we have projected the financial performance of the firm and the resulting impact on agency value. We are projecting that revenue will grow at 3% per year and that EBITDA margins will remain constant at 20%.

To estimate the value of the firm, we are assuming that the firm's independent appraiser arrives at a Value of Earnings (enterprise value) representing 6.0 x EBITDA each year, though this number would likely vary slightly. To this Value of Earnings, the appraiser must also account for the balance sheet. In our example, the Balance Sheet Adjustment adds an additional \$250,000 to the agency's value. The sum of the Value of Earnings and the Balance Sheet Adjustment is the Equity Value, which is the value at which shares will be transferred.

At the bottom of this section, we have shown the profit distributions for the firm, which are projected to be 80% of EBITDA. The remaining profits are assumed to be left in the agency to fund capital expenditure requirements, growth investments or potential acquisitions. Finally, we have then expressed the value of the firm as a multiple of those distributions, in order to provide a leading indicator of the Buyer Coverage Ratio.

### **Perpetuation Calculations**

In the bottom section of the model, we have used the information generated from the first two sections to estimate how internal perpetuation will look for this firm over the seven-year period presented.

We have started with the value of the shares to be bought and sold each year, which is calculated using the equity value of the firm and the yearly percent of equity transferred. Then, we have assumed some terms for these purchases and sales: a 10% down payment, with the remainder financed over 10 years at 5% interest. The calculated down payment and the amount financed are then presented below the Equity Value Sold / Purchased each year.

Then, in the blue boxes at the bottom, we have provided a summary of the key elements of the stock purchase from the buyers' point of view.

In Year 3, for example, 7.5% of the company will be sold by Bill Jones and purchased by Walter, Mary and Peter. The three buyers will pay a total price of \$946,000 for Bill's 7.5% interest, and they will pay 10% down (\$95,000) and will finance the balance (\$851,000) over 10 years with interest at 5%.

The principal and interest payments made by this group, as highlighted in the blue box titled Year 3 Purchases, will be \$110,000 per year. However, this group will also be entitled to 7.5% of the agency's distributions each year, which means they will collectively receive a distribution of \$127,000 in Year 3, and an increasing amount thereafter – assuming continued growth.

At the bottom of each blue box, we have presented a calculation of the Buyer Coverage Ratio, which for the Year 3 purchases is 115.5%. This means that although the buying group will need to come up with the down payment out-of-pocket, the buyers can expect that they will receive enough cash flow from the agency to make the principal and interest payments and even cover some of the tax obligations on the shareholder distributions. Because the dynamics and variables of the firm do not change over time – at least in this perpetuation model – the Buyer Coverage Ratio remains consistent for each year's purchases, as highlighted in the blue boxes for Year 4, Year 5 and beyond.

### **Conclusion**

This illustration is intended to provide an example of a perpetuation model that is functioning effectively. Each of the Four Pillars – a Healthy Operation, Willing Sellers, Able Buyers and an Effective Transfer Mechanism – is present. Of course, there is still no guarantee of success, since unforeseen circumstances will likely arise to create challenges. But the use of a forecast model which incorporates a set of assumptions that both sellers and buyers agree are realistic can be an invaluable tool for exposing flaws in a firm's perpetuation plan and for isolating issues that need to be corrected.





One Piedmont Center, Suite 500, Atlanta, Georgia 30305

404.233.5545

[www.reaganconsulting.com](http://www.reaganconsulting.com)