The Exit Strategy: Selling your Insurance Agency or Brokerage

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Certified Business Intermediary
Merger & Acquisition Master Intermediary

www.agencybrokerage.com
Agenda

• Planning the Sale
• Developing an exit plan
• Agency market value
• Enhancing the value
• The sale process
• Working with advisors
• Final thoughts
Planning the Sale

Most owners have plans for:

- Funding startup
- Marketing
- Training staff

- Tracking production
- Retaining clients
- Maximizing income
Planning the Sale

• Why plan the sale?
  – Improve the value
  – Sell for the best price and terms
  – Minimize tax liability
  – Maximize confidentiality when selling
  – Avoid distressed sale situation
  – Ensure an overall smoother sale process
  – Improve post-sale continuity

➤ You only get one chance to get it right!
Planning the Sale

- Sale consideration factors:
  - Financial:
    - Income
    - Debt
    - Taxes
  - Life:
    - Health
    - Family
    - Time/Stress
  - Market:
    - Demand
    - Supply
    - Capital
  - Other:
    - Economy
    - Regulation
    - Competition
Planning the Sale

- What drives agency owners to sell:

- Retirement: 28%
- Financial and/or economic concerns: 25%
- Life change: 19%
- Burned out: 14%
- Health issues: 14%

*Based on internal statistics from our clients*
Planning the Sale

Rules to Follow:
1. Set goals and follow an exit plan
2. Understand market value
3. Work on enhancing value
4. Understand the sale process and how to obtain the best deal
5. Seek professional guidance
6. Be flexible and committed to the process
1. Develop an Exit Plan

- Estimate market value
- Assess current goals
- Execute sale process
- Hold
- Determine objective
- Sell
- Identify areas for improvement
- Implement and monitor changes
Planning the Sale

Rules to Follow:
1. Set goals and follow an exit plan
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2. Agency Market Value

**Question 1:** What’s an agency worth?

**Answer:** That which a buyer is willing to pay and a seller is willing to accept!

**Question 2:** How do you yield the highest price with the best terms?

**Answer:** Understand what drives value to a buyer, prepare the agency for sale and execute a structured sale process.
2. Agency Market Value

• Formal appraisal methods:
  1. Income Approaches
  2. Asset Approaches
  3. Market Approaches

• The reality is that the value to a buyer is driven by:
  1. Pro forma revenue and earnings
  2. Risk/opportunity of the agency or book of business
  3. Terms of the transaction
2. Agency Market Value

- **Revenue & Earnings**
  - Valuing on commission revenue
    - Does not factor in *profitability*
    - More applicable in the sale of small book of business
  - Valuing on earnings
    - Provides a measure of the buyer’s Return on Investment (ROI)
    - Factors in the ability to cover financing debt and pay the buyer a salary
    - Applicable for valuing a business as a going concern
2. Agency Market Value

- **Revenue & Earnings**
  - Most common earnings used in deal pricing for an agency is EBITDA: Earnings before interest, taxes, depreciation and amortization
  - The pro forma EBITDA is inversely related to the buyer’s expected pre-tax ROI

<table>
<thead>
<tr>
<th>EBITDA Multiple</th>
<th>Implied Pre-Tax ROI</th>
</tr>
</thead>
<tbody>
<tr>
<td>4.0</td>
<td>25.0%</td>
</tr>
<tr>
<td>5.0</td>
<td>20.0%</td>
</tr>
<tr>
<td>6.0</td>
<td>16.7%</td>
</tr>
<tr>
<td>7.0</td>
<td>14.3%</td>
</tr>
<tr>
<td>8.0</td>
<td>12.5%</td>
</tr>
</tbody>
</table>
## Sample Pro Forma Recast Statement

### Tax Return Adjustments Pro Forma Description of Adjustments

<table>
<thead>
<tr>
<th>Description of Adjustments</th>
<th>Total Revenue</th>
<th>Operating Expenses</th>
<th>Operating Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Revenue</td>
<td>$ 964,754</td>
<td>$ 949,698</td>
<td></td>
</tr>
<tr>
<td>Total Operating Expense</td>
<td>$ 784,791</td>
<td>$ 536,794</td>
<td></td>
</tr>
<tr>
<td>Operating Income</td>
<td>$ 179,963</td>
<td>$ 412,904</td>
<td>$ 332,904</td>
</tr>
</tbody>
</table>

### Operating Expenses

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
<th>%</th>
<th>Adjusted</th>
<th>%</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Compensation of Officers</td>
<td>$ 87,485</td>
<td>9.21</td>
<td>$ 87,485</td>
<td>0.00</td>
<td>Owner's salary</td>
</tr>
<tr>
<td>Salaries and Wages</td>
<td>$ 312,874</td>
<td>32.94</td>
<td>$ 312,874</td>
<td>32.94</td>
<td>Landlord expense</td>
</tr>
<tr>
<td>Repairs and Maintenance</td>
<td>$ 6,003</td>
<td>0.63</td>
<td>$ 3,503</td>
<td>0.37</td>
<td>Fair market rent adjustment</td>
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<tr>
<td>Rent</td>
<td>$ 81,729</td>
<td>8.61</td>
<td>$ 68,400</td>
<td>7.20</td>
<td>Owner's PR &amp; property tax</td>
</tr>
<tr>
<td>Taxes and Licenses</td>
<td>$ 47,170</td>
<td>4.97</td>
<td>$ 22,007</td>
<td>2.32</td>
<td>Notes paid at closing</td>
</tr>
<tr>
<td>Interest</td>
<td>$ 53,876</td>
<td>5.67</td>
<td>$ 0.00</td>
<td>0.00</td>
<td>Non-cash expense</td>
</tr>
<tr>
<td>Depreciation</td>
<td>$ 433</td>
<td>0.05</td>
<td>$ 0.00</td>
<td>0.00</td>
<td>Discretionary</td>
</tr>
<tr>
<td>Advertising</td>
<td>$ 21,860</td>
<td>2.30</td>
<td>$ 21,860</td>
<td>2.30</td>
<td>Owner's insurance</td>
</tr>
<tr>
<td>Auto Expense</td>
<td>$ 410</td>
<td>0.04</td>
<td>$ 0.00</td>
<td>0.00</td>
<td>Owner's insurance</td>
</tr>
<tr>
<td>Insurance</td>
<td>$ 28,213</td>
<td>2.97</td>
<td>$ 14,107</td>
<td>1.49</td>
<td>50% Meals and Entertainment</td>
</tr>
<tr>
<td>Internet Expense</td>
<td>$ 6,245</td>
<td>0.66</td>
<td>$ 6,245</td>
<td>0.66</td>
<td>Personal professional fees</td>
</tr>
<tr>
<td>Miscellaneous</td>
<td>$ 7,637</td>
<td>0.80</td>
<td>$ 7,637</td>
<td>0.80</td>
<td>Non-cash expense</td>
</tr>
<tr>
<td>Office Expense</td>
<td>$ 30,458</td>
<td>3.21</td>
<td>$ 30,458</td>
<td>3.21</td>
<td>Discretionary</td>
</tr>
<tr>
<td>Postage and Delivery</td>
<td>$ 6,588</td>
<td>0.69</td>
<td>$ 6,588</td>
<td>0.69</td>
<td>Manager's Salary (est FMV)</td>
</tr>
<tr>
<td>Printing and Reproduction</td>
<td>$ 826</td>
<td>0.09</td>
<td>$ 826</td>
<td>0.09</td>
<td>Adjusted EBITDA</td>
</tr>
<tr>
<td>Professional Fees</td>
<td>$ 12,632</td>
<td>1.33</td>
<td>$ 10,632</td>
<td>1.12</td>
<td>Manager's Salary (est FMV)</td>
</tr>
<tr>
<td>Telephone</td>
<td>$ 24,200</td>
<td>2.55</td>
<td>$ 24,200</td>
<td>2.55</td>
<td>Adjusted EBITDA</td>
</tr>
<tr>
<td>Utilities</td>
<td>$ 6,931</td>
<td>0.73</td>
<td>$ 6,931</td>
<td>0.73</td>
<td>Personal professional fees</td>
</tr>
<tr>
<td>Amortization</td>
<td>$ 46,609</td>
<td>4.91</td>
<td>$ 0.00</td>
<td>0.00</td>
<td>Non-cash expense</td>
</tr>
<tr>
<td>50% Meals and Entertainment</td>
<td>$ 2,086</td>
<td>0.22</td>
<td>$ 0.00</td>
<td>0.00</td>
<td>Discretionary</td>
</tr>
<tr>
<td>Miscellaneous</td>
<td>$ 526</td>
<td>0.06</td>
<td>$ 526</td>
<td>0.06</td>
<td>Discretionary</td>
</tr>
</tbody>
</table>
2. Agency Market Value

• A pro forma EBITDA is an estimate of the buyer’s “investment” cash flow

• Might include adjustments for buyer’s expected
  – Changes to revenue
  – Management expenses
  – Additional investment costs
  – Cost reductions from synergies

• May be based on
  – An historic average
  – Prior year’s performance
  – Projection for future year(s)
2. Agency Market Value

- Why earnings matter

<table>
<thead>
<tr>
<th></th>
<th>Agency 1</th>
<th>Agency 2</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Revenue</strong></td>
<td>$500,000</td>
<td>$500,000</td>
</tr>
<tr>
<td><strong>Expenses</strong></td>
<td>$400,000</td>
<td>$300,000</td>
</tr>
<tr>
<td><strong>Discretionary Earnings</strong></td>
<td>$150,000</td>
<td>$225,000</td>
</tr>
<tr>
<td><strong>Price</strong></td>
<td></td>
<td>$750,000</td>
</tr>
<tr>
<td>Buyer's down pmt</td>
<td></td>
<td>$150,000</td>
</tr>
<tr>
<td>Amount financed</td>
<td></td>
<td>$600,000</td>
</tr>
<tr>
<td>Annual debt service</td>
<td></td>
<td>$103,623</td>
</tr>
<tr>
<td><strong>Earnings after Debt</strong></td>
<td>$46,377</td>
<td>$121,377</td>
</tr>
<tr>
<td>Owner replacement salary</td>
<td></td>
<td>$60,000</td>
</tr>
<tr>
<td>Return to investment</td>
<td>-$13,623</td>
<td>$61,377</td>
</tr>
<tr>
<td><strong>Cash on Cash Return</strong></td>
<td>-9%</td>
<td>41%</td>
</tr>
<tr>
<td><strong>Return on Investment</strong></td>
<td>12.0%</td>
<td>22.0%</td>
</tr>
</tbody>
</table>
2. Agency Market Value

• What are “risk factors”?  
  – Elements that put the future revenue/earnings at risk

• Examples of internal risk factors:
  – Declining or fluctuating revenue
  – Revenue concentrated with a carrier, producer, client or line of business
  – Weak protections or control over book of business
  – Above market compensation rates to staff and producers
  – Unproveable income/expenses
  – Low retention history
  – High loss ratios
2. Agency Market Value

- Examples of external risk factors:
  - General economic outlook
  - Changes in regulatory environment
  - Changes in carrier compensation rates
  - Hard/soft market cycle
  - Stock market performance
  - Interest rates and availability of capital

- How do risk factors influence the sale?
  - Can influence price
  - Can influence terms
  - Can make an agency unsellable
2. Agency Market Value

- A closer look at the impact of financing terms

<table>
<thead>
<tr>
<th></th>
<th>$500,000</th>
<th>$200,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Expenses</td>
<td>$300,000</td>
<td></td>
</tr>
<tr>
<td>Earnings</td>
<td></td>
<td>$200,000</td>
</tr>
<tr>
<td>Price</td>
<td>$750,000</td>
<td></td>
</tr>
<tr>
<td>Buyer's down pmt</td>
<td>$150,000</td>
<td></td>
</tr>
<tr>
<td>Amount financed</td>
<td>$600,000</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Length of Payment</th>
<th>Rate 6.0%</th>
<th>Rate 8.0%</th>
<th>Rate 10.0%</th>
<th>Return on Invested $</th>
</tr>
</thead>
<tbody>
<tr>
<td>3</td>
<td>$219,038</td>
<td>$225,622</td>
<td>$232,324</td>
<td>Negative</td>
</tr>
<tr>
<td>5</td>
<td>$139,196</td>
<td>$145,990</td>
<td>$152,979</td>
<td>None</td>
</tr>
<tr>
<td>7</td>
<td>$105,182</td>
<td>$112,221</td>
<td>$119,529</td>
<td>Moderate</td>
</tr>
<tr>
<td>10</td>
<td>$ 79,935</td>
<td>$ 87,356</td>
<td>$ 95,149</td>
<td>High</td>
</tr>
</tbody>
</table>

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2. Agency Market Value

- Average Inflation Rate
- Federal Funds Rate

Rate (%)


Copyright Agency Brokerage Consultants 2011
2. Agency Market Value

• Alternatively, what are additional opportunities to a strategic buyer?
  – Unique market position
  – Potential for cross selling
  – Special or limited contracts with carriers
  – Economies of scale

• Buyers may pay more for strategic value but the terms will be structured to ensure the potential comes to fruition.
2. Agency Market Value

• **Transaction Terms**
  
  – Generally buyers want:
    • To be able to leverage the purchase
    • The seller to share in the risk
    • Assurances that the business and goodwill will transfer

  – Considerations impacting value:
    • Amount of cash or equivalent delivered at closing
    • Terms of a seller note
    • Earn-out or retention-based payments
    • Seller employment agreement
    • Non-competition agreement of seller
2. Agency Market Value

- Why use an outside consultant to assist with a valuation analysis:
  - Understands how to interpret financial statements
  - Assesses weaknesses and strengths objectively
  - Knowledgeable of market conditions and market value

- Key: Use a knowledgeable analyst that is also engaged in agency sales.
Planning the Sale

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6. Be flexible and committed to the process
3. Enhancing Value

• How do you enhance the value?
  – Increase earnings
    • Grow revenue while maintaining profitability
    • Streamline operations to reduce expenses
    • Pay fair market compensation
    • Develop cost-effective marketing strategies
    • Watch your overhead costs and avoid long term obligations

➢ Average profitability...
  • Marketing-driven agency = 40-45%
  • Sales-driven agency = 30-35%
  • See The National Alliance for Insurance Education & Research’s annual “Growth & Performance Standards” for details.
3. Enhancing Value

• How do you **enhance** the value?
  – Minimize risks
    • Build customer loyalty by providing excellent service
    • Own, control and protect your book of business
    • Diversify your markets and customer base
    • Cross sell to build retention
    • Build in management tools
  – Train your replacement
  – Track key performance indicators
    » Closing rates and retention rates
    » Cost per lead and cost per sale
    » Revenue per employee
    » Commissions per CSR and producer
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4. The Sale Process

• More accurately, the *structured* sale process:

- Market Preparation
- Buyer Solicitation & Disclosure
- Offer & Negotiation
- Due Diligence
- Contract Closing Phase
- Post-Closing Transition
4a. Market Preparation

- **Pre-due diligence**
  - Goal: Collect, review and organize records.
  - Purpose: Minimize the chances of uncovering “landmines” and speed up the DD phase.

- **Offering memorandum**
  - Goal: Create a detailed executive summary of the agency.
  - Purpose: Educate and excite the buyer and move the process forward faster.

- **Buyer research**
  - Goal: Identify the most probable buyers.
  - Purpose: Develop a marketing strategy to discretely attract the interest of multiple potential buyers.
4b. Buyer Disclosure

- Protect the confidentiality of the sale
- Filter buyers based on financial strength and experience
- Create an auction by simultaneously disclosing multiple qualified buyers
4c. Offer Negotiations

• Types of offers
  – Term Sheet – Simple, non-binding letter
  – Letter of Intent – Detailed, non-binding letter
  – Purchase Contract – Detailed, binding contract

• Key considerations
  – Purchase price formula and terms of payment
    • Amount received at closing – average range 70-80%
    • Terms of payment on balance – fixed or contingent
    • “Clawbacks” or offsets on price
  – Guarantees or security on payment
  – Contingencies to the agreement
  – Period of exclusive dealings
4d. Due Diligence

• Due diligence is the buyer’s process of verifying the quality and condition of the business.

• Common phases:
  1. Financial
  2. Operational
  3. Legal

• The process can:
  • Vary from a few weeks to a few months
  • Make or break a deal!
4e-f. Post-Contract

• Pre-Closing
  – Removal of contingencies
    • Financing approval
    • Carrier approvals
    • Execution of employment agreements
  – Drafting of final closing documents

• Post-Closing
  – Complete transfer of business
  – Assist with transition
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5. Professional Advisors

- Merger & Acquisition Advisor
  - Advise on market value and ways to enhance value
  - Prepare and manage sale process

- Accountant
  - Assist with due diligence
  - Advise on tax implications

- Attorney
  - Assist with offer negotiation
  - Advise on legal implications

➢ Seek out experienced advisors that are knowledgeable of your business, the industry and the buy/sell process.
5. Professional Advisors

- Consult on enhancing value
- Facilitate private auction
- Negotiate best price & terms
- Minimize tax liability
- Minimize legal exposure
- Reduce seller’s stress and time
- Make a deal happen

nç The value of good advisors greatly exceeds the expense.
Planning the Sale

Rules to Follow:
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6. Be flexible and committed to the process
6. Final Thoughts

• What you should expect:
  – Committing time and resources to the process
  – Issues to arise along the way
  – Stress and emotions to come into play
  – A much better end result!
Questions or Comments

• Thank you for your time and I hope that you found this information useful.

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