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Now is the Time

Get Your Brokerage Sale Ready

By Eric Walker and David Townley.

In the 2000 edition of his national bestselling book *Boom, Bust & Echo*, David K. Foot declared that "the passage of the boomers into t heir 50's is having profound effects on the social and economic life of Canada."

Five years later, this dominant and aging group in our society is having its impact on many aspects of our economy, including the small- and medium sized enterprise (SME) sector, a group in which most privately-owned insurance brokers would qualify for membership. This sector is important to Canada's economic prosperity and employs a majority of Canadians in the national workforce.

Two research studies were published in 2005, one by the Canadian Federation of Independent Business (CFIB) and another by CIBC World Markets Inc., highlighting the succession and retirement plans and aspirations of SME owners and Canadian entrepreneurs.

The CFIB study indicates that only a third of SME owners are planning for their succession and the majority of those that do have plans are informal – that is, the plans are not written down. This situation is described as alarming because 41 per cent of SME owners intend to exit their business within the next five years.

Similarly, the CIBC study shows that the number of small business owners nearing retirement (age 55 to 64) is growing rapidly at a rate of 7.5 per cent annually from the year 2000. It is estimated that by 2010, $1.2 trillion in Canadian business assets will change hands. This represents "the largest turnover of economic control in generations." The demographic realities of the Canadian population suggest "that succession planning is increasingly becoming a critical issue." Yet almost one in three SME owners do not even know when they plan to retire.

Many owners of independent insurance brokerages will be represented in the trends identified in the research studies noted above. The insurance brokerage is a significant asset to the overall net worth of these owner/managers and the after-tax proceeds from its sale represent an important source of their retirement funding. As such, succession planning should be a priority consideration.

LONG-TERM PLANNING

Prudent owners of insurance brokers will have included succession planning as an integral part of their annual and strategic planning process. Succession planning focuses on transferring management responsibility and eventually ownership of a brokerage to a family member, employee group or an unrelated third party. This aspect of business planning creates options for an internal and external sale with the potential for enhanced sale transaction value. It emphasizes developing employees for management and technical service responsibilities, and operating an efficient and financially sound business.

Consider some of the best practices typically followed by the long-term planners. Keeping on top of these factors will help increase the value of a brokerage.

Economic, social and political environments – Business plans should be prepared annually. As brokers continue to experience significant changes in their industry, it is the business planners who will survive. Business planners will determine how to allocate business resources efficiently to take advantage of changing market conditions.

Employees – Successful brokerages have programs to hire, train and adequately compensate quality staff. Well-paid, highly competent employees generally handle higher workloads and take a reduced percentage of commission income relative to less competent employees. Operational improvements, workflow and automation can also significantly influence employee productivity. Growth – Knowledgeable brokers continuously develop and implement plans to foster growth in commission income. These marketing plans could include new business sales to existing clients, enhanced commission rates, up-selling insurable values, and cross-selling to existing clients. Consistent growth in commission income demonstrates a brokerage's sales capability and an ability to preserve market share. Maintenance of market share represents the potential to generate sustainable levels of pre-tax income, which enhances value.

Profitability – Operating costs should be controlled. However, continuing investment is needed to foster growth. These somewhat conflicting goals require disciplined operational management in the key functional areas of a brokerage; finance, sales, human resources and organizational control.

Quality of business – Managing the quality and placement of insurance business protects markets, reduces E&O exposure and enhances the potential for superior levels of contingent profits. Successful brokerages have a system of front line underwriting that is monitored and controlled. All potential risk exposures are addressed prior to policy issuance and updated on a regular basis. Preferred clients are profiled and a policy established for those who do not satisfy this profile.

Business Mix – Brokers should develop strategies to increase average account size through new production. For example, commercial accounts have higher average commissions per account and can cover operating expenses. Alternatively, service a large number of smaller accounts has the advantage of spreading the business risk of an account loss. In this case, management must ensure compensation for handling renewals is reduced or eliminated for producers not active in the process. Customer service representatives should be paid for processing renewals.

Retention – A brokerage's account retention ration is a prime indicator of future income stream. It is more profitable to renew existing accounts than to acquire new business. Fewer sales and less service time is required and satisfied clients often refer new business. Improvement in the retention ratio can be accomplished by ensuring good service levels. For example, this could mean sending timely renewal notices, providing prompt responses to customer queries or requests, communicating with customers on a regular basis (newsletters) and training staff. Customer service surveys can identify client concerns, resulting in regular positive changes (e.g. rate or coverage issues). Follow-up calls to lost accounts can help track client needs and present opportunities to re-solicit business.

Credit and collections – Brokers should establish proper credit and collection practices, particularly for outstanding agency-billed accounts, which should be received within 60 days from the effective date of the policy. Because of the requirement to pay carriers within 30 to 60 days, receivables beyond 60 days represent poor billing and collection procedures. Clients should be encouraged to pay on time. Good practices for agency bill personal lines accounts include pre-billing renewals 30 days in advance of the effective date, a second notice 10 days prior to the effective date and a third notice 10 days after the effective date with a notice of intention to cancel. Cancellation should occur within 30 days of the effective date.

For new personal lines business, payment should be received in advance of the effective date of the policy. Commercial lines accounts should be billed on binder, with a second notice sent within 10 days. Again, cancellation should occur within 50 days of the effective date.

Brokers can also reduce the risk of collection problems by moving personal lines clients to direct bill plans and placing commercial lines clients on monthly financing plans.

Location – To offset the disadvantages of geographical location related to potential commission revenue growth, brokers can look at expansion through acquisition, association with other firms (clusters), as well as the use of call centre and e-commerce technology.

Captive markets – For unique programs and specialty lines contracts with insurers and client, brokerages should create clauses that allow for the sale or transfer of the business at their discretion. First rights of refusal or requirements to obtain approval to transfer the business could ultimately reduce value at the time of the brokerage sale.

Employment arrangements – Producers should be required to sign employment contracts outlining compensation structure and the ownership of client lists and business. Ownership should be reinforced and protected with non-competition and non-solicitation agreements. These arrangements preserve the value of a brokerage business.

Size – The size of a brokerage should reflect a level of commission income sufficient to maintain an experience staff operating under the direction of a general manager. Other senior staff can assume quasi-management roles in their areas of responsibility (e.g. a senior personal lines customer service representative may also act as a personal lines manager).

Brokerages of this size may generate commission income of $1 million to $1.5 million. They begin to develop the management and systems capability that support future income streams. AS such, the potential value of these brokerages is enhanced and they become attractive acquisition candidates. Even larger brokerages, however, may find it more difficult to sell because of a more limited number of potential purchasers.

Financial position – Brokers must maintain strong balance sheets. A firm should have sufficient short-term assets (cash or near cash) to meet its obligations as they come due. Liquidity, or the availability of cash, gives brokerages the flexibility to invest in growth, purchase capital assets to improve productivity and take advantage of business opportunities such as acquisitions. Although they may have marketing and sales ability, cash deficient brokerages will not likely achieve their growth or productivity targets.

Insurers – Brokerages should have contracts with a stable number of markets to provide insurance coverage that matches customer targets. A successful brokerage should have most of its premium volume spread amongst four to five established standard carriers. This level of concentration helps to satisfy the volume requirements of carriers and can assist a broker in obtaining continent profits or volume bonuses. It also reduces the risk of dependence in the event of a market cancellation.

Producer compensation – A producer compensation structure should be designed to encourage growth and profitability, and be based on sales effort and service work performed. Brokers often overpay producers on the renewal of an account for service, while paying support staff to actually do the work.

Errors and omissions – Reduce E&O exposure by managing the quality and placement of business.

LONG-TERM VALUE DRIVER CHECKLIST

- Plan and set goals.
- Hire, train and reward competent staff.
- Plan and develop growth in commission income.
- Control operating costs.
- Select and target preferred clients.
- Develop strategies to increase average account size.
- Improve retention ratio.
- Enforce collection of accounts within 60 days.
- Maximize use of existing location through acquisition, association and technology.
- Maintain ownership and control of customer lists.
- Obtain size, management and systems to sustain future income.
- Ensure stable financial position with adequate working capital and appropriate levels of term debt.
- Coordinate market breadth appropriate to insurance needs of preferred clients.

- Design staff compensation to support growth and profitability.
- Manage clientele to reduce E&O exposure.

SHORT-TERM PLANNING

If you have not been a long-term planner, owners of brokerages should at least ensure that their business is presented to potential purchasers in a condition that maximizes its marketability, which should coincidently help to maximize the value (sales price) received for the brokerage.

The short-term planning process covers the basics and includes:

- Reviewing and assessing the operations of a brokerage for strengths and weaknesses – in effect performing a risk assessment. Having his knowledge enhances the ability to negotiate with a prospective purchaser. For example, a weakness such as a high number of mono-line automobile accounts could be presented as an opportunity for growth through account rounding or obtaining the related property business.
- Restructuring the balance sheet to ensure working capital levels are adequate or by maximizing the value of redundant assets (e.g., land and building, company owned automobiles) prior to sale.
- Restating operating results by adjusting net income for non-recurring items (e.g., litigation fees), non-economic items (management bonus), earnings/expenses relating to redundant assets (e.g., interest on excess cash) and non-cash items (e.g., amortization of intangible assets).
- Cleaning up, repairing, redecorating and refurbishing the working environment to convey the impression of a well-run office.
- Providing timely and accurate information from up-to-date broker management systems where key accounts reconcile to the general ledger (e.g., premiums receivable, cash, volume reports).
- Contracting and providing incentives for key management employees and production staff to remain with the brokerage and to protect the confidentiality and ownership of the customer list.
- Establishing corporate structures to minimize and defer corporate and personal income tax, therefore maximizing net proceeds upon the sale of the brokerage.
- Housekeeping, such as settling contingent liabilities and litigation, filing up-to-date tax returns and updating all corporate directors and shareholders minutes and registers.

SHORT-TERM BASICS CHECKLIST

- Understand operational strengths and weaknesses.

- Restructure balance sheet.
- Determine and present maintainable earning.
- Clean up, repair, redecorate, refurbish the office.
- Put your accounting and broker management system in order.
- Contract key employees.
- Structure to minimize tax.
- Settle lawsuits, pay tax, update corporate records.

PROFESSIONAL ADVICE

Brokers often do and should seek the advice of their professional advisors to assist in both developing a succession plan and implementing the sale of their business. Professional advisors are external to the brokerage's business and can provide detached expertise and non-emotional perspectives on issues that arise in long-term succession planning and in the shorter-term sale preparation and subsequent negotiation.

Prior to the sale, knowledgeable professionals can assist and coach an owner of a brokerage on business matters during the different stages of the planning process leading ultimately to the transfer of the business.

In the context of sale transactions, well-connected and informed advisors can assist in making a market for privately-owned business; assess whether selling the business is financially appropriate; value the brokerage and determine pricing strategies; structure a transaction to minimize tax; examine the market for special purchasers who might pay a premium price; provide time for a vendor to perform the regular duties needed to maintain the brokerage's operations during sale negotiations; act as a go-between when issues arise between a vendor and a purchaser; and generally help in the decision-making process when alternative offers and transaction terms are put forward. Demographics indicate many brokers will be transferring their business over the next five to 10 years. Those seeking a financially-secure and worry-free retirement should start their planning now. Seek advice from your external advisors when needed an dget your brokerage ready for sale.

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