Pathways Report

"Perpetuation 102"

By
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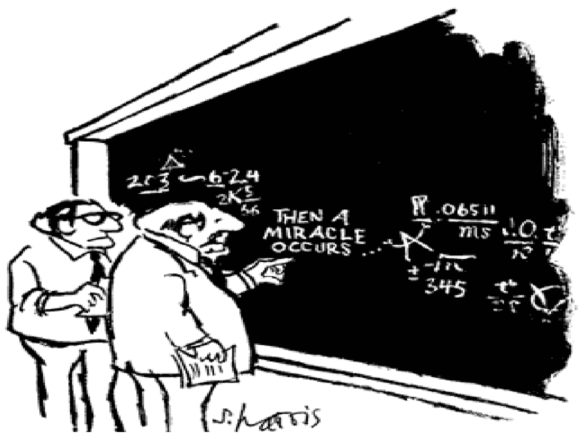

"I have a few questions on this part of your perpetuation plan, Bob."

In case you didn't get the memo, when someone asks, the answer is: "We're not for sale." And, based upon my highly suspect methodology, I've concluded that most of you have, indeed, gotten the memo. So, consider this Part Two of that memo, the part where I say: "I don't buy it." (Pun intended.)

First, you should know that at Broker's Path, we don't have a dog in this fight. We don't do M&A representations. We're Switzerland. How you exit the business is literally your business. Our job is to make your P&L hum like never before so that you have more than one option when the time comes. That said, we are witnessing an internal perpetuation revival of sorts as owners react to falling agency values and harder economic times. But, with this newfound religion comes a pretty rigid orthodoxy in agency behavior that most folks simply haven't considered. Hence, the subject of this month's *Pathways Report.* We hope you enjoy!

Before we start, let's identify those who can nod-off during this sermon. Everyone who is "family owned" or has become a large, closely held firm… let not your hearts be troubled. This sermon isn't for you. Family firms make choices that naturally support lifting-up the youth for succession and the big, aggressive regional brokerages with a dozen owners live and breathe this stuff on a daily basis. To these two groups, I'm preaching to the choir. So, pretend to be interested. To the rest of you, it's time for a reading from the Book of Daniel!

* * *

"The Devil is in the Details"

Let's put theory aside and talk about how internal perpetuation really works. First, forget what you hear from "HR-types" when it comes to ownership. The folks who control and grow books of business perpetuate agencies- period! They generate enough income to stroke checks back to the Corp (Big Joe, retirees, whomever). It's fine if a person, maybe two, who I will regrettably call "overhead", own shares, but the simple fact is: Producers control most of the stock in firms dedicated to internal perpetuation. (I'll circle back to ESOP variations to this rule later.) <u>Therefore, understanding the Producer life-cycle is the end-all, be-all to internal perpetuation.</u>

Producers vary. Some have multiple personalities with un-medicated disorders and make no effort to hide bombastic super egos that crush their inner "id". Still, others behave like that infamous insurance agent of yesteryear: Ward Cleaver. (*Beaver's Dad was an insurance agent, if you recall. If you don't know who Ward Cleaver is, then stop reading this article and go sell something young man!)* But, with all their variations: <u>Producers share one important thing in common; a stock buying life-cycle. Miss that, and you're going to sell to an outsider no matter what you say publically.</u>

At around the same time a Producer starts raising a family, he/she shows signs that he/she can actually produce. It seems as though sometime around age 37, those hunters who bring in the pelts are offered membership into the "club", the stock buying fraternity. That's also the time when a Producer takes a liking to "stuff" that his friends can't afford to buy. As a result, the amount of stock purchased by these 37-to-42 year olds is nominal at best. (Right now there's a 40-year old "mondo" Producer in a regional firm with a boat-load of stock chaffing at this remark, which is why I told him/her to be still!)

The careful observer should note: this initial stock buying group spans a five year period of time (age 37-to-42). This five year period begins roughly after the first five years of proving oneself worthy of the opportunity of going into debt (buying stock) by demonstrating that they can actually generate new business. As it turns out, this sixty month pattern repeats itself, which makes it a pattern, I guess.

On the other end of the chronological scale, Producers past age fifty (+/-) usually don't step-up and buy more stock. If they do, it's a one-last-time event. Now, make no mistake. The over fifty group makes choking stock payments. It's just that *because of the debt service* they typically don't rack up more stock debt after age fifty unless they joined the party late (older).

Seven years is a common payment schedule for agency stock notes (though ten years is more common in large regional firms). By age 57, the Producer/owner needs the stock distributions (bonuses, dividends, etc) to pay for college educations, pay-down the mortgage, and start salting-away some cash for retirement.

Producers under-draw their incomes so that there's money (income) left at the end of the year to cover their stock payment(s). That's why the late fifties are so vital to Producers. They finally get to draw their run-rate salaries and keep all the stock distributions. That typically lasts for the next sixty months (age 62 +/-). Beyond that, the CEO/Pres./Board starts to nudge the discussion towards "picking a date". That's when the last sixty-month dance begins. Owning a lot of shares and sitting on the Board can suppress the pressure a 62(+/-) year old Producer feels at that point. If they make it another five years (age 67+/-) they have enough stock or business to stonewall those who seek to take both.

Anyway, around the time a Producer turns forty, his/her book has grown enough to support more stock payments. They've "matured" by then, which means that they aren't chasing screw-ball accounts and they've managed to live through all the mood swings and still be respected by their elders for the most part. By age 45, their initial stock has been paid for and now they're ready to take-on more stock. And, that's exactly what they do for the next five years. Along the way, this Producer will inherit a few accounts and get the occasional "lay-down" referral from one of the president's friends. As a result, 45-to-50 year old Producers belly-up to the bar and order several more rounds of stock, taking-on more debt over the next sixty months. That group of Producers accounts for the lion's share of new stock subscriptions. If they don't, the place is going to sell externally regardless of what's publically preached unless an ESOP is involved or someone on drugs has done the stock evaluation for the past twenty years, suppressing its value beyond all reason.

Lastly, Producers need to earn roughly $300,000 a year (at least) in W-2 and 1099 income in order to make a meaningful contribution to internal perpetuation. The further you get from this number, the more stockholders you're going to need. As generalizations go, this one isn't much of a stretch. The reason your agency's leaders gave you this article "young man" is because they know it's true! To my knowledge, you have never read such a thing before which is why I'm compelled to prove it with something called "math". So, go ahead. Skip the next section with stereotypical Producer ambivalence. (I would if I were you.) I only put it in here to beat-down the noise from other "consultants" who get their hands on all our stuff…

"Two Trains Leave the Station…"

1. I'm assuming a $600,000 book @ 27% "split" for absolutely no good reason.
2. Which means that I'm ignoring the "new" and "renewal" stuff all together just to aggravate my detractors. I also "round" the numbers which chaps their backsides as well.

3. I'm acknowledging the fact than many year-end "chats" between Mr. Big and the Producer includes a "bonus" that seems conspicuously tied to the number of shares a Producer is buying. I call it a "Good Guy Bonus" to stress the point that it's subjective. It's tied to quasi management-type stuff like helping out around the place; attending more than half of the sales meetings, that sort' of thing. It's why more than one Producer gets paid on a single account, for example, or why inherited "house" accounts find their way onto a Producer's book-run as if by magic. Mind you, it has absolutely nothing to do with the Producer's stock payment coming due. It's totally subjective and is c*learly not a dividend on the stock* that all stockholders would be entitled to… right Mr. Big? By the way, I use $25,000 in my example below and the fact that this number makes things cash-flow for the Producer is a total co' inky dinky because, like I said, it's totally subjective… (a' hum).

4. Which is why I'm assuming there is, in fact, a small dividend on the stock just to reinforce the fact that the other "bonus" isn't a dividend on the stock… (a'hum).

5. Our Producer expects to book $600,000 in revenue, but under-draws his salary because the economy sucks and he knows better than to come-up short on his yearend stock payment.

6. Lastly, I'm assuming this agency is centrally located in North America, the USA perhaps… the land of the free and home to 50% tax rates on a W-2 and half that on a 1099 because the Feds, the State, and the AMT Ferry take about that much when it comes right down to it. I'm also assuming a time warp in which 50% will remain 50%, which is dumb on my part.

➢ Our Producer earns $162,000 and Mr. Big "bonuses" him $25,000:	$187,000
➢ He drew $10,000 a month:	($120,000)
➢ Available at year end before tax:	$ 67,000
➢ "The Tax Man Cometh" on the $67,000 he under-drew:	($ 33,500)
➢ **After tax cash from Ordinary Income at Year End**	**$ 33,500**

Next:

➢ A $10 per share dividend on 1850 shares before tax:	$ 18,500
➢ "Pay Unto Caesar Capital Gains and States (46) Income tax:	($ 4,500)
➢ **After Tax 1099 (etc) Income:**	**$ 14,000**
Comes to…	**$ 47,500**

$47,500 = Disneyland on $2,500 and $45,000 for Stock!

At today's interest rates, $45,000 pays for $300,000 worth of stock over seven years. But, that number is a tad misleading because stock is bought at different share prices, presumably, but you get the drift. This Producer will get slammed with: *"We're not saving a* *dime for the kid's college educations! You just can't keep buying stock in the Agency!"* by his/her spouse every year. He clears $3,000 a paycheck after taxes because he under-draws, but to his government, he's rich. He makes way more than $250,000, which is why this life commitment can play hell with a marriage and often does (seriously). Then, one day, the payments stop and the Producer gets to keep the yearend cash. Instead of stroking a check to buy stock, he will stroke a check to USC for his freshman son's $45,000 annual tuition, excluding, of course, the cost of room and surf board.

If this hypothetical Producer has four other partners his age doing the same thing ($225,000) and some younger folks, just getting started ($50,000), they'll pay-in roughly $275,000 a year over a twenty year span between ages 37 and 57. That's $5.5 million or exactly 1.7 "times" a $3 million dollar agency after you subtract-out the interest expense. Nothing stays the same for twenty years, but over the past twenty years it just so happens that the values of agencies averages-out to 1.7 "times" revenue which translates into the 6.0 EBITDA without all the balance sheet distractions. Yes, I know that seems low, but it's 100% true.

OK. So, your math-head is hurting. Just think of it this way. The five Producers (above): some bigger than $600,000 and some not-so big, collectively have an average book of $500,000 each. Add-in some green Producers, house accounts, personal lines and profit-sharing, and this agency is squarely in the $3MM to $3 1/2MM range depending upon the results in any given year. Their internal perpetuation plan is cash flowing. Pretty cool, huh? The Law of Substitution allows you to mess with book size, number of stock buyers, and such, but the outcome is the same. And, not one consultant that I paid for, over the years, ever explained it as simply as I just did. That's because they never slept on the couch after the wife accused them of signing her name to more stock debt… which I vehemently deny to this very day!

And that, folks, is <u>exactly</u> how internal perpetuation works! There's not an Underwriter or Account Manager who knows how this all works. They just know that you're rich, tan, and lucky… lucky enough to die five years earlier than most of the general population from all the stress. Even if that's not true, the typical retired Producers looks like death warmed over, if you ask me. Tan, but worn out just the same.

Then a Miracle Occurs…

If you stop to think about it, internal perpetuation over generations is nothing short of a miracle. That's why it's so cool. This mythical agency (above) needs to spin-off $42,500 of cash on a $600,000 book (Bonus + Dividend) just to make the wheels turn. That's seven percent. Actually, it's more like ten percent because no agency has the cash on hand that the P&L calls "pre-tax", especially at the end of the year. Pre-tax is a hypothetical number. It's not real. That goes double for sixty percent of you reading this: Sub Chapter-S Corps who must juice personal incomes to cover the flow-through tax.

Since we know that this hypothetical agency (above) probably has one or two senior dudes who aren't paying-in and are taking the cash home, then you're looking at a profitability target near eighteen percent (+/-) over the long haul just to keep the "pyramid scheme" (some call it) chugging along. In truth, it's closer to 20% because not all Producers make it. And, therein lays the rub. If profit is a known, or rather, a must, then the growth portion of the equation has to be a positive number or the plan folds like a cheap gypsy tent.

What Could Possibly Go Wrong?

Not growing, year over year is a bummer if you're cash flowing internal perpetuation. However, growth can also be a trap. For sustained growth to occur on an ever growing basis you need an ever growing number of stock buyers, over time, to carry the debt service on an ever-growing stock price (in theory).

Now that agency values are down, a three-year average calculation will cushion the fall, but try explaining that to a 48-year-old's spouse who warned him/her not to buy more stock every year! Go two or three years without the 45-to-50 year olds subscribing to more shares, and the wheels come off internal perpetuation. No-growth firms need to juice operations towards the twenty-five percent range, re-code business to inflate stockholder incomes (at the expense of Producers shown the door or converted to "handlers"), re-paper the loans (good luck if Old Joe gets the payments), or convince Producer's: *"Now is the time to buy more, now that's it's cheaper!"*. That's always fun to watch…

The pressures are real. It's why you'll find "book succession" schemes in some agencies. That's where retiring Producers get paid by younger Producers over several years on a sliding scale. I've seen lots of those plans and I can tell you that invariably those firms perpetuate at a significantly lower cost (value, stock price, owner's equity) than otherwise. You'll see "vested interest" used to create equity transfers over time as well. It's cashless behavior and when you see it you'll know that agencies use it for one of two reasons. Family owned shops use it to help transfer equity. The rest use vested interest to transfer all of the year-end cash to a few select owners who have zero intention of helping fund perpetuation, but want to tie-up Producers for life. I'm not saying that's bad. It just "is".

All of this hand-wringing assumes that the owners at the top of the food chain are committed to parting with their cash to support internal stock-buying behavior. Which begs the question: "Why?"

The realist in me lands on a solitary answer. That, and real life experience with such things. If Mr. Big decided he wanted to end the game (sell externally), then the youth and mid-life buyers, who comprise the lion's share of the business and a boat load of stock, would revolt and toss Mr. Big out on his rear. He knows it, or at least he knows it's a possibility. And, I might add, that has nothing to do with the "votes" on the matter. If a handful of Producer's who haven't had their turn at the trough threaten to bolt, assuming the rumors about selling are true, then Mr. Big tends to avoid those discussions at all cost, even if he has 51% control. His Board (partners, etc) who are taking home piles of cash (finally) want to stay at the trough a whole lot longer as well, especially these days! Selling a few years ago was a legit option to this cultural détente, but these days… forget about it! If Mr. Big wants to avoid a palace coup, he better keep his thoughts on selling externally to himself… for now. If he doesn't, he'll get harpooned.

Internal Perpetuation 102:

Time ticks away. Ownership funding slows in times like these. And, under the mathematical laws of "median and mean", the weighted average age of your stock (owners) gets older and older.

Moreover, as cash-flow tightens, the 57+ group isn't about to dilute ownership as readily and share distributions as freely as before. *"That guy is a barbarian,"* comes into play when the Board considers offering young Attila more shares, these days. Other than large regional brokers, who is currently funding new Producers? (Are those crickets?) Even the regional players have concerns of their own.

One day in the not-too-distant future, a couple of the "senior" guys in a regional firm take themselves and a few hand-picked young studs on a seemingly harmless golf vacation. They know they can't sell the firm, not now anyway, and they know that bringing up the subject is career suicide back home. They realize that sticking around for a few more years will help offset their loss of enterprise (stock) value. "*Tell me again why we have a 22% minority shareholder discount on our stock?"* one of the younger guys asks as they approach the first tee. "*My name is on those General Indemnity Agreements, too!"* another older Producer barks back in the bar after the round. *"That goof ball we hired two years ago couldn't sell a red suit to Santa Claus! We should code that business to you, young man, and dump that guy!"* booms another on the deck amid agreeing nods and late night cigar smoke.

The cultural fracture goes un-noticed back home, but it's going on all across America just the same. If you're serious about internal perpetuation, then you better get folks into a room and hash things out, because privately they've all decided that "retirement" is the last possible thing on their minds. Individually and collectively, no one is selling.

Growth + Profit = Perpetuation:

I use this formula (above), but I'm not its author. It was a cultural mantra I was raised in as a young man. The firm was a big, gnarly, hard charging, internally perpetuating Agency. It is now twice its size and casts a huge shadow over its region. That formula, their formula, is the reason.

MYTH	FACT
Internally perpetuating owners hold discounted shares and take "less" equity in the end as a result.	I'm not so sure. EBITDA multiples are lower now, but slow-to-no-growth firms who hold all the equity at the senior level haven't seen their values grow nearly as fast as internal perpetuators and they almost never achieve their stock earn-outs because they're stagnant cash cows that have been out to pasture for years. And, just for the record, those internally perpetuated and discounted shares were also <u>purchased</u> at a discount. I think that sort' of negates the discount issue unless they sell externally, doesn't it? By the way, those internal buyers were assisted by seasoned mentors who helped internal stockholders grow much larger books and helped with "inherited accounts". Lastly, it's a lot easier to get into the ownership game in an internally perpetuated firm. Produce and you're in unless you really are a cultural vampire.
Internally perpetuating owners don't take home as much cash over the years prior to selling.	OK… that one is typically true. Internal Perpetuators retire earlier because the culture demands it. They use distributions to pay for stock rather than beach houses and they have to keep producing long after the two guys down the street with a $2.5MM agency ever did. Privately, elder statesmen in internally perpetuating firms would trade places with those guys down the street in heartbeat. But, the internal "deal" has helped them get rich, just the same, and they've had one hellova time victimizing some of these sleepy agencies in the process. Besides, those two guys in sleepy hollow haven't said three words to each other in months!
Operationally, both models work about the same.	Internally perpetuating staff outperform their counterparts by a bunch! They earn more, too. They handle more revenue, clients, and new business. They don't put up with any grief from a co-worker who isn't pulling on the oars just as hard. Accounts are retained as if the Producer's life depends upon it, because it does! No growth means a Producer's underwater on stock payments. Two years of that and Mr. Big will have trouble covering the shortfall and will likely un-wind the stock notes and offer "career counseling" just before that Producer goes home to tell his irate wife that their "draw" has been reduced, big-time. Conversely, "Bob" says "whatever" when his office manager wants to add to staff because she claims that the crew is over-worked. He owns the joint and hates the noise. Internal perpetuation means lots of healthy conflict and emotion (some bad, much of it good). Just the opposite for Bob's shop who tends to overlook performance and preserve the "order". He can afford it. Invariably, Bob's shop could go from "very profitable" to "obscenely profitable" if he ran the place like his internally perpetuating competitor.

The Guys in the Back Pew…

This won't take long. This *Pathway's Report* is directed at you folks in the back pew, the recent "we're not for sale" converts. Frankly, I'm becoming a little fed-up with some of you. Not all of you, but a disappointing number of you just the same. Here's why:

You make more than your cardiologist with a fraction of the stress and a much brighter future (which I admire greatly) and yet, your operations run at about ¾-speed. (If that doesn't read "½-speed", my Editor changed it.) Of all the folks who could increase their incomes, their agency's value, the quality of life, and personal fulfillment of the employees, you profess to care about, it's you. And yet, week in and week out it's the back pew for you, no commitment to change. It drives me nuts.

Twelve years ago it so drove me nuts, that I bought into such a firm. Five years later, each of the owners tripled their equity and doubled their incomes, and we simply exploded in size, scope, and cultural purpose. Unfortunately, the reduction of contingent income; the looming "healthcare" effect; pending inflation; the economy in the suck-zone; and the walloping the "rich" are going to receive, any day now, still won't get many of you lucky dogs to budge from the back pew. You're going to ride it down, sideways if your luck holds out, but ride it nonetheless to the end of your days. To you, I ask but one thing. Wave as you go by.

Of Things to Come…

Most of us forgot, but the, sixty month-long, Dot-Com bubble affected the Producer pool beginning in 1995. It's 2010 now. Those 27 year olds, you would have hired from 1995 to 2000, would be 42-to-47 years old now. I'm certain you hired folks back then, but the Dot-Com bubble effect in agencies is noticeable if you ask me. I think we're about to go through that again. New Producers are being dropped from the budgets. It's only a matter of time when the effects of that materialize in lower growth rates, deceleration of stock values, compression of incomes, increasing age of ownership group, and other things that basically suck if you're giving your cash to younger buyers to help fund internal perpetuation.

Three-year averaging has slowed agency stock values from plummeting, but that won't last much longer. Concerns about financial security; the sun setting Bush tax cuts; rumblings about Social Security; Doctors refusing to accept new Medicare patients (You in a few years); Buyer's more wary than ever before; longer durations for performance earn-outs with reduced cash up front and the kids wandering back home, in need a temporary help, has put the brakes on agencies selling and/or owners retiring. Privately, many ask me: "Where the hell would I put the money if I did sell or retire?"

Closing Remarks:

For 955 years *"We're not for sale"* is something only Methuselah could say and actually mean it. But, even he died the following renewal cycle. You are all going to sell individually or collectively at some point. That's why you have Buy-Sell Agreements in place with your partners, by the way. Internal perpetuation means, by definition, that your entire culture is dedicated to selling your ownership to buyers you've already identified.

Lastly, we're definitely busy these days. Ok, we're swamped! But, I've noticed that some owners avoid calling us because we are a threat. The "other guys" don't pose such a threat, or so it seems. They offer guidance and perspective which is nice. They charge for it too. On the other hand, we represent "change" because we show you *how to change, step by step.* So, it takes some fortitude to bring us in. Invariably, I learn that fear of failure never entered our client's minds when hiring us. Fear of success actually did. And, I guess that's only natural. But, for those of you willing to dust off your operations and open your imagination to a better place, you'll soon realize that the most grateful of all will be your employees who have waited and waited for things to finally happen. The good ones will thank you the most. That, in itself, is reason enough to pick up the phone.

Until next month…

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WE NEED YOUR PERMISSION TO ENROLL YOU IF YOU WANT TO CONTINUE TO RECEIVE OUR MONTHLY REPORTS. PLEASE REPLY "YES" TO THE COVER EMAIL WITH YOUR NAME AND EMAIL ADDRESS. IF YOU DON'T RESPOND - OUR NEW VENDOR WILL NOT SEND IT TO YOU!!!