Building a Life Insurance Practice That Can Be Sold

GARY R. SCHULTE, CLU

Abstract: As the most productive group of agents in the life insurance industry's history helps their fellow baby boomers with retirement and business continuation planning, they find themselves faced with their own succession planning challenges. Long a topic of agent study groups, the industry has not yet produced standards or best practices for the capitalization of a life insurance practice.

This timely issue has gained greater significance with the recent interest of larger financial institutions in buying life insurance agencies and individual practices. This dynamic not only adds considerable opportunity to the marketplace for agents wanting to sell their practices, but it also raises concerns about the best interests of clients. This article examines the subject from a balanced perspective regarding all involved parties -- the seller, the buyer, the carriers, and the clients. Strategies that can create equity in a life insurance practice, considerations in selecting a buyer, and suggestions for the terms of sale are all addressed.

This issue of the Journal went to press in April 1999.

"The secret to my success has been simple; when everyone wants to sell, buy; when everyone wants to buy, sell."

-- J. Paul Getty

The economic life of a life insurance agent's clients typically consists of two distinct phases: wealth accumulation and wealth conservation. The life insurance industry offers two groups of products to accommodate prospects, depending upon whether they are in the accumulation or the conservation stage of their lives.

Agents face the same two issues in the life cycle of their own practices. In the early years, they are devoted to building a clientele and managing a successful sales career. If they do it right, they eventually must ask themselves the same question many of their own clients ask: "Now that I've built it, what am I going to do with it?" Too often agents have a better answer for their clients than they do for themselves. Today, when almost every successful business can be considered a potential acquisition target, this might be a question worth answering. Not surprisingly, the focus of publicly traded financial service companies is

now turning to life insurance agencies and individual practices as a new source for customer growth. Whether the equities markets can successfully transfer the value of a life insurance practice into a balance sheet asset is unknown, but there is increasing interest in the subject among capital pools looking for under-valued business assets. Regardless of how a successful agent's practice is ultimately capitalized, the issue of succession planning is in need of industry guidelines, not only for the benefit of the agent, but also that of the clients and carriers.

Capitalizing one's life insurance practice is no longer an issue only for the established or mature agent. Marketable equity should be of concern to all agents planning to make the insurance business their career. If they build their practice from the start with a strategy for what it will look like when they sell it, chances are the business will be of greater value when that day comes. In fact, the biggest sale of an agent's life could be the day on which he or she sells the practice, but it will not happen by any natural course of events. There must be a detailed plan in place several years before if a gratifying result is to be achieved. This is why it is so important to plan for that result today.

What Does An Agent Have To Sell?

The first and most important question is: How does an agent determine the value of his or her life's work in economic terms? The only answer is another question: How much is someone willing to pay for it? The answer to this question requires viewing the typical practice as an outsider might look at it. If a successful agent were in the market to buy someone else's practice, what would they be willing to pay for it? What characteristics would they look for? Premiums in force, policy count renewal commissions, and persistency come to mind. These are the measurables and quantifiables, but which of them can actually be sold by the agent? What about the intangibles -- goodwill, intellectual properties, client relationships, and professional network? Much of the practice's real value for the agent lies in these areas. How they are organized and packaged can greatly impact what someone might be willing to pay for them.

The question of who has the right to sell what varies greatly from one practice to another and is not addressed in this article. Generally, however, the carriers own the premium flow, and service fees usually belong to the agent. In some cases, the carriers believe they not only own the client relationship, but also that of the agent. In fact, when some companies sell a block of business they also "sell" their sales force, meaning they persuade the buyer that the agent's loyalties will follow the policyholder. This is sometimes valid and other times not, just as in the case of the agent view that the loyalties of the policyholder may be an asset which he or she owns. These issues revolve around legal, regulatory, and professional conduct considerations and must all be addressed ahead of time by the agent intending to sell any aspect of his or her practice. The point here is that what agents do or do not do today regarding the proprietary assets in their practice can dramatically affect the economic value of their life's work. Over the next few years, wiser agents will be developing plans to make sure the answers to questions about

succession planning in their practices are fair answers for all parties: the seller, the buyer, the clients, and the carrier(s). This article focuses on building value in a practice that is transferable, regardless of who actually owns it.

The way to assure the best result when a practice is sold in the future is to focus today on those key factors that lead first to the building of a successful business and later to the perpetuation of the entity after the agent is gone (accumulation and conservation). When agents pay passionate attention to those key factors, they can greatly increase the ongoing value of their practices for themselves and other stakeholders.

Taking this approach, the asset the agent can most influence in a practice is not the book of business, but the clientele. If the client base is properly constructed and serviced, and if it enjoys a strong relationship with the agent, everything else should take care of itself. This is an important departure from certain contemporary views on what it is an agent actually has to sell. Most programs offering agents equity involve the sale of a book of business or premium stream through some form of Agent Owned Reinsurance Company (AORC). These programs can work well, but since they are only available to select agents from a few carriers, most agents do not have true equity in their books of business.

Despite their limited success, however, AORCs do warrant a brief comment. They focus on the value of premium streams, surplus accounts, and policyholder assets rather than client relationships. They require a long-term production commitment from the agent (up to ten years) because it takes this long for meaningful profits on a book of business to emerge and become available to be shared. In addition, AORCs often require the agent payout to be made over a protracted period of time (five to ten years), in amounts that vary depending upon policy variables such as persistency and mortality. Factors such as the purchase price, date of the sale, and ultimate treatment of policyholders are usually in the hands of others. Furthermore, despite several attempts throughout the 1980s to build successful AORCs, there have been only a few successes. Still, assuming that the agent can live with the potential conflicts of a long-term relationship with a single carrier and that the agent chooses a producer group whose overall performance will be pleasing to the host companies and their reinsurance affiliates, AORCs can be a compelling proposition, subject to certain shortcomings.

The shortcoming that many AORCs and producer groups are now attempting to address is that their carrier relationships do not recognize that portion of equity in a practice or agency that consists of goodwill from relationships built by the sales force. For companies already rewarding these organizations with equity in their book of business through an AORC, with maximum compensation through a producer group, or with both, this will be a difficult sale. In the case of career agency companies with dedicated sales forces also looking for recognition of their goodwill, it will be even more difficult. These companies have often made generous concessions to their field forces to fend off competition from the independents. This is ironic, since the most often stated reason of the career agency companies for steering the course with their distribution system is the

value they place on the agency force.

Thus, the issue of goodwill equity is emerging as an opportunity or problem that, depending upon one's perspective, will be either capitalized upon or solved. If there is measurable value to this asset that is separate and distinct, it is probably transferable to interested third parties, which could open up significant opportunities. It may be more valuable, however, if it remains attached to the host carrier's book of business, adding to its embedded value through the momentum of trusted relationships. This would indicate that the host companies should still be among the most interested buyers, despite their resistance to the concept. If not a direct opportunity, it may provide the answer to other problems if an innovative solution is found.

For example, one approach would be the establishment of company-sponsored succession plans that do appraise, administer, and provide the funding for buy-out agreements between field force associates. Such plans might sponsor successors for agents and managers with the funds used for growing their distribution systems, as well as for providing subsidies for the purchase on the basis of an appropriate cost benefit analysis.

The moment is right for the development of company-sponsored succession plans for another reason, which should add considerable appeal to the concept. The equity being created by the demutualization and mutual holding company transactions underway at many major companies will provide the ideal vehicle for company-sponsored succession plans. Through financial instruments offered as publicly traded companies, a market value is achieved that reflects all aspects of the value being delivered, including sales. Given the somewhat arduous process insurance companies must go through to complete these types of transactions, it is likely that much of the research and valuation work regarding their field force has already been done. Depending upon regulatory and legal constraints, companies might fund their succession plans with various types of securities, including stock that is earmarked for this purpose, issued as a special class, or simply acquired by the company on the open market. The usual array of options, warrants, and lettered stock would also be a possibility. Several problems are mitigated by this approach in that it puts the interests of the company and field force on equal footing. One thing appears inevitable: If the host companies are not interested, others will be.

Who Will Buy It?

Although most of the issues discussed in this article pertain to traditional succession planning through an apprentice or partnering program, a new dynamic in the institutional buyer must also be considered. In business, timing can be everything, and today the most valued assets for financial institutions seeking acquisitions are trusting relationships like those which successful agents have with their clients. The strength of those relationships and their value to a would-be acquirer will be greatly affected by the intangible qualities agents build into their practice -- primarily the goodwill that will sustain and grow the practice after the agent is gone. For proof certain of this, one need only look at what

financial institutions wanting to break into the retail securities business over the past two decades have been paying for stock brokerage firms -- literally billions of dollars to acquire sales forces that controlled a clientele. In most cases, this was the only substantial asset in the acquisition. These transactions in this sister industry bode well for the future of agencies and agents who are prepared. Many of those wanting to overcome the entry barriers to the life insurance business will do the same as those who sought access to the securities industry did. Not only will they continue to buy companies, but they will also buy distribution. As legal barriers fall, the list of candidates for buying life insurance practices may include banks, stock brokerage firms, membership organizations, commercial P&C firms, and even accounting and law firms. Of course, some will continue buying life insurance companies to meet their objectives, but for agents who build their practice correctly, it will come to be viewed as a separate and distinct asset from their book of business.

Whatever an agent's personal views on the new entrants to the life insurance business may be, the fact is they are here, or at least on the doorstep. The unfortunate reality that has created this opportunity is the fact that the labor-intensive demands required to build a quality clientele are no longer an economically viable option for financial institutions wanting to grow their business. This means that today's successful agent has a scarce resource that almost no one is replenishing. As they learn what these new delivery systems have to offer, thoughtful agents will want to consider this type of sale in their succession planning strategy. It may, for example, make good sense for a larger enterprise to consider buying an agent's practice, while leaving the agent in place with an employment agreement, and upon the agent's retirement replacing him or her with one of the buyer's own employees. Clients are probably better served by this approach than by becoming orphan policyholders. The carriers, too, should be fine, provided they continue to perform for policyholders.

These circumstances indeed present an unprecedented situation for the life industry that warrants serious strategic thought. With this in mind, three strategies to build equity in an agent's life insurance practice should be considered.

Strategy #1: Manage with An Eye on the Future

Long-term strategic thinking has been a dominant characteristic of many of the world's leading corporations. Less successful companies are often criticized for sacrificing long-term results in favor of ever-increasing quarterly earnings. Life insurance agents are conditioned to pursue an even shorter cycle between their activities and the measurement of results. The compensation system for agents does not encourage a long-term vision for building of a practice. Industry and company recognition is measured annually, while agents strive to meet annual goals through monthly objectives, which in turn are accomplished by planning each day carefully. While these practices comprise an important cultural aspect of the profession, for the agent wanting to build equity in his or her practice, this culture can be a double-edged sword.

While agents must concern themselves with today's results, their activities can still reflect a commitment to long-term thinking in the day-to-day choices made in building their practices. Agents should resist the tendency to be sales driven and should evaluate opportunities for their strategic fit before considering their current potential. This habit takes time to cultivate, but understanding its importance will help the agent overcome the kind of short-term behaviors that inhibit the accrual of value in a practice.

Avoid Fad Sales or Untested New Markets

A practice built around products or concepts that are aggressive, or tend to take advantage of tax windows, is not likely to have much value, primarily because the clients probably bought for the wrong reason. Over the long term, these transactions can be costly to all concerned. Even when a practice has just a small segment of the clientele that bought because of an advantage or loophole, it can taint the value of the entire practice. Whether sales built around "windows of opportunity" are judged as real opportunities or just gimmicks is of little consequence. Experience has shown that, when the client buys because of a perceived tax or legal condition that eventually closes or loses its appeal, the agent does not have the trusting relationship that makes a client valuable. Those who bought a policy to take advantage of a concept that may be challenged by the tax courts or regulators will not exhibit the loyalty to the agent that adds long-term value. Perhaps most important is the threat of potential liabilities from these situations rolling up to the new owner. Just the possibility is usually a deal killer for the prudent buyer.

The value of a practice is based largely on goodwill, the biggest single component of which is the level of policyholder satisfaction with his or her treatment by the agent, the company with whom he or she placed the business, and the ongoing value delivered by both. Much of a practice's value will be measured by client loyalty; it is the asset that matters most in financial services marketing, now and for the foreseeable future.

Look to the Next Generation

One of the easiest and most profitable long-term tactics is the development of a system for building relationships with clients' children and grandchildren. This will allow agents to leverage their influence with clients in ways that will multiply value exponentially. If an agent keeps accurate records and an up-to-date database on clients' offspring, regardless of whether the agent sold them insurance or even contacted them, the increase in value of a typical practice will be substantial. Due to recent technology advances in the field of customer communications, this type of easily acquired data is far more harvestable than it has been in the past. From the standpoint of succession planning, good records can provide literally thousands of qualified prospects, each at varying degrees of coming into their own as potential clients, and with each of whom the agent's successor would have the best possible reference to use when contacting them.

For example, suppose a 30-year-old agent were to create a database with details on each child and grandchild of his or her clients over a 30-year period. Capturing the information during normal service calls and entering it in the agent's client management system would require little extra effort from the agent (and, in fact, should be handled by a staff member). By the time this agent is 60 years old, he or she can bring the intern of his or her choice into the practice. Considering the typical agent's beginnings, it would be quite a contrast to start out with a favorable introduction to as many as 3,500 prospects! Any successor, including institutional buyers, would pay a significant premium for these additional files above the price for the agent's base clientele. Incidentally, if an agent does not have this kind of client database today, there are several third-party providers that can gather it at surprisingly reasonable fees.

Clients' Assets in Living Trusts

Agents should encourage the use of living trusts to assure that clients' assets are all in a known and safe place. Assets under management have become a driving force in the financial services industry, and agents should think along the same lines. Most planning experts agree that wills and the probate expenses associated with them are an inefficient means of planning. Many estate-planning attorneys now recommend inter-vivos or living trusts as the depository for client assets in the appropriate circumstances. Most established agents already affiliate themselves with a qualified estate planning attorney who can provide good trust work for reasonable fees. Agents should work with these professionals on behalf of those clients for whom a living trust is appropriate. A demonstrated commitment to the team approach to planning (attorney, CPA, and agent/planner) is also a reassuring feature to potential buyers of a practice.

An important side benefit of encouraging the use of living trusts is that, because they are part of the team that puts the plan together, agents will know where all of the client's assets are. With the exception of estate planning, it is unlikely most agents would gain this level of detailed knowledge about client assets in a typical insurance sale. Furthermore, in the financial services industry, it is no longer just assets under management that count. Transactions under control are becoming equally important. The use of living trusts will position the agent to be involved with both. This, in turn, can enhance the value of the clientele to potential buyers. Of course, care must be taken regarding right to privacy and related liability issues in transferring this type of information. In addition to working with qualified professionals in the planning process, agents should work with their own qualified legal staff as well as counsel provided by involved carriers when the practice is sold.

Build the Practice Around Customer Values

Institutional buyers of insurance distribution are not usually attracted to the high profile producer. In fact, a practice built around the strength of the agent's personality can actually be a liability in the valuation process. It may decrease the goodwill component

because, ironically, the more the agent is worth to the practice, the less the practice is worth to a new owner. The agent's talents are what make the practice a success, but it is the ongoing value as perceived by its customers that makes it marketable. Image-building efforts should be centered around the agency or its key services and unique clientele. Also, the strengths of an organization that will be there for clients long after the agent is gone should be traded upon. This is why community banks once enjoyed such loyalty; they combined a personable neighborhood presence with being institutions. Mergers into the mega-banks have somewhat compromised this advantage in recent years, but the relationships with their customers is a primary asset the larger banks are buying in this type of acquisition. If a part of the purchase price in a bank acquisition is its image in the community it serves, an agent can build that same kind of value. There are many ways to institutionalize an insurance practice while remaining personable. The most common example is a quarterly client newsletter that provides relevant information and also familiarizes clients with the staff or associates (no pictures of the agent, please!).

Even sole practitioners can legitimately present themselves as an agency, rather than as an agent. Everything that makes the clientele feel they are doing business with a business, while enjoying a relationship with its principal representative, will contribute to the right image. Agents should promote the products sold and the services offered to the community. The agency should become known for how it serves clients, because that is what a successor will be willing to pay for. Colonel Sanders eventually faded into the background and Kentucky Fried Chicken became KFC. This is how marketing legacies are built, by putting the value of the work above the importance of the artist. Ray Krock avoided the problem altogether, by retaining the founder's name in the business, even though it was he who built it. It was not until McDonald's was a household name that the public began to hear about who Ray Krock was. Although the value of the agent's relationships is a key part of goodwill, the goal of the agency is to be seen as a business that serves, rather than as an agent who sells. As such, image building efforts should have the agent's thumbprint all over them, with the agent's mug shot appearing nowhere!

Strategy #2: Build A Practice That Eliminates The Need For Its Founder

Leverage Value by Performing Key Functions through Others

Marketable agencies must eventually have a staff that can run the business with minimal involvement from the principal. In the early years of a practice, this person may be an executive assistant. Later it will be the key office person (KOP) and his or her staff. Any practice substantial enough to be sold for meaningful value should have a KOP to manage the day-to-day operations. This individual, or his or her staff, is usually responsible for policyholder service, commission accounting, and new business. Beyond the day-to-day operational value of this position is the responsibility to do everything humanly possible to help the agent to focus on doing those things that only the agent can do to build the business.

The next step requires an apprentice to the principal, who may eventually own part of the business.[1] This type of system helps the agency grow in a cost-effective way and helps established agents create a market for their business. Many industry observers believe that such programs will be the only practical solution to growing agents in the future, especially since it is becoming increasingly more difficult to grow a successful practice. When a practice grows through the internship of others, its value is clearly enhanced.

An alternative approach to mentoring is to consider merging with another successful and complementary practice. One plus one can equal three with the right team. There have been many great partnerships in the life industry. Typically, the best fit is between a rainmaker and a technician: one person who is outstanding at prospecting, uncovering needs, and building relationships, and another whose strengths lie in casework, case presentation, and follow-up.

An innovative choice to consider is applying the concepts of this discussion to the agent's own acquisition strategy. If certain individual practices do have the value discussed in this article, agents should consider being buyers themselves, consolidating a few successful practices into a single large agency. This result could put the new entity on the radar screen of the larger players in the acquisition competition.

Promote Joint Work

Joint work with newer agents who may someday be potential buyers of the practice is both smart and motivating. Joint work is the forgotten gold mine that gives many agents their start in advanced markets by allowing them to sit at the feet of established professionals in their marketplace. It is also the best way for newer agents to learn selling skills and for senior agents to sharpen their own skills. As company resources for new agent development dry up, joint work activity is enjoying a resurgence. As already noted, it is beginning to fall upon the industry's veterans to grow the agents of the future through apprentice programs. This is hardly a burden because joint work provides a great opportunity for screening fellow agents and interns as possible successors for the purchase of a given practice. The appointment of an individual successor is not in conflict with an institutional acquisition of the practice. On the contrary, a strategy for having a successor in place to help position the practice for sale to a larger entity can make good sense. Obviously, this means an understanding must be reached with the apprentice, who would agree to the possibility of a different role as successor in the event of a sale to a larger entity.

A strong, controlled joint work environment can also be a strategy for turning an individual practice into an agency. This approach will work best when there is an opportunity or desire to grow more sales people within the practice. The objective would be to attract a person with experience as a sales manager, willing to build the practice by training new agents with specific techniques and procedures developed by the principal. This type of individual would prefer being an employee of the practice, growing a sales

unit under its specialized umbrella, as opposed to a more traditional agency environment. The principal in such a situation can then provide solid proof to an institutional buyer that a source for future growth exists. This kind of perpetuity in an insurance practice can have substantial influence on its value to certain buyers.

Put Information Systems In Place that Support the Sales and Service Functions

A solid, well-developed client management system and supporting service culture are an important part of any valuable practice. The glue that holds client/agent relationships together, it is recognized as a major component of the asset that is being sold. A good system is not just a client database assembled from input into a contact management software package. Today's practice needs a sophisticated agency management system, with a relational database containing complete information on every aspect of the historical relationship with clients, including all information about their assets.

A symbiotic fit between sales, administrative, and service systems will be the centerpiece of a marketable practice because it can be perpetuated. Service to clients should be demonstrably automated, prompt, and responsive. Potential buyers will want to see a practice with a long history, reputation, and capacity for giving superior service. The degree to which they find it will reassure purchasers that there is ongoing value in the business.[2]

Develop Revenue Sources That Complement One Another

Annuities and disability income, long-term care, and related morbidity products can all help to balance the revenue stream of a practice. From a liability standpoint, today's agent understands that the client may expect to be informed about all products the agent is licensed to sell, including those that protect clients against losses other than death. Also, a more complete product mix can increase both the diversity and number of products owned per client and thus strengthen the value of the practice. Like potential for sales growth, the owning of multiple products by a clientele is a major value influencer for certain buyers.

Most agents today are moving toward some form of financial planning, or at least asset allocation and retirement planning. Since life insurance is only a partial solution to financial planning or retirement funding, most agents are equities licensed, and, as such, they owe it to their clients to be knowledgeable about those products that they feel qualified to sell. On the other hand, there is a distinct line between financial or retirement planning, and portfolio management. Even though many agents are appropriately licensed, few qualify as asset or portfolio managers. Agents wanting to create transferable value in their practice are better off identifying a few good mutual fund families that cover the risk profiles of most clients. Many of these products are excellent accumulation vehicles for the plans most agents draft and will complement traditional insurance products as well. This discussion is, therefore, focused on the life insurance practitioner

who has built a clientele by selling insurance. With the exception of variable life and variable annuities, equity-based products are part of the equation because they are called for in the implementation of a plan that involves the purchase of insurance. Although these products play an increasingly important role in the life insurance sales profession, the most valued practices for the kind of acquisition discussed herein tend to be those built around the sale of mortality and morbidity products, with investment products in a supporting role.

Run the Practice like a Microcosm of a Fortune 500 Company

The agent should maintain every production and renewal record, preferably in a single computerized gross revenues ledger, showing what has been paid by carriers for the agent's efforts. While production records should be maintained for many reasons, showing a steady pattern of growth over time will be among the most important statistics when it is time to sell. Graphs, charts, and spreadsheets should chronicle each year's performance in key areas. Most businesses that are about to be sold prepare a package for interested parties, showing all key financial and related data. The more positive information available on past performance, the better. It is, therefore, good business for an individual agent to run his or her practice like a microcosm of a Fortune 500 company. This can be accomplished by completing the following steps:

1. Appoint a board of directors, usually consisting of a mentor, manager, or associates. This is a common practice among many agents, but the board should share the larger vision of long-range planning.

2. Deliver an annual report, covering overall results as compared to objectives. The report should consist of a narrative from the chairperson and CEO, and the same type of strategic and qualitative information one might see in the reports prepared by the carriers the agency represents.

3. Prepare a balance sheet and P&L statement. This is likely to already be available through the agent's accountant in a basic format. The real value from this data comes when calculating profit margins, key performance indicators, fixed and variable costs, and appropriate financial ratios.

4. Evaluate key functions using spreadsheets, as if they were divisions within the practice: new business, Member Service, commission accounting, research and development, and, of course, sales and marketing.

Just as insurance companies track profit centers and profits by lines of business, as well as measure employee productivity, the principal of the marketable practice will know his or her numbers and ratios. Like the CEOs of Fortune 500 companies, agents should be expected to provide their boards with carefully documented plans that will be monitored and measured on a regular basis, and detailed explanations of every important event in

the company. While building a practice, tools such as these will pay big dividends in the form of improved profits to the agent. When it is time to sell the practice, the positive impression such records will make on the purchaser will contribute significantly to the valuation process. Buyers will recognize superior performance as transferable only if it is clearly documented. This point cannot be overemphasized: That which is not documented will be discounted!

Strategy #3: Build A Practice That Is Commodity Resistant

In a world that is rapidly moving toward a commodity-based approach to every product and service imaginable, there is great opportunity for taking a contrarian approach by becoming what can be termed "commodity resistant." This trait is an especially important strategy in the perpetuation of an insurance practice. The financial services industry is eagerly tagging, labeling, and commodisizing its every asset to accommodate the growing, technology-driven appetite for control of customer relationships. In the process, they seem to be overlooking the fact that earned relationships are not the same as obligatory relationships. The commodity brokers can securitize the client's home mortgage, pension obligations, car lease, or even group health insurance.

Banks, property and casualty firms, and mortgage companies, on the other hand, deliver their product through a demand slope they influence but do not control. The function of marketing is to facilitate demand and is usually the institution's responsibility, while the sales function is one of fulfillment, delivered by its representatives. Life insurance agents have historically been missionary marketers. They create their own clientele out of thin air by initiating relationships, uncovering needs, delivering solutions, and validating all their work with high touch service. They may not create demand, but they often awaken it, which means that they also fill a marketing function. When these combined marketing and sales functions are professionally practiced, the agent enjoys a sort of resistance to being reduced to a commodity, which makes the practice more valuable.

This difference must be carefully documented if its value is to be reflected in a purchase agreement, especially if the sale is to someone other than a fellow agent or agency. If agents plan to stay on after selling, they can usually expect their future value to be measured in two areas: maintenance of existing relationships and enhancements with new relationships. Typically, new ownership will overestimate its own ability to assume an earned relationship with existing clients and will underestimate the agent's ability to bring in new business. In the case of the institutional buyer, both of these mistaken assumptions should be mitigated by advance preparation on behalf of the agent. It is urgently recommended that, if the agent plans to stay on after the practice is sold, a written agreement on the value of these kinds of services be in place prior to the sale of the practice. The agreement should identify and quantify those key services and attributes that the agent delivers which are simply not available elsewhere. Although these may be many in a given practice, the commodity resistant traits discussed below consist of those unique skills that will contribute directly to three key results: growth, quality, and

profitability.

A Following Within Their Profession

The agent's following is of special value to the new owner who wishes to establish credibility within the specialty of the practice (i.e., estate planning, benefit consulting, or deferred compensation). It can also be of substantial value to institutional buyers who tend to make acquisitions within niches of the financial services industry. They will often want an experienced individual to help find future acquisitions and who will also serve as a filter in evaluating candidates. Agreement should be reached that the value of these skills will be recognized in the workout portion of the purchase price.

Industry Specific Expertise

Understanding how to navigate one's way through the administrative, regulatory, and cultural obstacles created by external forces is a valuable intellectual property. This means knowing how to get certain important things done better than anyone else with regard to the practice, its carriers, and the entire operating environment. These skills will almost always be undervalued by the purchaser, until he or she sees them in action, but by then it will be too late for the seller to receive specific compensation for his or her contributions. It must, therefore, be priced ahead of time.

Skill in the Maintenance of Obsolete Profit Sources

Many skills that once were important to a growing practice are now important only in a custodial way. These activities may range from the servicing of profitable clients that have no potential for future growth or valued clients that are high "maintenance" and unlikely to accept a new relationship, to administering a closed-end block of business. Custodianship includes activities that today's mentality rejects but wants to profit from. As such, those who receive these types of profits should be expected to pay for them.

Street Smarts

Successful agents all share one common trait -- the benefit of experience. An agent's instincts in times of change, challenge, or opportunity are an important intellectual property. This resource should be nurtured and noted throughout the agent's career. Many individuals too often fail to credit their street smarts for those choices and initiatives that changed the direction of their careers in positive ways.

Incidentally, this asset is just as valuable when it steers an agent away from an ill-fated trend, as it is when it guides him or her toward a sound one. Often the things that do not happen after one's instincts throw up a red flag are more important than the things that do happen.

A Passion for the Business

A passion for the value of their product, their profession, and their clientele are some of the emotions that run freely through the spirits of commodity-resistant agents. This zeal, which is omnipresent among successful life insurance agents, is increasingly rare among new entrants to the business, both institutional and individual. It is, therefore, a valuable resource, not only to the future leadership of a practice, but also to the carriers they represent.

There is an obvious contradiction between this third strategy and the other two, which should be addressed. The first two strategies follow the mandate of building marketable equity in a practice by shifting the emphasis away from the agent. There is a kind of vocational paradox here, in that for the first two strategies to be successful, the agent must first develop genuine commodity-resistant characteristics. It is for this reason that the third strategy is the most important, for without the commodity-resistant skills of the agent, real value in a practice is unlikely to develop. When it becomes commodity resistant, the practice takes on a life of its own, becoming the legacy of the person who built it. The irony is that perpetuity in a business is dependent upon systems and processes that have their genesis in innovation and creativity. A fundamental principle is at work: Artworks which are superior enough to command a premium price are not produced by mediocre artists. The key, then, to the third strategy is to use commodity-resistant gifts to create a practice which, like fine art, withstands the test of time.

Identifying the three strategies that create equity in a life insurance practice shows that the value of a practice in today's marketplace will be greatly influenced by the strategic skills with which the agent builds it. Agents should make choices in building their practices, not just by how they view their careers tomorrow, but also from the point of view of the person who will someday buy the practice from them. If agents picture themselves walking arm-in-arm through their practice at some future date with the person or company that will be their successor, then decisions made today about running the business will be made with the ideal successor's best interests in mind. A significant benefit to this philosophy is that it will only work if it is in the best interest of clients. Otherwise, it will not have value to those further up the distribution channel.

Pricing Considerations

While the value of a practice is essentially determined by what someone is willing to pay for it, this article posits the belief that agents capable of creating real value for a buyer will want to sell their business in the same way they built it -- by putting the client's best interests first. The goal is to get a fair price, while attracting buyers who value the agent's own disciplines and characteristics. A seller should therefore identify and seek out those potential buyers who fit the seller's profile. The factors discussed as follows will help a seller know if a potential buyer is the right "fit."

Similar Values, Ethics, and Business Practices

This factor is important not only for the perceived value of the practice, but also to the clientele who will deal with the successor. Agents who sell their practices sell the relationships they have earned with their clients; these relationships will only have value to those capable of continuing to earn them.

Client Compatibility

This factor -- closely related to the above -- is the likelihood that the successor will win acceptance from the clientele and will be able to relate to their needs and expectations. Without compatibility between the buyer and clientele, the sale is unlikely to hold up. Again, a buyer whose values conflict with those of the seller is likely to be disappointed with the purchase.

Financial Strength

The buyer should have the financial resources to buy the practice outright, even if he or she chooses to finance it through a third party or pay for it in installments. If for no other reason than that, the seller should never agree to an installment sale unless it is fully collateralized. Regardless of how payments are made, the terms and conditions should be self-adjusting as they pertain to the variable factors, but guaranteed with regard to the fixed factors. Any perception of financial uncertainties about the transaction tends to be disastrous to ongoing value for all concerned parties.

Professional Credibility

When the buyer is a fellow agent, he or she should enjoy a similar professional status to that of the seller. In the case of an institutional purchaser, credibility is achieved through a combination of the buyer's resources and the agent's support for an appropriate period of time. The buyer expects to purchase a type of "instant credibility," which the seller should support, at least until the buyer is able to provide acceptable levels of expertise and professionalism in the new relationship.

It is especially important during the transition period, when the general client base meets the new owners, that the seller stay close in order to deliver high touch attention and service. This is true for both individual and institutional buyers, but especially in the case of the latter.

Capable of Building Relationships

In the case of institutional buyers, agents usually stay on for a significant period, possibly several years. It would not be advisable, from a professional point of view, for an agent to turn his or her clientele over to an entity that is likely to be impersonal and may be primarily dependent on an electronic relationship with its clients. A practice correctly built is a labor of love, resulting in a collection of valued and trusting relationships. When an individual agent or small agency purchases the practice, it should be relatively easy for

the seller to gauge how capable the purchaser is in building relationships. In the case of institutional buyers, however, sellers should take a closer look.

Other Considerations

Sometimes an individual or entity (such as a larger agency or securities firm) will be willing to write a single check to purchase the database and solicitation rights of an agent's clientele. In such cases, a significant discount is usually applied due to the unknowns about future revenues. This transaction would be the most extreme example of selling certain rights to a practice and is not a recommended strategy. It is more likely that the buyer wants to acquire both solicitation and ongoing service responsibilities to the practice in the form of a "work out" in which a substantial part of the price is paid out of future revenues. While this arrangement yields a potentially better price for the seller, it is dependent on future results, over which the seller may or may not have sufficient control.

Given the right buyer, pricing should reflect substantial value for the goodwill established by the practice. In determining goodwill value, both present and future revenue streams should be considered. Then the variables that are the workout portion of the agreement should be added to this amount. It is important to note that institutional buyers may plan to do cross-selling, which should result in superior results if the goodwill components are in fact valuable. Thus, the workout price should reflect revenues from all sources of product, including new ones introduced by the buyer.

The amount for the basic purchase price can be paid in a lump sum or in guaranteed installments, but it should be a fixed amount. In addition to this amount, several approaches that reflect future performance can be considered. These are the variable portion of the purchase price, which can be paid any number of ways:

- Percentage of all revenues from new sales for a fixed period (five to ten years);
- Commission split on existing policyholders and a second on database prospects (i.e., contact management files on prospects and clients' children);
- An additional lump sum for all existing clients and a percentage on all future sales for a specified period of time;
- Declining percentage on all future sales: x% years 1-2, y% years 3-6, z% years 7-10;
- Level Payments over a period of years based upon profits, regardless of future sales;
- Computerized model that generates regular payments based upon agreed-to variables such as socioeconomic profile and number of products owned per client household or business, persistency, and sales growth; and
- Additional consideration given to external factors such as legislation or economic and regulatory factors that may have an adverse impact on the practice.

Monitoring of the purchase agreement usually involves administration by a third party

and cooperation on the agreement itself from the carriers involved. These costs must be negotiated, but generally the administration of a buyout is not difficult. It is also important that such transactions be as public as possible and not be viewed as strictly a two-party transaction. Instead, there should be a stated transition strategy that is open to all interested parties for review.

An additional consideration in the purchase agreement is how the proceeds will be taxed. Compensation to the principal who stays on is taxed as ordinary income, while proceeds from the sale of the practice will generally be taxed as a capital gain. This is usually true, even if those proceeds are paid on a workout basis indexed to future profits. The counsel of a good tax adviser is essential to this aspect of the agreement.

The Institutional Buyer

In the recent frenzy of the financial markets to find business assets that are not already overvalued, there is growing interest among some acquisition and growth-oriented firms in buying life insurance agencies and individual practices. While this trend appears to offer great opportunities to individual agents or agencies, such acquisitions are often paid for primarily with stock in the acquiring firm. If such a purchase converts the equity in a practice to a currency that appreciates with the momentum of a bull market, the result can be rewarding, to say the least. If an agent sells his or her life's work at perhaps six times earnings, but the purchase price consists of stock that is trading at 30 or 40 times earnings, the result may be disheartening. For the buyer, it is a kind of reverse dilution of his or her stock. The market has probably already adjusted the buyer's stock for its perceived value and perhaps even its future potential. For the acquired agency, this type of transaction may work out only if the momentum of the stock market (which many feel is overvalued) continues. Granted, the equity in the insurance practice is "dead equity," in that the typical practice has no ongoing upside-value beyond that calculated in the purchase agreement. Some publicly traded companies argue that they bring the leverage of market psychology and the momentum of the economy to that equation, and, therefore, the value the market places on their stock is as real as the value they place on the businesses they buy. In making this argument, they miss the point. When successful agents consider the sale of their life's work, its value should not be dependent upon the psychological vagaries of the stock market. If for no other reason, the worst case scenario on the downside should consider service to clients.

Given what a typical practice brings to the table, it must be emphasized that an acceptable buyer profile should be a prerequisite for any sale. This means finding a buyer that contributes in ways that result in the best of both worlds. It is quite feasible to find a buyer who is primarily interested in the practice because of what the buyer has, rather than only because of what the agent has -- a buyer that genuinely wants to grow and expand his or her business through a combination of the buyer's resources and the talents of those running the business he or she acquires. This may still be an institutional buyer, but one with a strategy to grow by adding quality distribution the buyer can nourish

rather than premium revenue the buyer can skim off. In such a case, growth would be driven, not by consolidation to feed an inflated price earnings ratio, but by a marketing plan dedicated to synergies created by vertical integration, cross selling, and high-tech support. Under this scenario, the seller should be more willing to accept stock as part of the purchase price, because he or she then joins a real business with a future based upon sales growth rather than consolidation or market psychology.

Conclusion

Selling a life insurance practice for value is not yet a popular concept, but it will be. Hopefully, the insurance industry leadership will evaluate this phenomenon and provide guidelines and resources for those considering this type of transaction. Meanwhile, the agent who builds a marketable practice will want to create an entity with a life of its own -- one that has value far beyond its premiums in force. The value of a loyal and fertile clientele is considerably more difficult to measure than is the value of a sterile but more predictable premium stream. When deciding between the purchase of a block of business and a sales force, the potential buyers must decide if it is more advantageous to own the company revenues or the agent relationships.

Both have their advantages, but the relationship side favors creative options that provide the flexibility to resist the industry trend toward becoming commodity brokers. With proper planning, the capitalization of an agent's practice can be accomplished in a way that affirms its value in the most powerful way one could hope for: by validating it through the loyalty of its customers and perpetuating it through the application of sound business disciplines. When this happens, everyone wins -- the agent, the clientele, the buyer, and the carriers. **J**

(I/R Code No. 600.00/4400.00)

Gary Schulte, CLU, is a specialist in the design, restructuring, and enhancement of life insurance distribution systems at the actuarial and consulting firm of Milliman & Robertson. The author of several books and articles on product distribution, Mr. Schulte gained his practical experience during more than 25 years as an agent, agency manager, chief marketing officer, and life company president. He can be reached at gary.schulte@milliman.com or 415-332-3737.

---

(1) See Richard McCloskey, Mentoring Systems (1991). A successful example of this approach is the mentoring program developed by Richard McCloskey, one of the industry's great general agents. Over a number of years, McCloskey has perfected a program in his agency whereby newer agents are permitted to intern under a mentor or established senior agent.

(2) See Michael Gerber, The E Myth Revisited (1994). This book is highly recommended reading for

anyone wishing to learn more about how agents can leverage themselves through staff and systems to create business value that is transferable. This insightful book explains why most small businesses fail and why so few of those that survive create transferable value. It will provide the reader with approaches to leveraging their time in unique ways to create equity in a service business.