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NATIONAL ELECTRICAL MANUFACTURERS
REPRESENTATIVES ASSOCIATION

Succession Planning Process
White Paper

Presented by: T.I.P.S. 4 Reps

T.I.P.S. 4 REPS

TAX PLANNING
INVESTMENT FIDUCIARY MANAGEMENT
PENSION SOLUTIONS
SUCCESSION PLANNING

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This white paper will summarize the need for a very specific and customized process of Succession Planning for Manufacturer's Representative organizations. It is brief in nature by design and has as its goal, you taking away from this paper a process that is repeatable and applicable to almost any Succession plan and key points that applies to all Succession plans. Each step in the process could validate an entire paper unto itself, but for brevity sake I have tried to summarize the most salient points.

After specializing with manufacturer's reps since 1995 we have worked on 100+ Succession Plans and have come to realize that Succession planning is an integral part of an agency's success. There is a reason the word success is part of Succession planning! Succession planning for an agency breeds success.

Our white paper will focus on the Succession plan of an agency that is accomplished through a key management team or partner transition. This does not deal with a merger or outside acquisition. There will be another white paper outlining the specifics of this type of Succession Plan.

The process T.I.P.S. 4 Reps has implemented for Succession Planning is called R.E.P. Management™ (**R**etirement and **E**xit **P**lan). This paper will be summarized under the following categories

1. Succession Plan Definition and Significance for a Rep Agency
2. Financial Plan/Retiring Owner (s) goals and objectives
3. Key Employee Management
4. Valuation
5. Tax Structure of Payout
6. Line Loss Provisions on payout
7. Insurance Funding
8. Drafting Succession Planning documents/Blueprint
9. Coordination of Tax, Legal and Business disciplines for implementation

1. Succession Plan Definition and Significance for a Rep Agency

It is just good business to think about Succession planning well in advance of your retirement. Just as you are looking for continuity for your line card so in turn your manufacturers are looking for the same as evidenced by how many manufacturers ask about an agency's long term Succession Plan.

Succession planning is a process and not an event. Succession planning is much more than just selling your stock when you retire. Succession planning is about creating value in your agency, maintaining the value between now and retirement and ultimately realizing the value upon your death, disability and retirement.

As we will discuss in the valuation section, the value of your agency is contingent upon the level of gross commission of your agency which is impacted by key employees you have in place. Therefore your key employees are crucial to your overall plan because if there are no key employees there is no succession plan.

You should begin to discuss and work out an overall plan at least 5-7 year prior to your retirement. This should give you time to develop the key people and be comfortable with the transition of the relationship on your lines to your key people.

2. Financial Plan/Retiring Owner (s) goals and objectives

It is important for the partner or owner of an agency to establish what timeline there will be in phasing down and your ultimate retirement. In lieu of this it is helpful to develop an overall Financial Plan that takes into consideration your existing assets and potential cash flow generated from a proposed buyout. This allows the owner to quantify the timeline of retirement and establish a baseline minimum required to achieve his/her financial goals.

3. Key Employee Management

As we have said already there is no internal Succession plan without key people. The planning to build a successor team should begin well before your ultimate retirement. You need to groom your successors well in advance.

The goal with your key people is to groom them for ultimate ownership but more importantly to bridge the time between now and your retirement. You need to ensure they have an incentive to stay with the agency, help it grow and have a disincentive to leave.

Many owners have a knee jerk reaction to automatically give stock to key people but there are many strategies that you can implement to help retain key people, provide them with an incentive to stay and ultimately groom them for Succession. Some of these options are

Stock
Stock Options
Phantom Stock
Deferred Compensation

This stage really only applies to those agencies with owners who are going to sell to a key person or people and have 2-3+ years until they retire.

4. Valuation

The next step in the process is developing a base value of the agency as if you sold the company in a stock sale. Historically the formula for the rep agency value has been 1 times annual gross commission of the agency. Although that can be a good starting point the real value of an agency is simply this: the cash flow available to the agency to make payments when an owner retires.

The technical accounting term for this is EBITDA or Earnings before Interest, Taxes, Depreciation and Amortization. To use an example: If a retiring owner earns $265,000 per year and receives a $25,000 profit sharing plan deposit each year and Travel and Entertainment of $10,000 per year, that would mean that next year when he is retired the company will not need to make those payments and consequently have this $300,000 of cash flow available to make payments to the retiring owner.

You would have to minus out what costs if any are associated with hiring someone to replace the owner but nonetheless you take the bottom line cash flow available which in our example is $300,000. We have to back out taxes on this amount which would be around $90,000. So the total net cash flow available to make payments would be $210,000 per year.

Typically you then assume a multiple of this number which ranges from 3-6 times depending on the agency, success, expenses etc.

This is a simple way to determine a fair value for your shares.

5. Tax Structure of Payout

After we have established what the stock value would be we then look to see what the net cost of the buyout would be using the typical stock sale. The problem with a typical stock sale is that the payments are after tax payments (not tax deductible). Therefore in order to make principal payments in a 40% combined tax bracket the net after tax cost you would $1,666,000.

In other words the company or key person/people would have to earn $1,666,000, than pay 40% to the IRS or $666,000 to be left with the $1,000,000 net after tax.

The seller would pay capital gains tax on that amount and assuming a 20% capital gains tax he/she would net $800,000 after tax. The "scorecard" on this transaction would be the following:

Cost	$ 1,666,000	
Net to Owner	$ 800,000	48%
Net to I.R.S.	$ 866,000	52%

This means the I.R.S. is a 52% "shareholder" in this transaction. Our goal for our R.E.P. Management™ is to net at worst the same $800,000 in this example but provide a legitimate strategy that could lower the overall cost of the payout.

Depending upon many factors we will typically structure the payout as a book value and deferred compensation plan or Personal/Corporate Goodwill. We also look at consulting payments and ESOP's as options. All of these strategies allow the buyers to deduct the payments.

Using just the book value stock sale and deferred compensation structure as an example, our plan would be to pay the seller a very small amount of value in actual stock and make payments to him in the form of deferred compensation. The deferred compensation is deductible to the company but income taxable to the retiring owner.

Therefore we calculate what amount of deferred compensation we need to pay the retiring owner so that after they pay income taxes on the amount they are left with the same $800,000 in this example. Our R.E.P. Management™ on this case would be to pay $10,000 for the stock and $1,320,000 in deferred compensation. The net after tax benefit to the retiring shareholder would be the same exact $800,000 but now the net after tax cost to our R.E.P. Management™ is just over $1,330,000 vs. the stock sale at $1,666,000 for a cash flow savings of over $330,000.

This is very important because the additional cash flow savings to the buyers make the transaction more palatable and we can now show that the company can afford to make the payments. The scorecard in our R.E.P. Management™ would be

Cost	$1,336,000	
Net to owner	$ 800,000	60%
Net to IRS	$ 536,666	40%

The net gain to the overall transaction is the $330,000 of savings or a 20% net increase on the cost of the sale.

6. Line Loss Provisions on payout

After we have established the structure of the payout we look at how the payments will be made. The length of time and the variability of payments fall under the line loss provision step. We can either make the R.E.P. Management™ payments fixed or one of these options

A. 3 year average of gross commission paid as a % each year until the number is attained
B. % of annual gross commission for 5 or 7 years with a floor and a ceiling on the payments
C. % of annual gross commission with no floor and ceiling.

We review with the owners and potentially buyers the best solution.

7. Insurance Funding

There should be a review of the life insurance that would be needed to help fund the payout at the death not only of the retiring owner but also the key people. The retiring owner should have ken man insurance the key people.

The amount of insurance needs to be reviewed along with how it will be owned and whether term insurance or some form of cash value life insurance should be used to fund the plan.

8. Drafting Succession Planning documents/ Blueprint

You should then establish a "blueprint" of the overall plan and review with all parties involved to make sure everyone is on the same page.

Typically we suggest for one of our Tax Attorneys to draft the blueprint but any Tax Attorney should be able to draft the plan. Ideally the attorney would not represent either the buyer or seller but would help represent the transaction as a whole. We typically help coordinate the implementation of the drafting of the agreements.

Drafts are completed and any revisions that need to be made are reflected in the updated agreements. Once the final agreements are presented then all parties sign to put into place the R.E.P. Management™

9. Coordination of Tax, Legal and Business disciplines for implementation

I am going to suggest to you that you should hire someone who can help coordinate and implement the plan. That can be T.I.P.S. 4 Reps or typically a business consulting accounting firm. Bottom line is you can go "direct" with the Succession plan or you can hire someone to help with the process.

If you went direct you would have to find all the following advisors and coordinate the entire process

Accounting firm- to verify tax structure
Tax Attorney- Draft agreements and quantify tax structure legally
Business consultant- to coordinate all advisors and the plan
Valuation analyst- to perform the valuation on the rep agency
Insurance Advisor-To help fund insurance
Financial Advisor/Financial Plan- To develop financial plan and ensure payout meets financial goals

The time, effort and expense of this project going "direct" would be cumbersome at the least.

In summary the uniqueness of what a rep agency is and the disciplines involved in bringing a customize solution to the rep agency owners validates the reason why you must plan well ahead for your Succession plan and hire someone to coordinate the process and structure the transaction as to make it cost and tax efficient for all parties.