



Reserving—A Key Strategy for Today's Private Business

by Matthew Andersen

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Recent economic events have sent a clear and compelling message to business owners: It is time to create a solid plan that addresses economic downturn contingencies, succession planning and business liquidity. Relying on credit from a bank or hoping that willing buyers will be ever-present in the marketplace is simply not enough. Reserve planning is a strategy that can help businesses and business owners make their futures more certain when the economy is volatile or during internal or external exit opportunities.

The Importance of Reserving

It is estimated that there are over 6 million businesses in the United States that have less than 500 employees, and the vast majority of these businesses are privately held.* The value of these businesses typically makes up a large portion of the intangible net worth of their shareholders. Yet some of these small- to mid-sized organizations have not put into place strategies that help them preserve, protect, grow, and, when preparing a business for sale, access the value of their businesses.

Whether a business is considering an internal sale, such as a management buyout or employee stock ownership plan, or an external sale to a private equity company or strategic buyer, there are several steps that have to be taken: audited financials, valuations, legal work and more. These steps help establish clarity into the business and provide the means to ascertain important information about the business, helping the buyer determine value. However, none of these steps provide any level of surety that a business will have increased in value during the business life cycle, and they certainly will not provide assurance that the business will be able to be sold.

One strategy can help provide assurance that when the time comes for the sale of a company, succession planning or minority shareholder buyouts, the chance for success has the highest possible odds. That strategy is called reserving.

Reserving helps provide businesses:

- » The financial means for business continuity in succession planning
- » A springboard for unlocking value via a recapitalization or outright sale of the business
- » The ability to weather financial or economic downturns with greater ease

Theory of Reserving

Reserving is a simple technique, but can have tremendous importance to a business owner by helping to maximize the value of the business. The theory of reserving focuses on what the reserve delivers in terms of value and the critical components that go into developing a reserve methodology that is custom-fitted to a business and its ownership.

Background

Reserving may sound like a new planning strategy, but many businesses in the United States use reserving techniques. For instance, banking organizations are required under the Basel Accord (Basel II) to maintain certain minimum capital requirements and reserves for future liabilities. In addition, many companies that issue long-term debt or have future expected obligations use reserving techniques as well. In all of these settings, reserves are typically required by law or by a legal document of sorts.

Reserving for small- and mid-sized privately held businesses generally has little to no regulatory or legal requirement. Without a regulatory or legal framework, reserving can be somewhat more difficult, but provides an opportunity to truly meet a business owner's objectives.

* U.S. Census Bureau. 2006 U.S. Census.

Unlocking Value

Being able to unlock the value of one's business is a critical challenge for any owner that has created a meaningful business. The primary means of creating value in a business center around the business' ability to:

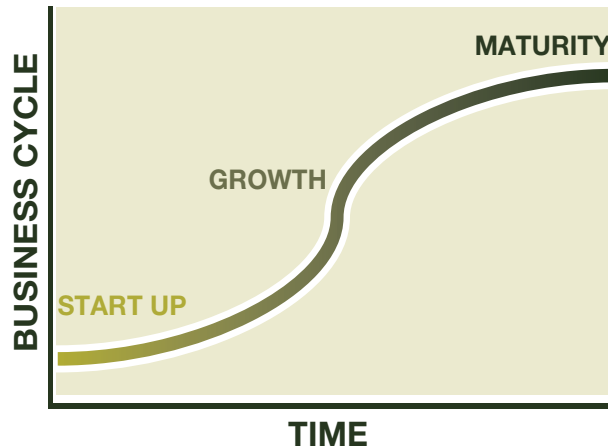
- » Sustain short-term business cycle challenges
- » Capture marketplace opportunity
- » Maintain a strong cash flow
- » Have a good balance sheet and income statement

Reserving is a methodology of planning that helps businesses in every one of these situations by providing a liquidity reserve that a company can use in a number of ways to improve its situation despite the circumstances. For example, it can be a financial resource to tap into for the purpose of either weathering a storm or capitalizing on "blue ocean" opportunity.

Understanding the Situation

There are three critical components involved in getting reserving done correctly for business in today's environment:

- 1) **Business Life Cycle** — Understanding where an organization is in its business life cycle is critical to understanding its needs and resources. It is also critical to understand where the business will be in reference to accomplishing the objectives of its owners. An example of a business life cycle is found below:



- 2) **Objectives** — All businesses will change hands at some point. Whether a business stays within a family, is taken over by successor management or is acquired by an external party, there will be a need for the current ownership to unlock value from the business. Understanding the timeframe and nature of one or more of these possible alternatives is important to establishing a reserving technique that can enhance the value of the business.
- 3) **Business Risk** — Understanding the business risk or volatility of cash flows or future liabilities is also of primary concern in the reserving process. For instance, seasonal cash flows, correlation to certain industry or economic risks, or future obligations of the company for minority shareholder buybacks can all factor into the risk levels of the business and, therefore, its reserving requirements.

Added together, these three factors result in the reserving requirements of the business:



The Practice of Reserving

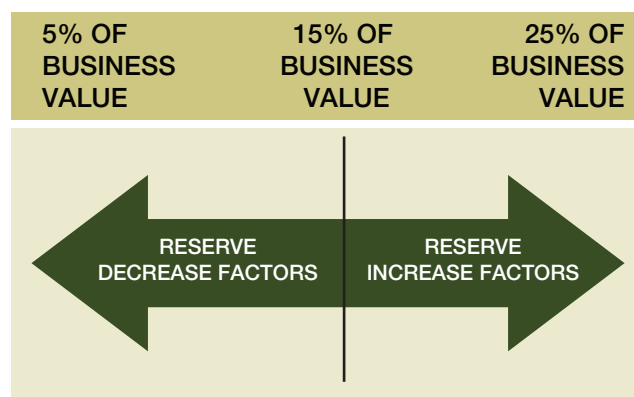
The practice of reserving is centered on: quantifying the reserve amount that helps the business maximize its value; setting timeframes for achieving the reserve amount; and selecting appropriate assets to utilize to help maximize dependable access to the reserve when the need arises.

Quantifying the Reserve

Once an understanding of the business cycle, objectives and risk of the business have been assessed, it is important to begin quantifying the reserve needed to help the business accomplish its goals. In general, by the time a business is ready for its primary liquidity event, it should have on hand a reserve of anywhere between 5 percent to 25 percent of the value of the organization, with an average of 15 percent.

The reserve amount will increase to the higher boundaries for businesses that: are early in the business life cycle and therefore may have less predictable cash flows; are interested in a management or family buyout objective; or that have greater volatility or inherent risk.

The reserve amount will decrease to lower boundaries for businesses that: are larger and deeper in the business life cycle with steady cash flows; are more externally buyout focused; or have less inherent risk.



In many cases, general business valuations can be obtained from taking the EBITDA (Earnings Before Interest Taxes Depreciation Amortization) plus owner compensation times a multiple of anywhere from four to eight times. For example, if a business had an EBITDA of \$800,000 and owners' compensation of \$200,000, the business might be worth anywhere from \$4 million to \$8 million.

Annual Reserving

Once the reserve amount has been determined, it is important to establish timeframes to achieve the reserving requirements needed to meet the businesses objectives. Based on the business and growth assumptions, the reserve may have several layers and be deployed over time to handle business growth and growth in valuation assumptions.

Selecting Reserve Assets

Selecting reserving assets can be as important as the reserve itself. Since the primary asset objective of the reserve is to provide capital liquidity, high risk or volatile assets are typically not acceptable. Therefore the assets that the reserve is invested in need to have the following characteristics:

- » Immediate liquidity
- » Stable during interest rate changes
- » Stable in varying credit environments
- » Stable during equity market fluctuations

The types of assets used in reserving strategies, and their key characteristics, are laid out below:

	SAVINGS ACCOUNT	CERTIFICATES OF DEPOSIT	GOVERNMENT BILLS & NOTES	INSTITUTIONAL LIFE INS.
Issuer Credit	Bank and FDIC	Bank and FDIC	US Govt.	Carrier
Credit Rating	NR to A	NR to A	AAA	AA to AAA
Interest Rate	Short	Short to Medium	Short	Medium to Long
Change	Monthly	Upon Reinvestment	Upon Reinvestment	Quarterly
Interest Rate Risk	None	Minor	Minor	None
Liquidity	High	Restrictions	High	High
Collateral Value	100%	100%	100%	100%
Tax	Federal and State	Federal and State	Federal and State	Tax Deferred
Life Coverage	NA	NA	NA	Yes

The standard insurance amount of \$250,000 per depositor is in effect through Dec. 31, 2013. On Jan. 1, 2014, this may change. Loans and withdrawals may generate an income tax liability, reduce available cash value and reduce the death benefit, or cause the policy to lapse.

A quick example of how institutional life insurance can offer certain tax advantages in the reserving process is detailed below:

INSTITUTIONAL INSURANCE ASSET - 60 YEAR OLD MALE						TAXABLE OPPORTUNITY COST ASSET				DIFFERENCE	
Year	Age	Net Annual Outlay	Cash Surrender Value	IRR On Cash Surrender Value	Total Death Benefit	Year	Net Annual Outlay	Asset Value	Annual Return	Asset Value Difference	Annual Return Difference
1	61	\$1,000,000	\$1,000,197	0.02%	\$13,938,865	1	\$1,000,000	\$1,016,250	1.63%	(\$16,053)	-1.61%
2	62	\$1,000,000	\$2,027,687	0.92%	\$14,966,355	2	\$1,000,000	\$2,049,014	1.63%	(\$21,327)	-0.71%
3	63	\$1,000,000	\$3,086,280	1.42%	\$16,024,948	3	\$1,000,000	\$3,098,561	1.63%	(\$12,281)	-0.21%
4	64	\$1,000,000	\$4,179,450	1.76%	\$17,118,118	4	\$1,000,000	\$4,165,162	1.63%	\$14,288	0.13%
5	65	\$1,000,000	\$5,308,168	2.00%	\$18,246,836	5	\$1,000,000	\$5,249,096	1.63%	\$59,072	0.37%
6	66	\$1,000,000	\$6,468,639	2.15%	\$19,407,307	6	\$1,000,000	\$6,350,644	1.63%	\$117,995	0.52%
7	67	\$1,000,000	\$7,636,270	2.18%	\$20,574,938	7	\$1,000,000	\$7,470,092	1.63%	\$166,178	0.55%
8	68	\$1,000,000	\$8,953,144	2.50%	\$21,891,812	8	\$1,000,000	\$8,607,731	1.63%	\$345,413	0.87%
9	69	\$1,000,000	\$10,330,712	2.75%	\$23,269,380	9	\$1,000,000	\$9,763,856	1.63%	\$566,856	1.12%
10	70	\$1,000,000	\$11,783,239	2.96%	\$23,269,380	10	\$1,000,000	\$10,938,769	1.63%	\$844,470	1.33%

Based on 2.5 percent opportunity cost and 40 percent state and federal income tax rate.

Case Study

The following is a case study example of a business that has entered into a reserving discussion:

Company: Acme Corporation.

Ownership: 100 percent shareholder is 60 years old.

Business: Distribution of paper goods to hospitality industry.

Business Life Cycle: Mature.

Objective: Sell the company in seven to 10 years to management. The management team in place has really led the organization and will continue to do so. The company president is also the owner's son and would own approximately 90 percent of the company post transaction with 10 percent of non-voting shares going to the EVP of marketing and EVP/COO.

Reserving Assets: The reserve will be constructed with money market and/or short-term CDs and institutional life insurance with a target value of \$15M by year 10.

Risk: Business volatility has been at a minimum, barriers to entry are high and Acme has long-standing relationships with buyers and manufacturers.

EBITDA: \$15M is projected to be \$20M by the seven-to-10 year timeframe.

Valuation: 5X's EBITDA is the current assumed multiple; therefore future valuation is approximately \$100M.

Reserving: The business would like to have 15 percent of the future valuation on hand to accomplish a leveraged buyout of the current owner by the management team.

INSTITUTIONAL INSURANCE ASSET - 60-YEAR-OLD MALE						TAXABLE ASSETS				RESERVE VALUE
Year	Age	Net Annual Outlay	Cash Surrender Value	IRR on Cash Surrender Value	Total Death Benefit	Year	Net Annual Outlay	Asset Value	Annual Return	Asset Value
1	61	\$1,000,000	\$1,000,197	0.02%	\$13,938,865	1	\$100,000	\$101,625	1.63%	\$1,101,822
2	62	\$1,000,000	\$2,027,687	0.92%	\$14,966,355	2	\$100,000	\$204,901	1.63%	\$2,232,588
3	63	\$1,000,000	\$3,086,280	1.42%	\$16,024,948	3	\$100,000	\$309,856	1.63%	\$3,396,136
4	64	\$1,000,000	\$4,179,450	1.76%	\$17,118,118	4	\$250,000	\$568,954	1.63%	\$4,748,404
5	65	\$1,000,000	\$5,308,168	2.00%	\$18,246,836	5	\$250,000	\$832,262	1.63%	\$6,140,430
6	66	\$1,000,000	\$6,468,639	2.15%	\$19,407,307	6	\$250,000	\$1,099,848	1.63%	\$7,568,487
7	67	\$1,000,000	\$7,636,270	2.18%	\$20,574,938	7	\$500,000	\$1,625,846	1.63%	\$9,262,116
8	68	\$1,000,000	\$8,953,144	2.50%	\$21,891,812	8	\$500,000	\$2,160,391	1.63%	\$11,113,535
9	69	\$1,000,000	\$10,330,712	2.75%	\$23,269,380	9	\$500,000	\$2,703,622	1.63%	\$13,034,334
10	70	\$1,000,000	\$11,783,239	2.96%	\$23,269,380	10	\$500,000	\$3,255,681	1.63%	\$15,038,920

Liquidity Event Plan: The \$100M needed in the seven-to-10 years will be made up of the reserve being the cash infusion, senior debt from a banking organization and subordinated debt from a mezzanine capital provider. Capitalization will appear like this:

Equity Cash	\$15M
Senior Debt	\$50M
Subordinated Debt	\$35M
Total Sources	\$100M

It is important to note that leveraged buyouts only work with a meaningful amount of equity. The role of the reserve in this case is to prepare the business to have its own means of "down payment" to allow the senior management team to complete a buyout of the current owner at a fair price level.

In this case study, the best of both worlds has occurred. The owner is able to fully exit the business when he wants to and will obtain a fair valuation for the organization. For the management team, within five-to-10 years the business will be debt-free and the cash flow will be totally owned by the new management team.

Completing a reserve transaction like this requires careful planning and assistance from several key advisors. However, going down the path of unlocking private business value is accomplished by setting up a reserving methodology that makes sense given the business, its objectives and overall risk.

Overall, taking the first step toward a reserving strategy is really taking the first step toward unlocking business value — which is one step closer to more certain future.

About the Author

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Matt Andersen is a senior vice president of NFP Corporate & Bank Services. He works with National Financial Partners Corp. (NFP) owned and member firms on nonqualified plans and executive benefits strategies for their clients. Prior to joining NFP, he had extensive industry background working with two national consulting companies, and completing the management training program of a Fortune 250 organization.

Andersen has authored numerous articles, white papers and best practice reports on business strategy/strategic planning, executive compensation, long-term incentives, executive benefits, COLI funding, ICOLI funding, BOLI funding, asset management, fixed income securities and structured products. Andersen has been published in *American Banker* and *AALU Quarterly*, and has presented at industry and company events. Lastly, he sits on the AALU Regulatory Reform Committee and is vice chairman of the Nonqualified Plan Committee.

Andersen earned a bachelor's degree in corporate communication, and is scheduled to complete a Masters of Business Administration in banking and financial services management in 2009. He has received professional designations of Chartered Portfolio Manager and Chartered Risk Analyst from the American Academy of Financial Management. He also received the designation of Accredited Investment Fiduciary from the Center for Fiduciary.