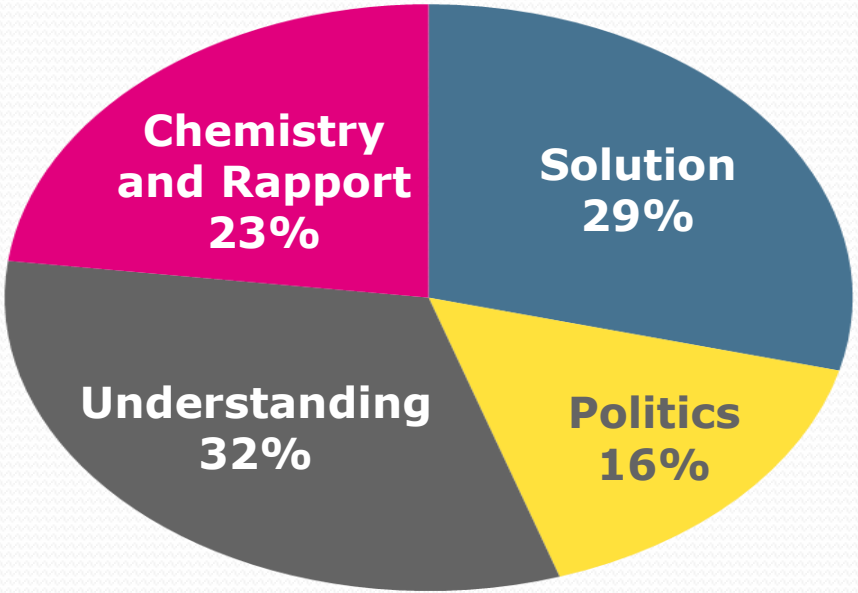
FINANCIAL PLANNING
ASSOCIATION *of* AUSTRALIA

2018 PROFESSIONALS CONGRESS

SYDNEY 21–23 NOV

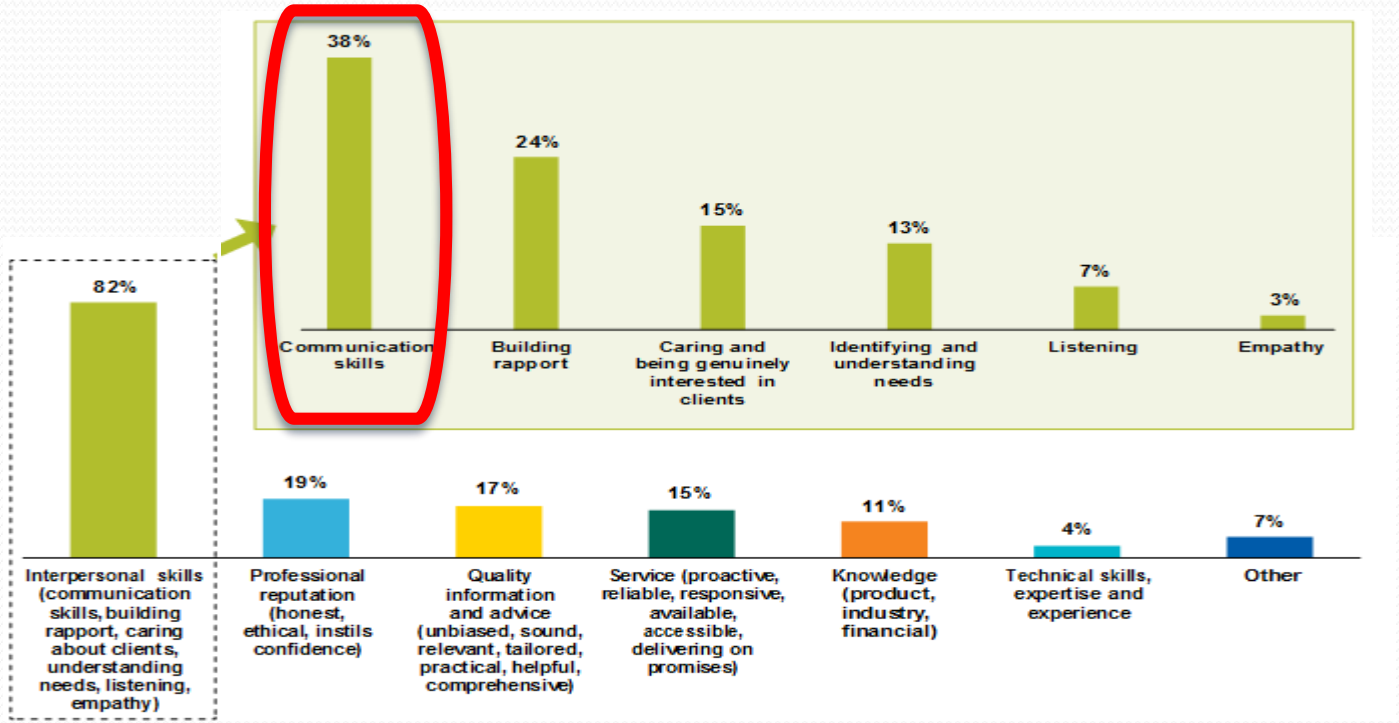
How Customers Decide

70%
'How You Deal'



30%
'The Deal'

The qualities of trusted advisers



Source:
AFA White Paper, The Trusted Adviser, May 2013
Zurich Financial Services
Beddoes Institute

Key learning outcomes from this morning's session

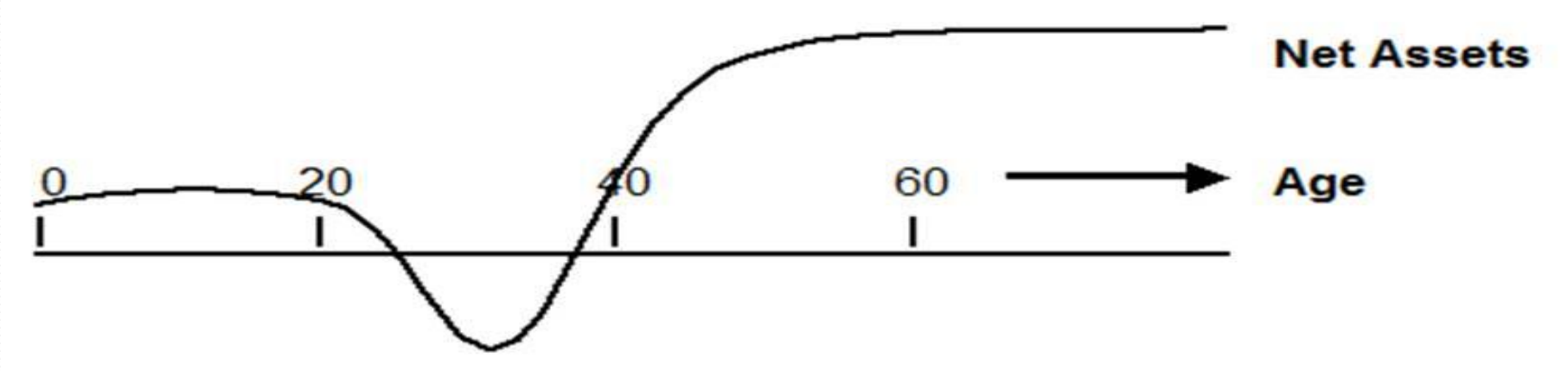
- Know your client
  - How are business clients different?
  - Who is your client and why are they in business?
  - Where does business risk advice fit within your client's overall wealth protection strategy?
  - What are the benefits to clients?

- What are the insurable elements of the advice process?
  - Key customer exposures and needs & interrelatedness
    - Succession Planning
    - Keyperson Capital / Debt Protection
    - Keyperson Revenue Protection
  - Top 3 penetrating questions that draw out each advice need
  - Some technical aspects

- Summary tips and reminders

A client's wealth creation journey and the part advisers play

Wealth creation lifecycle



Phase 1 Dependant	Phase 2 Survival	Phase 3 Stability	Phase 4 Freedom

Who are your business clients? Align with their WHY

What makes your business clients unique?

How are they different?

Why are business owners in business?

What are their values & goals?

Client values & needs

Clients keep telling us...

About themselves and their businesses...

My goals
"My business is my super and key to my retirement"

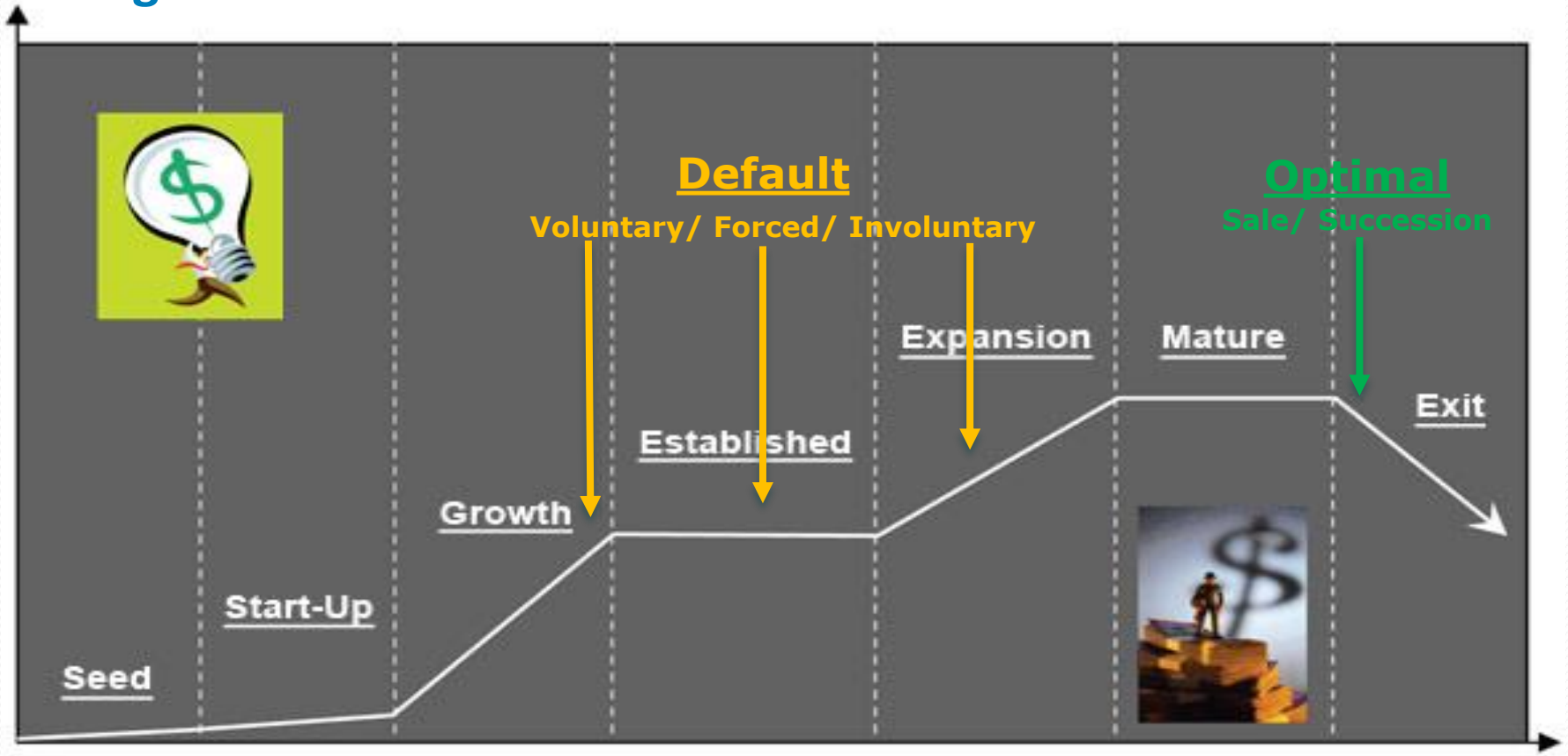
My values
"I am proud of my business and have invested a lot of time and hard work into it"

I am unique
"My business is unique and different. I am key to the success of my business"

Ongoing dependence
"My business is my largest asset and the engine to my wealth creation and family's lifestyle"

My situation
"I am financially fully committed to my business. Even my house and personal assets are on the line"

Client's business lifecycle - securing their retirement through realising the value of a lifetime of effort



In the news

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Why Baby Boomer business owners may retire with nothing

Published 25 February 2014 10:00, Updated 26 February 2014 12:40

Agnes King

Robert McMaster from tooling company c-mac at his factory at Girraween in Sydney's western suburbs. Photo: Rob Homer

Robert McMaster had his $5 million steel fabrication company, C-Mac, located in western Sydney, valued in December. The result was shocking.

"They valued my business at $0," the 59-year-old second-generation family

End of an era: Carol and Laurie Small are retiring after four decades in business.

Aquarium closes its doors after 40 years

By **Belinda Connolly**

THE owners of St George Aquariums have made the difficult decision to close their doors after 40 years.

Owners Carol and Laurie Small will retire in November and decided against selling the Rockdale business to a new owner.

"We are quite passionate about what we do and are wary of people coming in and not being able to support it with the rent money," Mrs Small said.

"We thought if the new owners failed we would have to come back in.

"We haven't had a holiday since 1995 and we come in every day to feed the fish.

"Our son and daughter have worked here for 15 years but they didn't want to take it on."

Mrs Small said many customers were saddened by news of the closure.

"We've had so many now saying they can't believe it and they are quite upset.

"They all say it is an icon — it is the end of an era. It is hard because it has been our life."

The business started in a Carlton backyard where Mr Small made the fish tanks.

> **"We've had so many now saying they can't believe it and they are quite upset. They all say it is an icon — it is the end of an era."**
>
> **— Carol Small**

"It took three months to start the business because we didn't have enough money to put tanks on the shelf," Mrs Small said.

"We are renowned for making good tanks.

"There are a few aquariums around but we had so much variety.

"We had about 1000 varieties of fish, everything from goldfish to saltwater exotics and Australian natives, starting from 50¢ to a few hundred dollars."

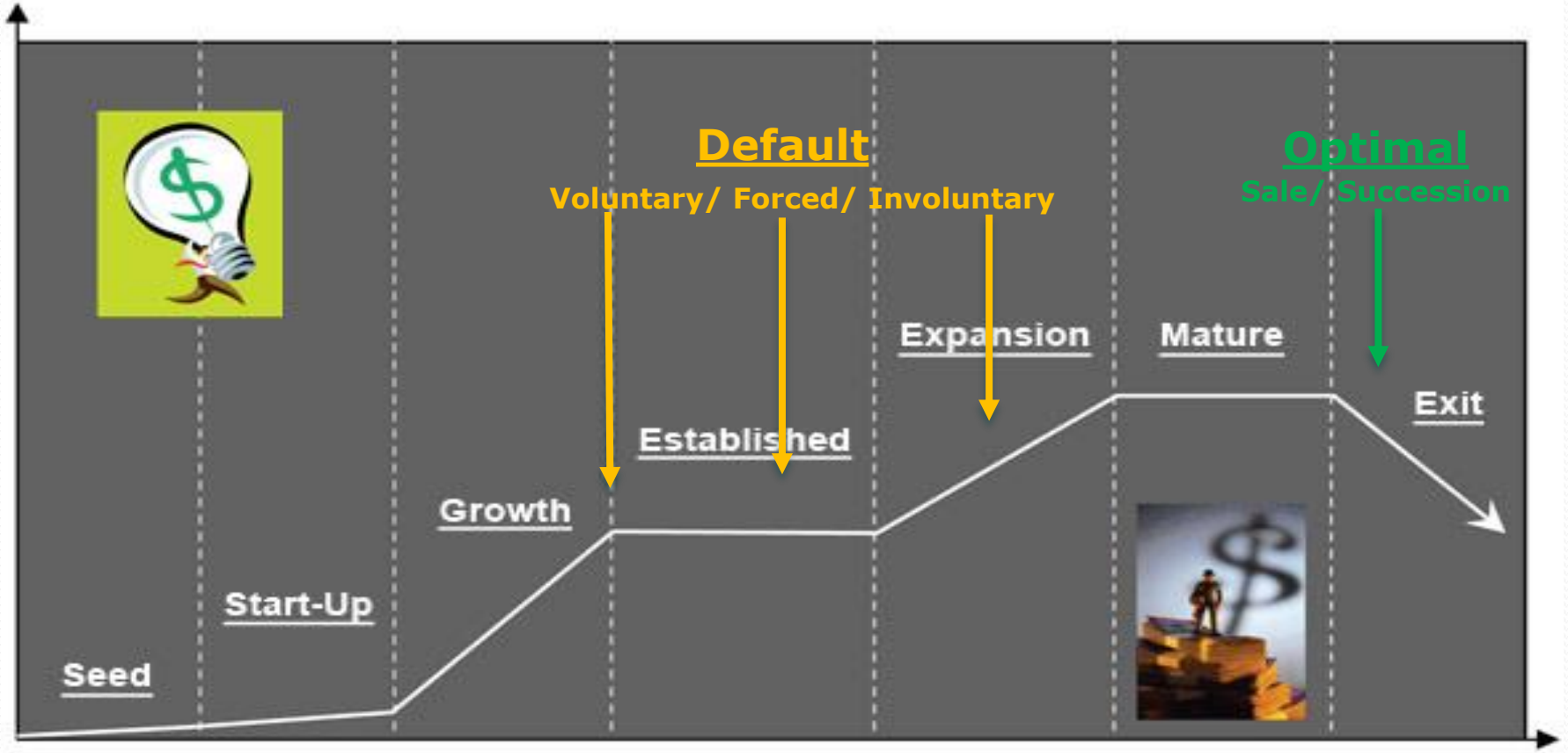
Mrs Small said she would miss the many children who came to buy their first pet.

"I love the joy of seeing the children come into the shop," she said. "I love the children and the kids love the fish."

SME Proprietors' succession concerns = advice opportunity

- 40% of SME's totally reliant on the proceeds of their business sale to fund retirement, yet 85% do not have an exit plan
- 40%-50% were likely to exit business within next 5 years
- Avg age of SME owners is 56 and 68% plan to retire in next 10 years
- 95% of all business in Australia are SME's. They employ in excess of 3.6 million employees[1] and their combined value is estimated at more than double that of all the ASX-listed companies- estimated wealth $1.2 trillion

Client's business lifecycle - securing their future through realising the value of a lifetime of effort invested in the business



Current situation business owners find themselves in

Voluntary Exit

- Retirement
- Looking for a change
- Circumstantial

Forced exit

- Disagreement between partners
- Voluntary absenteeism
- Non-performance
- Bankruptcy & Fraud

Involuntary exit

- Death
- TPD
- Critical Illness

SHAREHOLDERS' AGREEMENT??

NO

NO

NO

Advice gap & opportunity

Voluntary Exit

- Retirement
- Looking for a change
- Circumstantial

Forced exit

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Involuntary exit

- Death
- TPD
- Critical Illness

EXIT AGREEMENT

% Chance?

BUY/SELL AGREEMENT

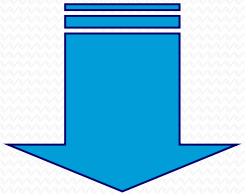
% Chance?

Buy/sell & Exit Agreement (2 x individual or 1 x single agreement)

BUY/SELL & EXIT AGREEMENT

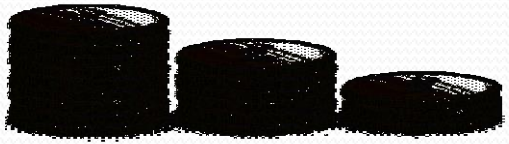
Voluntary *and* Forced *and Involuntary* Exits

PRE-NUP & WILL FOR BUSINESS



- Remaining partners must buy departing partner's share (put & call options)
- Voluntary vs Forced – price is usually discounted - varies between 50% and 100%
- Payments terms agreed – upfront 20%-30% & rest funded from cashflow over 3-4 yrs
- Involuntary – agreed values or formula

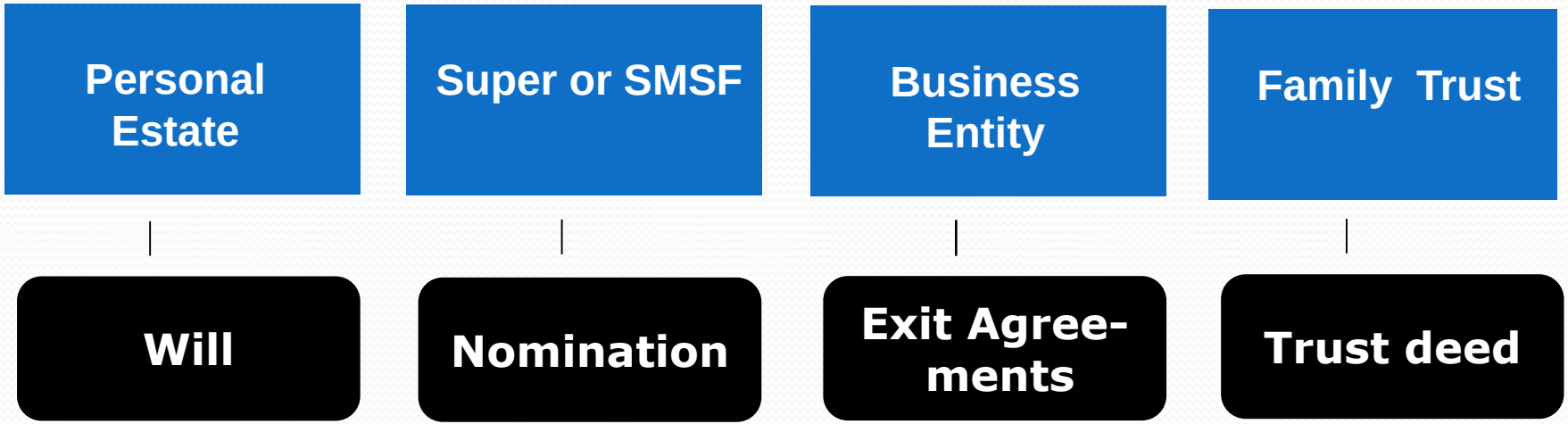
Role of accountants



CPA vs Chartered Accountants

NUMBER ONE IN NUMBERS

The 4 Estates



The right money goes to the right people at the right time

Client values & needs

Clients keep telling us…

About what they expect from us…

Align with my goals
"Help me build my wealth and protect my retirement"

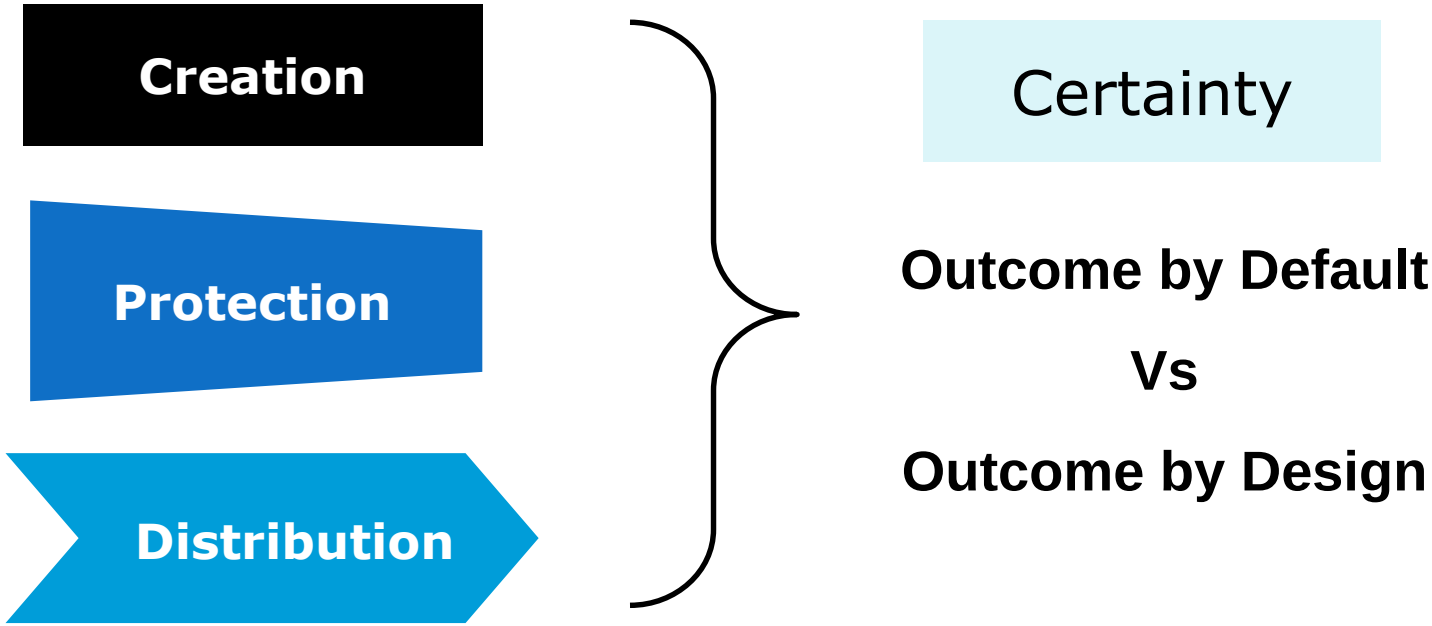
Aligning relationships
"I take advice from the people I trust"

Delivering value
"Take an interest in my business. Stick with me and share my vision. I expect a tailored service"

Align with my focus
"Help me grow my business and save money"

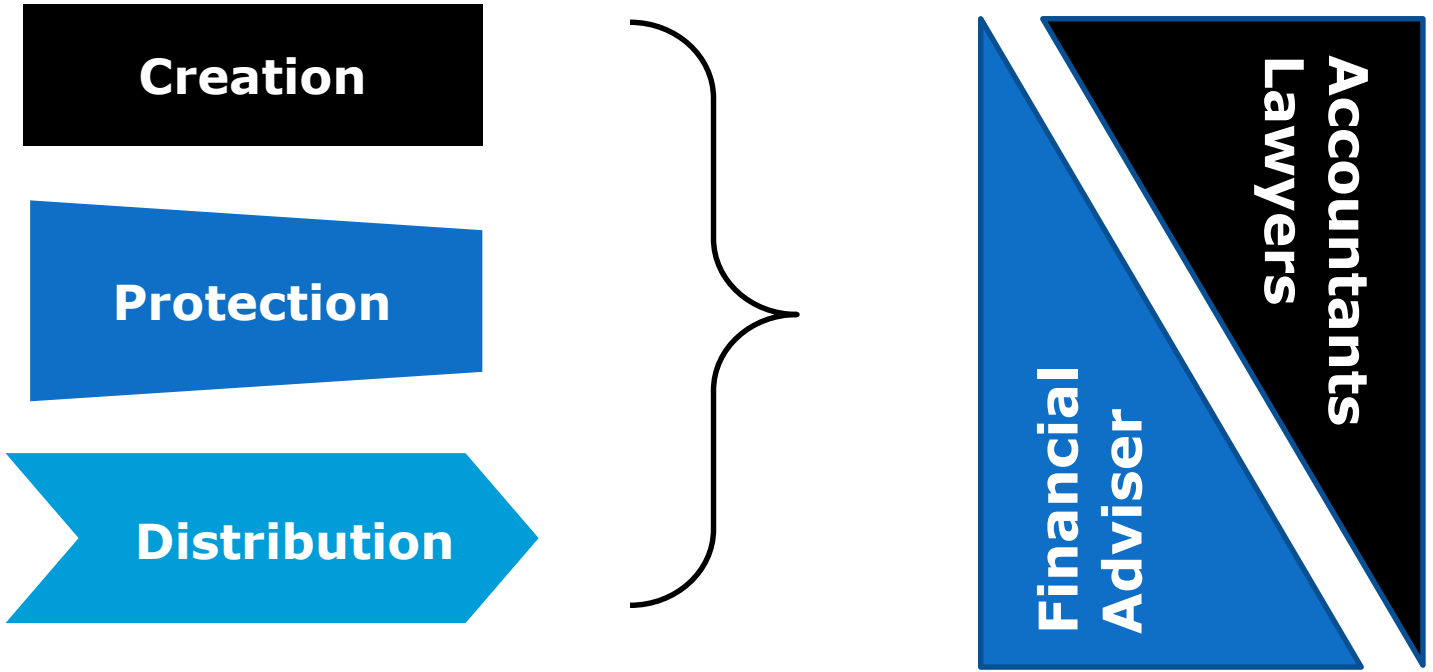
Outsourcing complexity
"In complex matters I feel most comfortable engaging the services of an expert. Make dealing with you as easy as possible and don't use jargon"

The advisor's role



Creating certainty through addressing deficiencies in their overall wealth creation, protection and distribution strategies

The business client situation and how advisers fit in



Compliments and works together with client's other professionals

Overall advice proposition

Supporting needs and strategies

Manage complexity & tax

Maximise retirement

Right money to right people @ right time

Diversify investments

Save money

Core protection needs and strategies

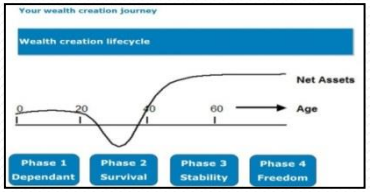
Succession planning

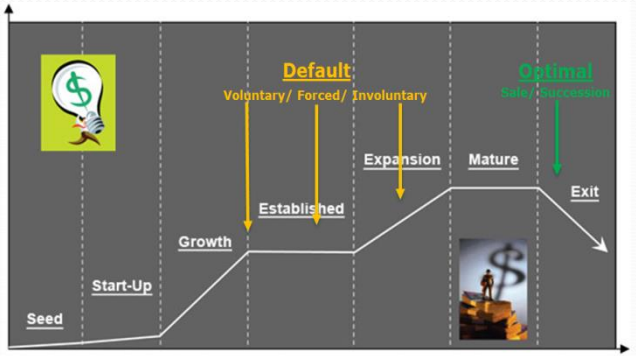
Debt/asset protection

Keyperson protection

Income protection

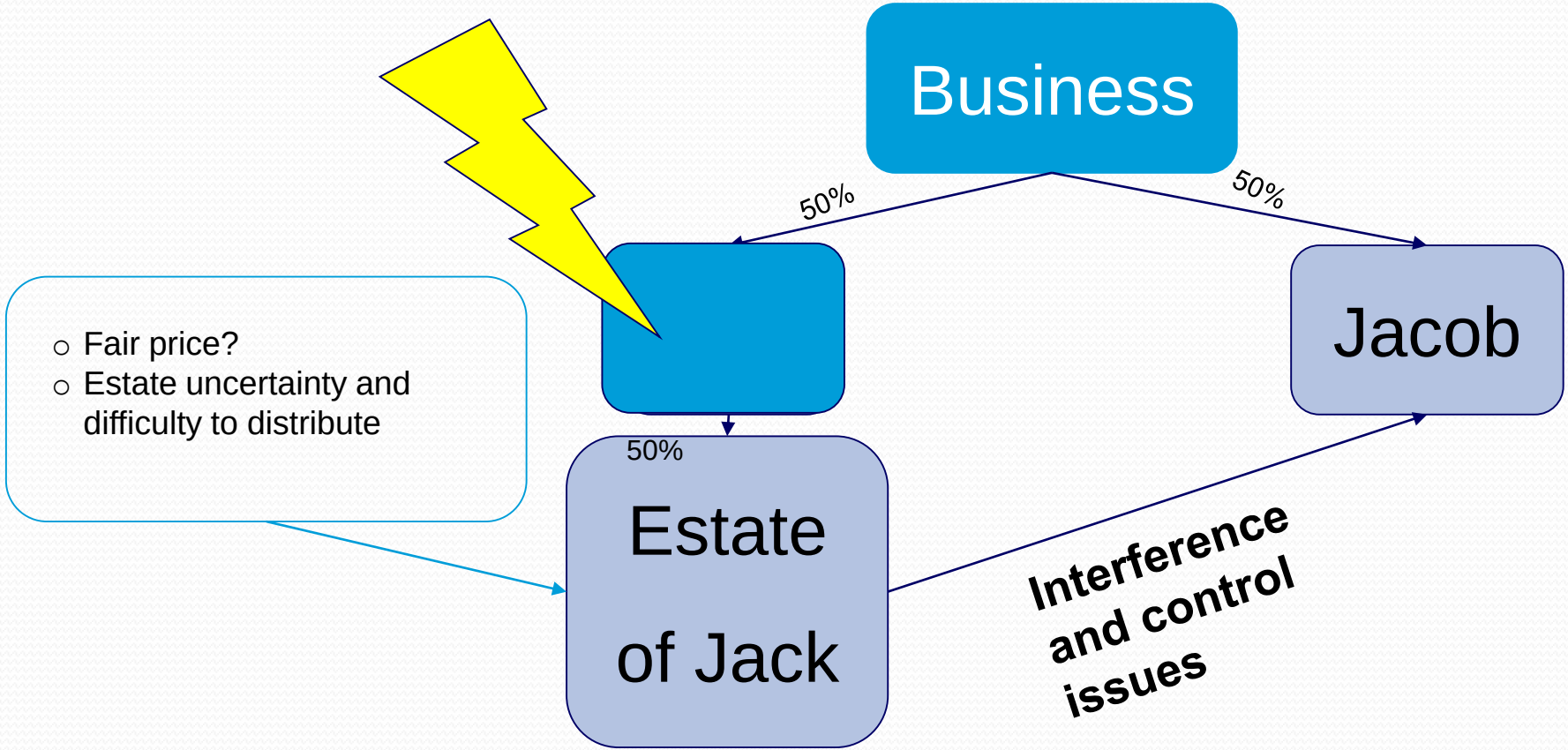
Business Exp





Business Succession Planning

Scenario - No planning, no business succession



Advice solution

Voluntary Exit

- Retirement
- Looking for a change
- Circumstantial

Forced exit

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Involuntary exit

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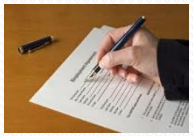
EXIT AGREEMENT

FUNDING?

What does it achieve?

Business succession solutions and funding

Funding the buyout of a deceased or disabled partner or shareholder's equity in the most cost-effective and certain manner



- The transfer of the shares is handled through a separate legal agreement with some trigger events that coincide with insurable events. These agreements are drawn up by solicitors and can include involuntary, voluntary and forced exists

- Certainty for *departing owner* around fair compensation for lifetime of effort:
  - realisation of their equity in a timely manner for a pre-agreed price (avoids unreal expectations, delays and loss in equity value whilst providing a capital guarantee)
  - avoids spouse/family member to have to participate in a business they know nothing about

- *Remaining shareholders* retain control of their business and avoid having to:
  - accommodate their business partner's spouse/family member as a decision maker & business partner
  - the estate selling out to a competitor or another business partner
  - increase their personal or business' debt levels to fund a buy-out

- It is much cheaper than funding the buy-out through borrowings (even if it is possible to obtain bank funding at such a crucial stage considering the business has just lost one of its key people)

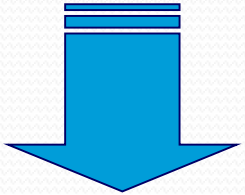
Customer's (less attractive) alternate strategies to insurance

Strategy	Details	Attractive/ Certain?
Fund via borrowings	• Ability to obtain funding after loss of keyperson or owner in severe doubt • Increased exposure of personal and business assets via additional guarantees and security • Significant cost of debt & certain strain on cashflow vs low cost of insurance hedging strategies • Reduced or eliminated capacity to access further borrowings to fund future business growth and expansion	
Sell business or personal assets to raise funds	• Business assets used to generate revenue and surplus assets doesn't exist • Personal assets already used as security or encumbered by guarantees so sale not possible • Lifestyle impacts of selling unencumbered personal assets not attractive	
Sell equity in the business	• Finding a purchaser at short notice extremely difficult or inviting a competitor to buy in or take over not desirable • Dilution of value of the business due to loss of key person or owner (valuations based on future revenue) dilutes ability to raise funds through sale • Sale of equity is a lengthy process and often dependant on vendor finance	

BUY/SELL & EXIT AGREEMENT

Voluntary *and* Forced *and Involuntary* Exits

PRE-NUP & WILL FOR BUSINESS



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- Involuntary – agreed values or formula

Agreement preparation - considerations

- Products without agreement is not a solution and could cause major problems
  - Succession compromised
  - Double dipping
  - Tax consequences

- Specialists vs Generalists (turnaround)
  - Client's lawyer vs experienced specialists
  - Fixed fee vs time-based
  - Future amendments

- Ownership & tax considerations
  - Products vs purposes (no cross-ownership!!)
  - Complex business structures – tailored tax outcomes
  - Insurance trust

Valuation considerations

- Sources of valuation
  - Independant valuer (eg accountant)
  - Directors' valuation
  - Recent purchase or buy-in
- Valuation methodologies
  - Balance sheet valuation
  - Discounted cashflow
  - Rules of thumb
  - Maintainable earnings
- Historical results vs Future forecasts?
- In the absence of a valuation?

How much? Valuation methodology

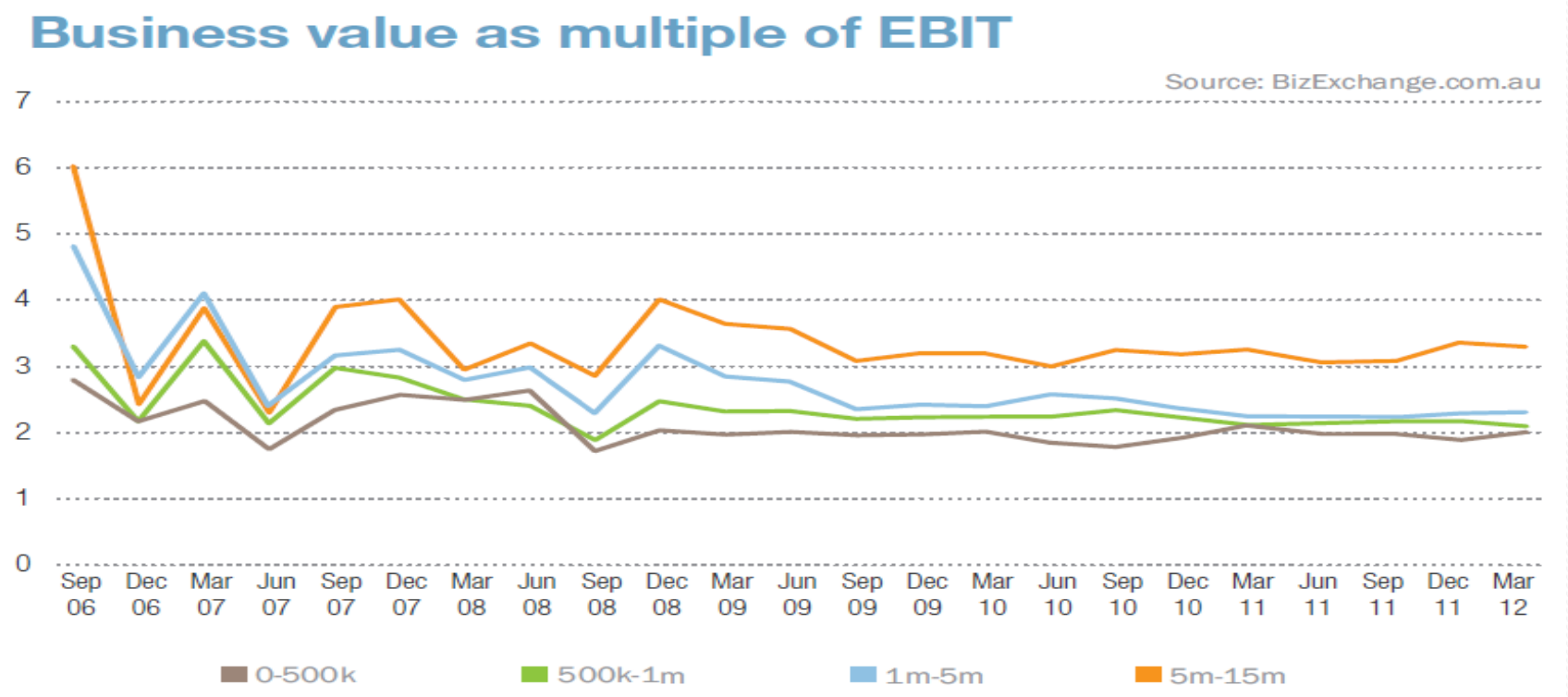
BUY/SELL COVER (IF MORE THAN 1 OWNER)

	Maintainable earnings (EBIT/EBITDA)	
Multipled by	Multiple of earnings (Investor Risk vs Return)	
Multiplied by	Applicant's % share ownership	
Plus	Gross-up for CGT @ 25%	0
Equals	**Total Buy/Sell Cover**	**$ -**

Suggested multiples of earnings

Small Business (Gross turnover <$1M) - approx 1 to 3 times
Medium Business (Gross turnover $1M to $5M) - approx 2 to 5 times
Large Business (Gross turnover >$5M) - approx 4 to 7 times

Some market research around EBIT multiples



Top questions – business succession

- What is the value of your business today? Assuming a willing buyer willing seller - how much would you want?
- Could your business continue in the event of your death and total and permanent disability? How much would it be worth if you weren't able to return?
- Is there currently a strategy or plan in place to maximise the value of your business and achieve a successful exit? What actions are needed to get the business ready for a sale?
- Has the equity of any of the business owners been willed to a family member or someone else?

Essential components of succession planning

Business succession solutions and funding

Business will or pre-nup

Funding the buyout of a deceased or disabled partner or shareholder's equity in the most cost-effective and certain manner

Business debt (& asset) protection

Facilitates the release of personal guarantees over business debts ensuring the business owner's personal estate and assets are not impaired or exposed

Key person protection (human capital)

Mitigates the impact of a business owner or key employee's long-term absence on the productivity & profitability of the business thereby protection the goodwill and underlying business value

The business lending "security stairway"

Personal g'tees taken

Personal assets secured and/or shareholder loans subordinated

~76%

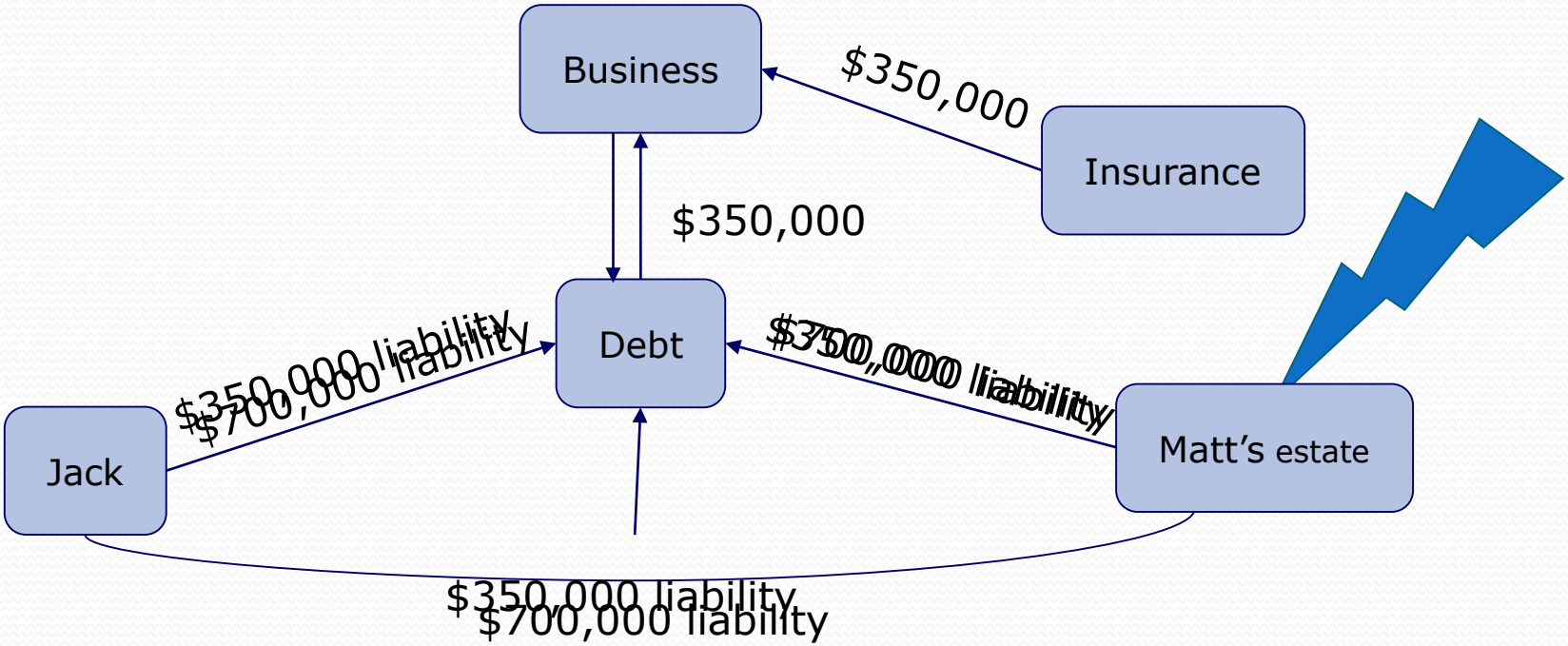
Business assets secured

Loan agreement trigger events

~ 100%

Debt cancellation – personal guarantees & joint & several liability

To create more certainty, insure full debt rather than owner's share of the debt



Why insuring the debt is important for our business customers

Business debt (& asset) protection

Facilitates the release of personal guarantees over business debts ensuring the business owner's personal estate and assets are not impaired or exposed

- Personal guarantees do not die with the individual but is automatically transferred to their estate in the event of their death. Until the guarantees are released, the deceased's estate cannot be finalised, and hence surviving family members cannot access their inheritance including the family home

- Often banks protect business lending by taking security over the personal assets of the owners. Ordinarily, security will only be surrendered once the entire debt is repaid, leaving the personal assets exposed

- It is common for business lending agreements to state that the death or long-term disability of a key person in the business (including owners and guarantors) will be a trigger for the refinance or repayment of the entire loan

- Often the buy-out value of the equity in an involuntary exit or succession agreement is negotiated on the value of the business without debt. Therefore, ensuring that the debt is repaid supports the buy-out value of the equity

Top questions – debt protection

- Have any of the owners, directors or their spouses provided personal guarantees over the Business' bank debt(s)?
- Have any of the owners, directors or their spouses used their personal assets or wealth to provide security over the Business' bank loan(s) or lease liabilities?
- Is the death or disability of any of the owners, directors, their spouses or any key employees a condition of default or refinancing under the bank lending agreement(s) or lease liabilities?
- Is there an expectation that the shareholders and directors' loans are to be repaid in the event they exit the business?

Key person capital (debt protection) – Taxation considerations

Cover	Fringe benefits tax on premium	Premium deductible	Taxed as ordinary income	Capital gains tax
Life	No	No	No	No, unless recipient was not original beneficial owner and gave consideration for the policy transfer.
TPD	No	No	No	Yes, if proceeds paid to someone other than the life insured or their relative[1].
Trauma	No	No	No	Yes, if proceeds paid to someone other than the life insured or their relative[1].

1. Relative includes (a) spouse (b) parent, grandparent, brother, sister, uncle, aunt, nephew, niece, lineal descendant or adopted child (c) spouse of b.

Tax planning

- Document purpose in minutes/file notes
- ATO view
  - Sole trader cannot insure themselves as key person revenue
  - Can have other employees as key person revenue
- 1 or 2 policies?
- Review cover amount and purpose regularly

Other considerations – Key person protection

Key person protection (human capital)

Mitigates the impact of a business owner or key employee's long-term absence on the productivity & profitability of the business thereby protection the goodwill and underlying business value

- Mitigates business interruption in relation to loss of human capital. Key relationships could suffer, revenue and profitability could plummet and the business cashflows may become strained, making it difficult to meet operational, debt and creditor commitments, leaving the business vulnerable to administration and bankruptcy
- In addition to some key employees, most business owners are key people and their sudden departure will surely impact on the bottom line. Further to the revenue impacts the business will have to entice, recruit, train and pay a suitable replacement(s), adding to the strain on cashflow and bottom line
- Maintains business value for remaining owners. Valuations of businesses operating as "going concerns" are mostly based on a multiple of the ongoing profits the business is predicted to generate in future. This cover indirectly protects the equity of the remaining business owner(s) by replacing lost revenue and funding the additional costs of obtaining a replacement if necessary. This keeps the bottom line, and hence the valuation & goodwill of the business, intact

Key points – keyperson revenue protection

- When and who?
  - Multiple owner businesses
  - Single owner businesses
- Eventual impact? For WHO's benefit is this?
- Assessment
  - Profits – revenue & expenses
  - Goodwill - multiplier
- Grossing up for income tax on claim proceeds?

Key person revenue – Taxation considerations

Cover	Fringe benefits tax on premium	Premium deductible	Taxed as ordinary income
Life	No	Yes	Yes
TPD	No	Yes	Yes
Trauma	No	Yes	Yes

Top questions – keyperson revenue protection

- What separates you from your competitors?
- When was the last time you went on holiday and for how long?
- Are there any employees whose death would impact on the profitability or continuity of the company? What about you – you are an employee too?

General tips and reminders

Business succession solutions

- Insure each equity owner for their share of the business value before debt
- Business owner is entitled to have any reasonable amount
- Business value can be gauged using maintainable earnings (EBIT) x multiplier
- Include CGT for tax-free realisation of equity benefit
- Ensure solicitor is engaged to draw up legal agreement
- Remember succession strategy is also available to sole owners

Business debt (& asset) protection

- Insure 100% of debts if personal assets used as security or personal guarantees have been provided
- If customer operating as a partnership also insure 100% due to joint & several liability
- Include overdrafts, business loans/lines of credit, bank bills/bonds, debtor financing and hire purchase/ equipment finance
- Crucial to address shareholder and directors' loans

Keyperson protection (human capital)

- Smaller businesses more vulnerable as not many revenue generators and goodwill really tied up with business owners
- Attempt to measure impact on bottom line over say 2 years assuming strategy includes making cashflow available to replace keyperson asap
- Cost of replacing keyperson + impact on turnover / gross profit