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Agency Value -- Fundamentals You Need To Know

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Growth by acquisition can be a very valuable tool but only when part of an effective strategic marketing plan. An agency must first be able to grow internally. An owner that feels they need to acquire a book of business in order to grow usually has much more serious problems. Lack of internal growth usually means producers are not producing or CSR workloads are not appropriate or a sales and marketing plan does not exist. An agency that cannot grow internally is not as valuable to an outside buyer. Since many agencies today are using acquisition as a major growth strategy, you need to understand valuation for that transaction.

When your agency is at either end of a merger or acquisition the issue of agency value is a poignant one. If you are already in the middle of the deal it is probably too late to worry about agency value. The time to take action is well before any move toward a merger or acquisition or even implementation of an internal buy-out.

Today, too many deals are still occurring in which the buyer is paying too high a price in too short a period ***and*** has not properly analyzed whether the purchase is good for the agency. Buyers may feel that the purchase is too small to warrant a professional valuation without even getting a quote. Regardless, this should not preclude them from performing their own valuation. Perhaps the most common error made during these "self-made" deals is to set the purchase price as a multiple of revenue.

Multiple of Revenues

The multiple of revenue approach for valuing a business is outmoded and is not recommended by most professional consultants. This method survives by word of mouth and misunderstanding. Multiples published in trade journals or consultants' newsletters after a sale is a reference used to communicate the purchase price but does not detail the actual approach to the establishment of that price.

Even though some transactions still occur today using the multiple of revenue approach, it is being done out of ignorance of more accurate methods. Paying 1.5X - 2X revenues will save you time but will cost you money.

When a valuation uses a multiple of revenue it ignores variation in profitability and risk. Two firms with the same revenue may vary significantly in both the risk that profit will be sustained, as well as in the actual profit margin. An astute buyer would not pay the same revenue multiple for both firms.

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Fair Market Value

A professional consultant appraises an agency based on its fair market value. Fair market value is defined in IRS Revenue Ruling 59-60 as "the price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts."

Fair Market Valuation is dependent on three major factors:

- **Sustainable Earnings Capacity** -- the value of the firm's earning capacity, the profit the firm should be able to generate for a third party.
- **Inherent Risk** -- the value of the firm's earning stream must be tempered by the risk that the earning capacity will not be maintained over time.
- **Tangible Net Worth** -- the value of the firm's balance sheet after assets have been turned into cash and all liabilities have been satisfied.

Reported pre-tax profit is **not** the firm's sustainable earning capacity. To properly calculate, the appraiser will make pro forma adjustments to the most current actual financial statements. Pro forma (Latin for "as a matter of fact") refers to a presentation of data, such as a balance sheet or income statement, where certain amounts are hypothetical. Pro forma adjustments for a valuation are made by the appraiser in order to show the true earning potential of an agency that a third party could expect to generate. Line item adjustments are intended to remove the effects on the profit of an agency due to ownership, write-offs, one time expenses, etc. Pro forma adjustments include:

1. Discretionary income and perks to owners
2. Removal of non-recurring income and expense items
3. Non-operational business expenses
4. Items that have not been reflected

The valuation methods are then based off this pro forma pre-tax profit which tends to be in the 10-25% range today. When performing a valuation a professional appraiser will use more than one method and are at the discretion of the consultant. By using several methods the consultant is able to "box-in" the value with a high degree of confidence. The most common methods used include:

1. Capitalization of Earnings Method

Capitalization of earnings establishes the price a buyer could pay in order to yield a specific required rate of return on investment. This method of determining value is widely used in the financial industry. It is also widely utilized by knowledgeable buyers and sellers of independent insurance agencies.

The methodology first determines a risk free rate, which are ordinarily U.S. Treasury bonds of 20 to 30 years maturity. A separate risk premium rate, based on the inherent risk of the agency, is then added to the risk free rate to determine the total rate of return a buyer would require if he/she invested in the agency. The additional return required is usually in the range of 5% to 15%. The greater the perceived risk in an investment, the higher should be its return.

2. Price/Earnings Multiple Method

This method is most often used by major public corporations when making an acquisition or merging with another firm. Publicly traded insurance brokers have historically utilized this method in acquiring other agencies.

As a multiple of pretax earnings, the P/E multiple has averaged 5.0 to 9.0. The P/E multiple, however, is usually discounted before applying it to a prospective seller's earnings because the buyer does not want to dilute their own earnings and the potential seller typically carriers a higher level of risk. Most insurance agencies are valued somewhere between 4.0 and 7.0 times their pretax earnings.

The method determines the value of the firm by multiplying sustainable pretax income by an adjusted price/earnings ratio of publicly held insurance brokers. This price/earnings ratio has been adjusted to reflect the comparative attractiveness and risk of the firm being valued.

3. Discounted Future Earnings Method

This method determines the value of the firm by calculating the present, discounted value of the firm's future earnings stream. The earnings stream for the next five years is projected based on estimates of future revenue growth and increases in expenses for personnel, business development and operating expenses. The resulting earnings are discounted to present value using an appropriate discount rate.

This method can be difficult to use because it is hard to project the future. There are so many variables that can affect a firm's revenues, expenses and resulting profitability or sustainable earnings. The method has the potential to overstate value. This method, which allows for growth, is especially effective for determining value in cases where the current level of sustainable income is not entirely reflective of the potential profitability of the firm.

In each of the valuation methods, value is adjusted to take into account the amount of working capital necessary to produce the income stream. An investor buying only a book of business typically contributes working capital of 30 to 60 days (45 is average) of cash to generate the income stream. The amount varies based on the collection practices of the agency.

Final Value

The appraiser calculates the firm's value using these valuation methods and factors in the evaluation of risk in the firm by adjusting the multiple or rate of return. The appraiser will determine the risk by reviewing the book of business, interviewing the producers, assessing the overall business climate and investigating several other factors, including compatibility of the parties or the books.

The typical sale price today is 0.8 to 1.25 times revenue if it was paid for in cash today. If terms other than cash are used it will affect the value of the agency. Many owners ignore this when discussing value received, thereby adding to the myth of owners receiving prices in the 1.5X to 2.0X of revenue range. Present value needs to be calculated on future payments received. Astute buyers often base terms on retention of revenues and may pay a slightly higher value for lowering their risk.

The goal should be to pay the seller by using the profit created by the agency or book being purchased. If the acquisition generates a 20% profit margin you will need five years before you will realize any profit for yourself, assuming you pay only one times revenues. If you pay two times revenues it would take ten years before you realize a profit. This assumes the firm can generate a 20% profit margin before excess compensation to owners. Today many agencies or books generate profit margins of only 10-18%!

Whether you want to evaluate an agency for purchase or you wish to increase your own agency's value be aware of several fundamental valuation factors:

- The efficiency of systems, procedures and staff
- "Retain-ability" of key employees and key accounts
- Fair and equitable compensation plans for owners and producers
- Performance standards and ratios in line with industry standards
- Good loss ratios and market relations
- Desirability of medium-to-large commercial accounts versus other lines

Conclusion

The most important action you can take to improve your agency's value is to commit to base all decisions based on their effect on your agency's value. Operate as though you need to justify those decisions to a third party. By following the advice in this article you will position yourself today to sell at an above average fair price tomorrow. Remember that everyone must sell someday, either internally or externally.

About the Authors:

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