

DETERMINING AGENCY VALUE—PART 5

VALUATION METHODOLOGY (continued)

By: Chuck Coyne, ASA

This month we continue our discussion of how to determine an agency's value. Last month we discussed many of the typical inherent risk factors associated with a property-casualty agency. This month, we will briefly review two of the more commonly used valuation methodologies in determining an agency's fair market value. We will also discuss a simple multiple of pretax cash flow method to determine an agency value which will serve as a more accurate rule of thumb than the old *times commission multiple* method commonly misused by agency owners and some advisors. Next month, we will conclude this series on agency valuation with a discussion of adjustments to the balance sheet and the determination of an agency's tangible net worth. This will provide a completed example valuation for our fictitious agency ACE INSURANCE AGENCY, INC.

Commonly Used Agency Valuation Methods

We will briefly describe two of the more commonly used valuation methods. There are generally three basic approaches and varying different methods to valuing any business. These would include the following;

1. Income Based Approaches

- Capitalized Earnings Method
- Discounted Future Earnings Method

2. Market Based Approaches

- Sales Transaction Method (merger/acquisition transactions)
- Guideline (Comparative) Public Company Method

3. Underlying Asset Approaches

- Adjusted Net Asset Value Method
- Liquidation Value Method

The underlying asset approaches are special methods which usually have little or no use in determining the fair market value of a going concern service business, such as a property-casualty agency. Asset based approaches are most appropriate when valuing a business with a substantial amount of tangible assets, such as a holding company. An agency's most significant asset is its book of business, which is intangible in nature, and most appropriately valued using an income approach. Therefore, we will not discuss the asset approach.

The other two approaches, the income approach and the market approach, are the most commonly used and most appropriate methodology for valuing an agency.

Market Based Approaches

The market approaches are often used in valuing mid-size to larger agencies or when the purpose for the valuation is for a tax related matter, such as estate or gift tax matters or for Employee Stock Ownership Plans (ESOPs). These tax related matters require an independent valuation performed under the guide of the IRS Revenue Ruling 59-60. Ruling 59-60 states that the use of publicly traded companies in the same or similar businesses should be considered in the determination of fair market value of closely-held business interest when possible.

Performing a valuation using a market approach involves the selection of several publicly traded insurance brokers. The price per share, as determined on the stock exchange for the valuation date, is compared to one of many different earnings streams. For example, a comparison is the ratio of price per share to after-tax earnings per share commonly known as the P/E ratio, or the ratio of price per share to pretax cash flow or EBITDA (earnings before interest, taxes, depreciation & amortization) per share as another alternative. TABLE 1, shows the calculation of Enterprise Value to Revenues and EBITDA for a group of four publicly traded brokers. Enterprise Value (also referred to as Total Invested Capital of "TIC") is calculated by adding the total equity value (total common shares issued & outstanding multiplied by the per share price) with the total outstanding debt and value of any preferred stock as of the valuation date (here we used

June 30, 2004). The multiples are calculated as of the latest twelve months ended June 30, 2004 (the “LTM”) and for the estimated year-ending December 31, 2004 (estimates are from industry analysts). The median multiple of EBITDA for the LTM is 11.2 times, and 9.37 times for the estimated year-ending 2004. The median multiple of Revenue for the LTM is 2.6 times, and 2.3 times for the estimated year-ending 2004.

The main objective of using one of these market derived valuation ratios is to determine what the investors in the public market are requiring as a return for their investment in these insurance brokerages. The multiples of market price are useful to the appraiser as a barometer of the required rate of return for an investment in an insurance agency. There is some amount of subjectivity and adjustments required to use this method when valuing a much smaller privately-held agency.

As you can imagine, the publicly traded brokers are all much larger in terms of revenues, more diversified in types of products and services sold, geographically better diversified, have access to more capital, and have higher quality and depth in terms of overall management talent. It would be unrealistic for an investor to anticipate the same rate of return for a small privately-held agency as earned by these publicly traded brokers. Use of this valuation method requires substantial adjustments, and is best left to an experienced appraiser.

To illustrate, typical adjustments (discounts) to the publicly traded EBITDA multiples range from 30% to 50% for use in valuing a privately-held agency. Applying the June 30, 2004 median EBITDA multiple of 11.2 times, will result in a range of multiples, after discounting of between 5.6 to 7.8 times EBITDA.

Income Based Approaches

Use of an income based approach to value an agency is the most commonly used and often the most appropriate of the valuation methods available. We defined the value of a business as the present value of the future returns (i.e. earnings, cash flow, etc.) anticipated by a buyer. The income method of valuation converts an economic earnings

base, such as net cash flow or net after-tax earnings, into an indication of value, with the application of an appropriate rate of return (known as the discount rate or capitalization rate).

There are two basic methodologies using the income approach to valuation; the discounted future earnings method, and the capitalization of earnings method. The discounted future earnings method develops a multiple year forecast for the agency being valued which represents the anticipated results from future operations. The annual forecasted earnings are discounted to a present value using an appropriate discount rate (rate of return) to compensate the buyer for the inherent risks associated with the particular agency.

The capitalization of earnings method uses a single period earnings stream (i.e. net cash flow, net earnings, etc.) and divides it by an appropriate capitalization rate (rate of return) into an indication of value.

The main difference between the discounted future earnings method and the capitalization of earnings method is the rate of return used in the calculations. The discounted future earnings method uses a discount rate to capture the present value of the forecasted future earnings stream. Annual growth for the agency being valued is contained within each year of the multiple year forecast. The capitalization of earnings method uses a capitalization rate to calculate the present worth of the particular investment given the risks. The capitalization rate is the discount rate minus a growth rate, which represents the long-term (20 to 30 years or more) average annual anticipated growth for the particular investment.

It is very important for the appraiser to select an appropriate rate of return (discount rate or capitalization rate) which matches the economic returns being valued. For example, if the base is a normalized pretax cash flow then you must apply returns developed from pretax cash flow type investments. If an incorrect rate of return is used with a particular earnings stream it will cause flaws in the resulting value.

We could spend many more hours exploring this subject alone, however, keeping with our goal of providing a fairly simple and yet accurate method of estimating an agency's value we will not go into great length on the many ways to develop realistic rates of returns for use with the income approaches.

Developing A Range of Pretax Cash Flow (EBITDA) Valuation Multiples

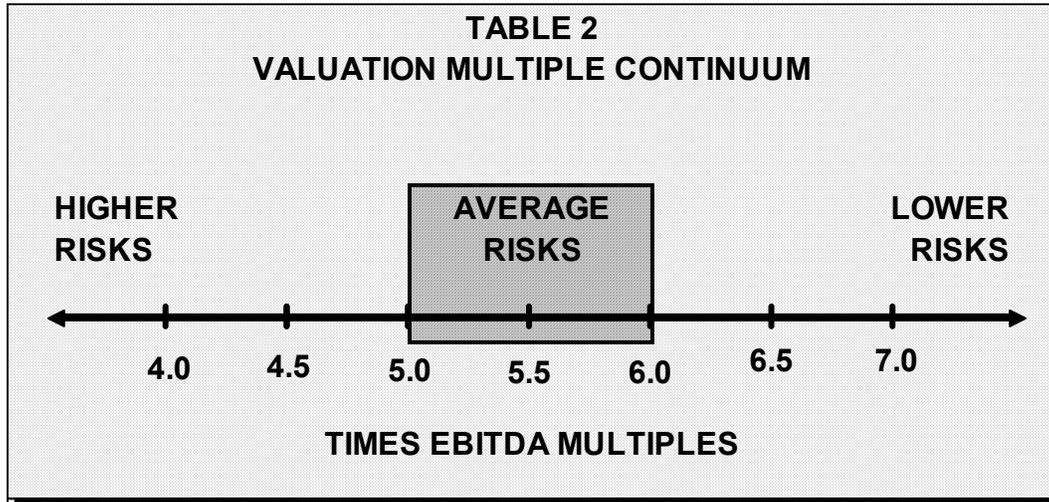
The main valuation premise behind the various market and income approaches to valuation is to estimate the economic value of an investment given the specific risk factors, and rate of return expectations associated with that investment. In the market approach, we use actual rates of return received by investors of publicly traded insurance brokers as a basis for developing an appropriate rate of return for an agency. In the income approaches, we develop discount rates or capitalization rates using information on alternative investments as a basis for developing an appropriate rate of return for a particular agency. It is very important for the appraiser to use the correct rate of return for the earnings stream being utilized in the appraisal.

A fairly reliable range of EBITDA multiples can be used to develop the value of a property-casualty agency. Applicable EBITDA multiples range from 4 times EBITDA on the low side, to 7 times EBITDA on the high side. That is, the value of most property-casualty agencies will fall within this 4 to 7 times EBITDA multiple range. The vast majority of "average-risk" agencies will generally value within a range of 5 to 6 times EBITDA.

When using this multiple of EBITDA valuation method it is extremely important to first develop a realistic normalized EBITDA figure that fairly represents the future earnings capacity of the agency to be valued. The second critical variable in using this method is to select the appropriate risk-based EBITDA multiple for the agency to be valued. Agencies with a higher than average levels of inherent risk, will tend to fall below a 5.0 times EBITDA multiple. Agencies with a lower than average levels of inherent risk, will

tend to value above a 6.0 times EBITDA multiple. Generally, there are very few agencies that value at the extremes of 4 or 7 times EBITDA.

Table 2 provides a graphical representation of this continuum of agency value multiples.



Determining what EBITDA multiple is appropriate for a particular agency is one of the most difficult and most subjective segments of the valuation. Last month, we discussed some of the main agency risk factors that affect value. The risk analysis requires an extensive review of the past financial and operating results and trends of the agency.

SAMPLE VALUATION CALCULATION

In Part 3 of this series of articles we developed a normalized earnings statement for a fictitious agency. The normalized EBITDA for our ACE INSURANCE AGENCY, INC. (“ACE”) is \$185,000 (rounded) as of the valuation date. Let’s assume ACE has an average level of risk after our review of its financial and operating trends. We decide that a range of 5.0 to 6.0 times EBITDA multiples is an appropriate for valuing ACE.

This results in a range of total invested capital (“TIC”) in ACE of between \$925,000 to \$1,110,000, as shown below:

Normalized EBITDA	\$ 185,000	\$ 185,000
Times EBITDA Multiple	5.0	6.0
Total Invested Capital ("TIC")	\$ 925,000	\$1,110,000

The total invested capital or TIC represents the value of all capital providers to the agency, both equity owners as well as debt providers. If we take the resulting range of TIC values for ACE and divide them by the normalized net revenues (\$802,182), we get a more accurate range of *times revenues multiples* of between 1.2 to 1.4 times.

The EBITDA multiple method results in a more accurate valuation of an agency because it takes both profitability and return on risk into consideration. Using the old rule of thumb 1.5 or 2.0 *times revenue* or *times commission* approach can be very misleading and does not consider the actual profitability of the agency.

Our EBITDA earnings calculation removes interest expense which is the annual cost of using debt financing in the operation. Therefore, to determine the equity value of the agency we need to subtract the value of any existing debt capital from TIC. If we are valuing the entire corporation we will also need to review the corporation’s balance sheet on the date of the valuation for adequate levels of working capital and tangible net worth. This will be the subject of next month’s column and is the final step in the valuation process.

Chuck Coyne, ASA is Regional Director, for Empire Valuation Consultants, LLC. The Firm has offices in West Hartford, CT, Manhattan, N.Y., Rochester, N.Y., and Atlanta, GA. Empire provides fair market valuations, perpetuation planning, ESOP and merger/acquisition consulting services. Chuck can be reached at (860) 233-6552 or e-mail at ccoyn@empireval.com.

**TABLE 1 - Publicly Traded Insurance Brokers
Market Multiples Analysis as of June 30, 2004**

Company	Ticker	Stock Price 06/30/04	Equity Value ⁽¹⁾	Enterprise Value ⁽²⁾
Brown & Brown, Inc.	BRO	\$ 43.10	\$ 2,982.8	\$ 3,042.6
Gallagher (Arthur J.) & Co.	AJG	30.45	2,860.9	3,013.9
Hilb, Rogal & Hobbs, Co.	HRH	35.68	1,296.5	1,479.8
Hub International Ltd	HBG	19.09	654.0	732.8

(1) Equity Value = Stock Price x shares issued/outstanding shares as of 06/30/04

(2) Enterprise Value = Equity Value + Total Debt + Preferred Stock

Valuation Multiples

Company	Ticker	Enterprise Value as a Multiple of:			
		Revenues		EBITDA	
		LTM	2004E	LTM	2004E
Brown & Brown, Inc.	BRO	5.52 x	4.99 x	14.62 x	12.71 x
Gallagher (Arthur J.) & Co.	AJG	2.38	2.07	12.43	10.09
Hilb, Rogal & Hobbs, Co.	HRH	2.63	2.32	9.06	7.85
Hub International Ltd	HBG	2.56	2.30	9.98	8.64
	High	5.52	4.99	14.62	12.71
	Average	3.27	2.92	11.52	9.82
	Median	2.60	2.31	11.21	9.37
	Low	2.38	2.07	9.06	7.85