DETERMINING AGENCY VALUE—PART 1

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This will be the first article in a multiple article series that I will be writing for the PIA magazine. This series of articles will be an update to a series of articles on the same subject I penned for this same magazine back in 1995. Since that time just think of how the world around us has changed. This updated series will incorporate some of the many changes in the underlying landscape of valuing an independent property and casualty insurance agency. I will also expand the series in order to incorporate more of the quantitative and qualitative issues that go into determining the value of an agency in today's environment.

What Is An Agency Worth?

In its simplest terms, an agency, or any other closely held business for that matter, is worth what someone is willing to pay for it. This of course means what a knowledgeable third-party buyer in an arms-length transaction would pay for it. The Internal Revenue Service for tax purposes considers the definition of fair market value to be *"The price at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of the relevant facts."* While we will be concentrating on determining the fair market value of an agency in this series, there are other valuation standards that could be applied depending on the circumstances. There are examples when a specific buyer may be willing to pay more for a particular agency based on unique qualitative and/or quantitative criteria that is available to that specific buyer. For example, during the past few years banks and other financial institutions have entered the insurance market and have acquired many local agencies. While establishing their base operation in this new and unfamiliar territory, many of these banks have been willing to pay handsome premiums above the price a typical financial buyer would be able to justify for the same agency. These often called "foundation agency's" are worth more to this particular buyer as a way to enter the market with talented and experienced agency professionals, an existing customer base ripe for potential cross referrals, and immediate clout with the insurance carriers. How much more will a specific "strategic buyer" pay for an agency is a difficult question to answer and one that is very much unique to the particular facts involved. We will not be addressing these types of strategic valuation issues in this series but instead we will address the more common financial buyer's valuation issues as defined in the fair market value context.

How does a willing buyer or seller determine the fair market value of an agency? Some people advocate using an industry formula such as the old *"1.5 times commission revenue"*. The major draw back to using a multiple of commissions is that the method relies on one factor only—commission volume. It ignores the very critical factors of the agency's operating risks and profitability. Besides, simply stated, a buyer pays for the business out of its future earnings — not its past commission revenues.

The purpose of this series of articles is not to make the reader a valuation expert but rather to provide you with a useable methodology to estimate a range of value more accurately than using a multiple of commission revenue approach. It will also allow you to better understand what key factors are important in determining the value of an agency. Identifying the "value drivers" of your Agency will help you understand how to increase your Agency's value over time. This should be your ultimate goal as an owner.

Valuation Approaches

There are three basic approaches to determining the value of any closely-held business, including; the Market Approach, Income Approach, and Cost Approach. In the valuation of insurance agencies, professional appraisers and knowledgeable buyers will generally use one or more of these various methods. The income approach would include the use of a capitalization of earnings method and/or a discounted future earnings method. In addition to the income approach many appraisers will use a market approach. The market approach determines an indication of value based on the prices paid by investors in the public market place for shares of publicly traded insurance brokers (i.e. Hilb, Rogal & Hobbs, Brown & Brown, etc.). As stated earlier, my intent is not to make you a valuation expert, but rather to give you a methodology to reasonably estimate the value of an agency when an actual independent appraisal is not required.

Probably the most often used and most practical valuation method applied by knowledgeable buyers and sellers and their advisors is an income approach. The basic premise behind an income approach to value is what is the present value of a stream of future earnings? In order to answer this question, let's summarize the steps we will cover in more depth in the following installments of this series on agency valuation.

Steps In The Valuation Process

To determine the value of an agency using an income approach, we must address the following three basic components of an agency's value;

1. Sustainable Future Earnings Capacity,
2. Operating and Financial Risk,
3. Tangible Net Worth.

Sustainable Earnings Capacity—The value of an agency is directly related to the profitability of its book of business. What would a hypothetical buyer reasonably expect to earn on the acquired agency's book of business after making adjustments for nonoperating and nonrecurring revenues and expenses, or after adjusting for additional expenses that may be required to sustain the purchased book of business.

Operating and Financial Risks—The value of an agency's sustainable earnings generated by its book of business must be adjusted by a risk factor to compensate the hypothetical buyer for the risk that its earnings capacity will change over time. Analysis of an agency's various operating and financial risk factors is necessary to determine how much additional investment return a hypothetical buyer will require to compensate them for the level of risk inherent in the investment. Examples of operating risk factors include high concentration of business in a few accounts, dependence on one or two carriers, the absence of non-compete agreements with producers, political or social accounts, frequent errors and omissions suits, and so on. Examples of financial risk factors include high levels of financial leverage (debt), lower than required working capital, poor accounts receivable collection, volatile earnings history, low productivity ratios, and so on.

Overall, the value of an agency is directly related to the level of profits it can generate in the future and the risk future profits will decline. Therefore, it is vitally important to assess the agency's capacity to sustain earnings.

Tangible Net Worth—This is the value of the agency's assets less liabilities on the date of the valuation. The fair market value of the agency's tangible assets, after adjustment for non-realizable assets (e.g. overdue receivables), are subtracted from any intangible assets (e.g. goodwill, purchased expirations, covenants, etc.) and all its liabilities. Basically, the analysis of the value of an agency's tangible net worth reflects the level of working capital and other tangible assets available to meet the agency's outstanding liabilities (e.g. outstanding debt, payables to the carriers, etc.).

Next month we will discuss the steps involved in determining an agency's pro forma earnings. This will require adjusting an agency's earnings stream for nonrecurring and nonoperating revenues and expenses. The resulting pro forma or "normalized" earnings will provide us with the basis for understanding the agency's future sustainable earnings stream.

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