DETERMINING AGENCY VALUE—PART 2

NORMALIZING THE INCOME STATEMENT

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This month we continue our discussion of how to determine an agency's value. Last month we briefly discussed some of the basics of agency valuation. We stated that regardless of what methodology you use to value an agency there are essentially three components which should be considered;

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

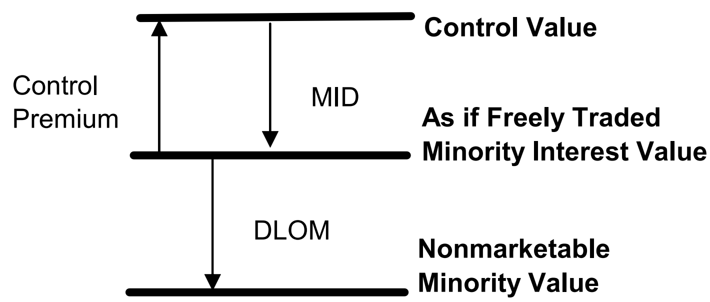
In this month's column we will begin our discussion of how to prepare a "normalized" income statement which we will use in our determination of the sustainable earnings capacity for a typical property and casualty insurance agency.

However, before we get too far into the adjustments that are typical in preparing a normalized income statement, we should first discuss the theory behind making these adjustments and the resulting level of value that we obtain from this analysis.

Levels of Value

There are certain levels of value that apply to the determination of the fair market value of a privately owned business or business interest. In this series of articles are primary objective is to provide the reader with a fundamental understanding of how to properly determine the fair market value of a 100% controlling interest in a typical property and casualty insurance agency. There are generally three levels of fair market value associated with the valuation of a privately held business recognized in the valuation community. These three levels of fair market value are commonly referred to as; the Control Value, the As if Freely Traded Minority Interest Value, and the Nonmarketable, Minority Interest Value. To illustrate the concept graphically, the following table shows the three primary levels of value.

Basic Levels of Fair Market Value



MID = Minority Interest Discount for Lack of Control
DLOM = Discount for Lack of Marketability

If you start with the center horizontal line in the table, you see that this is represents the marketable minority interest value. The term “marketable” (also referred to “As if Freely Traded”) here implies the ability to sell the interest in an open and active securities market such as one of the stock exchanges (NYSE, NASDAQ, etc.). This level of value would represent the value of a publicly traded security such as one of the national insurance broker’s stock (i.e. Hilb, Rogal & Hobbs, Brown & Brown, etc.). In fact this would be the typical starting valuation point when using the Guideline Publicly Traded Company Method under the Market Approach of valuation as discussed in last months article. To obtain a nonmarketable minority value (represented by the bottom horizontal line in the table), a discount for lack of marketability is applied to the base marketable minority value. This nonmarketable minority value level is often required when determination of a less than controlling interest in required. Minority interest fair market values are often required for many purposes including; estate and gift tax filing, employee stock ownership plans (ESOPs), minority shareholder disputes, marital dissolutions, and sales of minority interests to related or third-party buyers, etc. The above table assumes that the starting value is at the marketable minority value level of value. However, this is not always the case. If the initial analysis produces a control level of value then the base becomes the top horizontal line. To move this control value to the bottom of the table and produce a nonmarketable minority level of value the appraiser would require the application of two discounts. First the application of a minority interest discount (for the lack of control) would be taken to arrive at the marketable minority interest level, and then a lack of marketability discount is applied to arrive at the nonmarketable minority interest value. It should be noted that these discounts are not additive but rather multiplicative. If for example, there was a 20 percent minority interest discount ("MID") and a 30 percent lack of marketability discount ("DLOM"), then the total discount is *not* 20 percent plus 30 percent = 50 percent; but rather would be 44 percent (1-(1-20%) x (1-30%)) = 44%. If the value initially determined is at the center horizontal line representing a marketable minority interest value and a control level of value is required, then the application of a control premium may be necessary. The control premium attempts to quantify the additional value of an interest which enjoys certain control prerogatives not available to a minority interest owner.

A more thorough discussion of each of these discounts and the control premium is beyond the scope of this series of articles. We will concentrate on the control value, as depicted in the top horizontal line of the Levels of Value table. The discussion that follows throughout this series of articles will assume that the level of value we will determine is the fair market value at the 100% controlling interest. This is an important distinction as the adjustments we will consider to the historical income statements of the agency being valued, assumes a certain level of control only available to a potential buyer acquiring this level of control. In other words, a buyer of a less than 100% control ownership interest *may not* have the ability to realize the potential economic benefits assumed by the adjustments that we will make in our analysis.

Determining Sustainable Earnings Capacity

We defined ***sustainable earnings capacity*** as the amount of earnings a hypothetical willing buyer could reasonably expect to earn from an acquired agency after making the appropriate adjustments for nonoperating and nonrecurring revenues and expenses and after consideration of any new expenses that may be required to maintain the earnings into the future.

I would venture an opinion that it is no secret owners of privately-held businesses often run their businesses with tax avoidance foremost in their minds. It is also not unusual to find extraordinary expenditures or one-time sources of revenues present in any given operating period. In order for a potential buyer (either an internal or external buyer) to determine the true earnings capacity of a particular agency, certain *normalization adjustments* should be made. These *normalization adjustments* to the income statement are just what the name implies, each revenue item and each expense item is analyzed to determine if an adjustment is necessary to bring each to a level considered normal to sustain the operation into the future.

The Normalized Income Statement

In this series of articles we will use a hypothetical agency to explain the process of developing a normalized income statement. Next month's installment will include an example of a typical normalized income statement. The following will briefly explain the process of adjusting the income statement.

Actual Base Year

In the valuation of a typical agency using a historical based income approach, one of the most important determinations that must be made is what historical period best represents the sustainable future earnings capacity. Often in the valuation of an agency the current year's income is the best proxy for the following year and future years. However, there are occasions when an agency's current year income is not a good proxy for future income and the analyst will need to consider some form of past historical average income or possibly a projection of future income. Historical average income can be developed and will require basically the same process of normalization adjustments as we will discuss here with the current year's income. Use of 3-year or 5-year historical simple average or weighted average income will sometimes provide a better proxy for the future sustainable earnings capacity of an agency. In this series of articles we will make the assumption that the current year's income is the best proxy for the future income potential to keep things simple.

Determining Normalization Adjustments

We start by reviewing each revenue and expense category and asking the following questions:

1. "Is any portion of this revenue source or expense nonrecurring in nature?"

If the answer is yes, the nonrecurring portion should be removed so the remaining revenue or expenditure reflects only the level which is anticipated to recur in the future. Examples of some typical nonrecurring revenue sources would include; one-time bonuses or overrides from a carrier, commission on a line of business or a particular block of accounts that will be subject to a rate reduction (e.g. a block of business transferred to a carrier service center). Contingent/profit sharing commissions should be averaged over a period of years, typically the past five-years. Examples of some typical nonrecurring expense items would include; elimination of the compensation expenses paid to a terminated employee whose job has been eliminated, legal and accounting expenses associated with litigation or acquisition, or moving expenses.

2. "Are there any revenue sources or expenses that are nonoperating in nature?"

Are there any revenue sources or expenses not directly related to the ongoing business? Examples of some typical nonoperating revenues include; proceeds from sales of furniture or fixtures, automobiles, or rental income from tenants in an agency owned office building. Examples of some nonoperating expense items would include; the reported compensation paid to the owners which is in excess of what a non-owner employee would be paid for the same job tasks, adjusting for a family member's automobile expenses not used in the business, unusually high travel and entertainment expenses not necessary for maintaining the book of business.

3. "Are there any expenses that will change after an acquisition?"

This question is best answered after reviewing each expense category's historical trend. A review of the agency's past five years of income statements can assist you in finding expenses that will most likely occur after a purchase but not reported on the most recent income statement. For example, in your review you may discover that in each prior year a bad debt expense of approximately 2% of net revenue was reported, however, the current year income statement shows no bad debt expense. In your normalized statement you should consider the possibility that future bad debt expenses will be incurred at levels approaching the past historical levels. Another good example of an expense not reported in the current period which may over inflate the most recent year-end profitability is support staff salaries. A savvy agency seller may purposely lower the agency's support staff expense prior to sale by eliminating a position. This elimination may have the effect of decreasing the level of customer service and increasing the chances for future higher account attrition. By reviewing the prior year's level of expenses you can determine the agency's historical level of staffing required to properly service the business and make any necessary adjustments.

Additional Considerations

Agency owners considering an acquisition of another agency are not held to the strict definition of "fair market value" as promulgated by the U.S. Treasury for estate and gift tax purposes. Under the U.S. Treasury's fair market value standard, the value should reflect "the price at which the 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 relevant facts." This definition of fair market value is often thought of as a "financial buyer's" standard of value. Often, existing agencies will buy or merge with another agency. An alternative standard of value often called the "investment value" standard of value is more appropriate for these situations. Under investment value, a buyer may want to consider the additional value which is unique to them and not necessarily available to the typical financial buyer. The value determined will reflect the particular knowledge, expectations, abilities, and synergies of a particular buyer.

It is easy to imagine how an existing agency can look at a target agency's normalization of expenses in a different manner depending on the acquirer's plans. Will the acquisition remain a stand alone operation or will it be merged into an existing operation? Certain synergies that a particular buyer will have can be reflected in the normalization adjustments. An example would be absorbing some of the target's support staff expense with under utilized staffing in the buyer's existing operation. Do you need two receptionists, additional bookkeepers or other redundant administrative positions in a merged operation? These questions should be explored ***carefully*** in order for the prospective buyer to determine realistically what the future normalized expenses will be after the acquisition. A mistake many agency owners will make is to assume too many economies and not properly reflect the true costs associated with servicing the purchased business in the long-term.

Conclusion

The goal of normalizing an income statement is to identify only those revenues that a buyer can reasonably anticipate receiving after an acquisition and those expenses necessary to renew the business and replace attrition.

Next month we will further discuss the adjustments we will make to the normalized income statement of a hypothetical agency. Additionally, we will begin our discussion of the inherent risks of an agency and how a potential buyer should determine the appropriate rate of return for the associated risks.

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