DETERMINING AGENCY VALUE—PART 3

DETERMINING AN AGENCY'S EARNINGS CAPACITY

By: Chuck Coyne, ASA

This month we continue our discussion of how to determine an agency's value. Last month we discussed the "levels of value" concept and how it relates to the valuation of controlling versus minority interests. We also began our discussion of how to determine the sustainable earnings capacity of an agency through the process of normalizing the income statement.

We defined sustainable earnings capacity as the amount of earnings a hypothetical willing buyer could reasonably expect to earn from an acquired agency. This is after making 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.

Purpose of Valuation

As we discussed in previous articles in this series, a valuation prepared under the fair market value standard as defined by the IRS in its Revenue Ruling 59-60, requires the value to be representative of a price negotiated by a hypothetical willing buyer and willing seller as a *stand alone* business entity. Therefore, the fair market value standard does ***not*** presume that any synergy's or economies of scale will be available to the hypothetical buyer. This may not be the case in a purchase by an agency owner who has excess capacity in his existing agency which would allow for a reduction in the expense levels required to service the purchased agency's book of business. In our example, we will *assume* that the purpose for the valuation is to determine the fair market value as defined by the IRS in Revenue Ruling 59-60.

We will use TABLE 1 as an example of a typical income statement to explain the process of developing a normalized earnings stream for valuation purposes.

The Normalized Income Statement

We will briefly explain each adjustment we have made to the most recent year-ending income statement for Ace Insurance Agency, Inc. ("ACE"). We start by reviewing each revenue and expense category and asking the following questions:

1. *"Is there any portion of this revenue source or expense that is nonrecurring in nature?"*
2. *"Are there any revenue sources or expenses that are nonoperating in nature?"*
3. *"Are there any expenses that will change after a hypothetical sale?"*

REVENUE ADJUSTMENTS:

Contingent/Bonus — we have reviewed the historical trend of ACE's contingent income over the last five years and have found that historically, ACE has received contingent payments representing 6.3% of its prior year property and casualty commissions. Our calculation reduced the base year contingent amount by *approximately* $10,000 ($712,637 x 6.3%).

EXPENSES:

Executive Salaries — this adjustment is often the largest and most difficult to make. The resulting normalized compensation should be what a hypothetical owner would anticipate having to pay for non-owner executives with similar backgrounds, knowledge and experience to perform the same tasks as the current agency owners. There are two components of owner compensation that should be analyzed in determining a fair level of compensation:

1. *Sales compensation component*
2. *Management compensation component*

The following represents the normalized executive salary calculation for ACE:

1. Sales Component:		
Commercial lines book handled	$ 256,000	
Normalized commission rate	25%	
Normalized sales salary		**$ 64,000**
2. Management Component:		
Normalized net revenue	$ 800,000	
Management Fee	5.0%	
Normalized management salary		**$ 40,000**
Normalized Total Executive Salary		**$ 104,000**

We calculated the sales component using a 25% commission rate on the book of commercial lines renewals handled by Mr. Ace, the sole owner/executive. We used a 5% management fee to approximate the compensation that would be paid to an executive who handles the executive management tasks performed by Mr. Ace. Typically, the management fee will range from 3% to 8% of net revenue depending on the size of the agency and the tasks performed by the owners/executives. We have adjusted the base year executive salary by $54,376 to bring it to the normalized level of $104,000.

Sales Salaries — we have normalized the sales salaries paid to the agency's producers by reducing the higher level of commissions paid on first year production (new business) and to eliminate the salary paid to a new personal lines producer hired six months into the year. The purpose of our normalized income statement is to reflect the renewable revenues and recurring operating expenses, therefore, only a renewal level of expense should be included in our normalized sales salary. The rationale behind removing the salary paid to a new producer is that it represents a use of profits and not a necessary operating expense. A hypothetical buyer may decide to terminate the new producer with no negative effect on the agency's revenues. The combination of these adjustments brings the normalized sales salaries to approximately $75,000.

Support Salaries — we have not made any adjustment to the reported level of support salaries. However, as previously mentioned, adjustments may be required depending on the staffing levels needed to service the existing renewal business and the purpose for the valuation.

Benefit Expense — we have adjusted the normalized level of employee payroll taxes, group insurance, and retirement benefit expenses to a level that would be representative of what a hypothetical buyer would anticipate having to spend. We looked at the historical benefit expenses paid by ACE over the last five years. The average benefit expense as a percentage of total payroll for the four previous fiscal year-ends was approximately 18%. The most recent year-end benefit expense did not include a profit sharing contribution comparable to those which have been made historically. Agencies typically pay benefit expenses which will range from 15% to 20% of total payroll. We selected a level of 18% for our normalized benefit expense calculation.

Travel & Entertainment/Conventions — we removed expenses paid for the owner's wife and daughter for a trip to Hawaii to attend an industry convention. We also removed the cost of country club dues that, after further examination, had little influence on the owner's ability to sell new business or service existing accounts. These expenses are considered nonoperating in nature.

Automobile — we removed the cost of leasing an automobile for the owner's wife and a second vehicle for the owner. These expenses are considered nonoperating in nature.

Advertising/Promotion — we have removed the cost of a nonrecurring local cable television advertisement and several other nonoperating expenses.

Occupancy — we adjusted the reported rent expense to a fair market rental rate that a hypothetical buyer would anticipate paying. Mr. Ace has historically paid an above market rental rate on the building he owns in a separate partnership.

Dues/Subscriptions/Contributions — we eliminated several contributions made by the agency that, after further investigation, were determined to be nonoperating in nature.

Professional Fees — we reduced this category for nonrecurring professional fees for legal and consulting services associated with an estate and business perpetuation plan prepared for Mr. Ace. The resulting level of expense more closely resembles the historical professional fees incurred by ACE over the last several years and what a hypothetical buyer would anticipate spending.

Officers' Life Insurance — was eliminated as a nonoperating expense. This expenditure is a discretionary use of profits unrelated to earning a profit**.**

The net adjustments to the base year reported total expenses is $154,270 resulting in a normalized total expense of $653,364, which when subtracted from the normalized net revenues of $802,182, produces a *normalized* Earnings Before Taxes (EBT) of **$148,818**.

After adding back any interest, depreciation, and amortization expenses we have normalized pretax cash flow or Earnings Before Interest, Taxes Depreciation/Amortization, ("EBITDA") of **$184,554**.

Conclusion

A potential hypothetical buyer of ACE as a stand alone entity can expect to receive **$184,554** of pretax cash flow or EBITDA after making the appropriate normalization adjustments. Next month we will finish our discussion of how to take a normalized earnings stream and convert it to an indication of fair market value based on a risk adjusted rate of return.

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ACE INSURANCE AGENCY, INC.
NORMALIZED INCOME STATEMENT
FOR THE YEAR ENDED DECEMBER 31, 20XX

TABLE 1

	Actual Base Year	%	Adjustments	Normalized Base Year	%
REVENUES:					
P-C Commercial Lines	$485,889	**59.8**	$0	$485,889	**60.6**
P-C Personal Lines	226,748	**27.9**	0	226,748	**28.3**
Life/Group	23,455	**2.9**	0	23,455	**2.9**
Contingent/Bonus	54,897	**6.8**	(10,000)	44,897	**5.6**
Insurance Fees	9,558	**1.2**	0	9,558	**1.2**
Interest/Investment	11,635	**1.4**	0	11,635	**1.5**
GROSS REVENUES	812,182	**100.0**	(10,000)	802,182	**100.0**
Less: Broker Comm.	0	**0.0**	0	0	**0.0**
NET REVENUES	812,182	**100.0**	(10,000)	802,182	**100.0**
EXPENSES:					
SALARIES:					
Executive	158,376	**19.5**	(54,376)	104,000	**13.0**
Sales	102,335	**12.6**	(27,335)	75,000	**9.3**
Support	181,929	**22.4**	0	181,929	**22.7**
Total Salaries	442,639	**54.5**	(81,711)	360,928	**45.0**
Benefits	57,665	**7.1**	(3,500)	54,165	**6.8**
Total Compensation	500,304	**61.6**	(85,211)	415,093	**51.7**
SELLING:					
T&E/Conventions	30,863	**3.8**	(12,000)	18,863	**2.4**
Automobile	21,442	**2.6**	(11,842)	9,600	**1.2**
Advert/Promotion	17,056	**2.1**	(5,800)	11,256	**1.4**
Total Selling	69,360	**8.5**	(29,642)	39,718	**5.0**
OPERATING:					
Occupancy	51,980	**6.4**	(11,980)	40,000	**5.0**
Telephone	13,807	**1.7**	0	13,807	**1.7**
Postage/Shipping	8,934	**1.1**	0	8,934	**1.1**
Supplies/Printing	14,619	**1.8**	0	14,619	**1.8**
Dues/Subs/Contr	19,492	**2.4**	(10,000)	9,492	**1.2**
Taxes/Licenses	3,249	**0.4**	0	3,249	**0.4**
Insurance	17,868	**2.2**	0	17,868	**2.2**
Professional Fees	27,614	**3.4**	(15,000)	12,614	**1.6**
Equip/Rental/Maint	14,619	**1.8**	0	14,619	**1.8**
Bad Debts	6,497	**0.8**	0	6,497	**0.8**
Outside Services	2,437	**0.3**	0	2,437	**0.3**
Automation	8,934	**1.1**	0	8,934	**1.1**
Education	5,685	**0.7**	0	5,685	**0.7**
Miscellaneous	4,061	**0.5**	0	4,061	**0.5**
Total Operating	199,797	**24.6**	(36,980)	162,817	**20.3**
ADMINISTRATIVE:					
Deprec/Amortization	25,990	**3.2**	0	25,990	**3.2**
Interest	9,746	**1.2**	0	9,746	**1.2**
Officers Life Ins.	2,437	**0.3**	(2,437)	0	**0.0**
Other	0	**0.0**	0	0	**0.0**
Total Administrative	38,173	**4.7**	(2,437)	35,736	**4.5**
TOTAL EXPENSES	807,634	**99.4**	(154,270)	653,364	**81.4**
Earnings Before Taxes (EBT)	**4,548**	**0.6**	**144,270**	**148,818**	**18.6**
Addback: Interest	9,746		0	9,746	
EBIT	**14,294**	**1.8**	**144,270**	**158,564**	**19.8**
Addback: Deprec./Amort.	25,990		0	25,990	
EBITDA	**$40,284**	**5.0**	**$144,270**	**$184,554**	**23.0**