DETERMINING AGENCY VALUE—PART 4

VALUATION METHODOLOGY

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This month we continue our discussion of how to determine an agency's value. Last month we calculated an agency's earnings capacity using a hypothetical income statement. We determined the agency's normalized pretax cash flow which we defined as; earnings before interest, taxes, depreciation/amortization, ("EBITDA"). This month we will discuss some of the more important risk factors which should be considered in the valuation of a property-casualty agency. The analysis of these risk factors will assist us in determining the appropriate rate of return required to compensate a *hypothetical willing buyer* for the inherent risks associated with the particular agency we are valuing.

Risk Assessment

You should generally start your valuation analysis of an agency with a review of its past financial history. A review of the agency's year-end income statements and balance sheets for last five fiscal years will usually provide a good frame work for this analysis.

As we have mentioned previously, the value of an agency is primarily a function of its *sustainable earnings capacity*. By assessing the risk factors inherent in a specific agency's operations we can estimate the required rate of return a prospective buyer would demand given the risk that the sustainable cash flows may not materialize as forecasted.

Space does not permit me to go into a great amount of detail assessing all of the various risk factors associated with a typical agency valuation. However, we will briefly discuss some of the more important factors. The proper due diligence required to assess the risk factors of an agency is time consuming but very important in the actual valuation process.

- **Volatility of Revenues—**a key question to answer is; how predictable and stable have the revenues produced by the agency been over the last five-years? A stable and growing revenue history is less risky than a history of revenues which exhibit wild fluctuations up and down throughout the years.

- **Profitability—**as measured by true normalized cash flow (EBITDA) should be reviewed for similar qualities as the revenue stream. A well managed agency should maintain a certain level of annual profitability after making the appropriate adjustments for non-recurring events. A stable history of profitability is less risky than a history which exhibits inconsistent profitability from year to year. The level of normalized pretax cash flows (EBITDA) will generally range from around 15% of net revenue at the lower end to 30% or greater at the higher end of the spectrum. Generally, we see agencies normalized pretax cash flows (EBITDA margins) in the 20% to 25% range. A few very well run agencies will consistently perform with high twenties to low thirty percent EBITDA margins.

- **Sales—**does the agency have well trained and effectively managed sales personnel? How much are the sales dependent on one key-person and does the agency have effective producer contracts with non-competition/non-piracy agreements in place?

- **Dependence on Top Ten Accounts—**is the agency dependent on certain key accounts which make up a large percentage of the agency's annual commission revenues? Accounts that individually provide in excess of 5% or more of commission revenue are considered *"jumbo accounts"* and potentially riskier to a prospective buyer. The same is true of a group of accounts which make up a disproportionate percentage of an agency's total revenues. For example, a fairly common benchmark is an agency's top ten accounts should provide no more than 20% of the agency's total revenues. Otherwise, the loss of one or more of these accounts can negatively impact future profitability of the agency and a potential buyer would need to be adequately compensated for this increased risk.

- **Industry Mix Among Accounts—**another important area to review is the agency's concentration in any one industry or line-of-business. Obviously a concentration in a specific industry or line-of-business can result in problems if that particular industry or line-of-business economically declines or falls out of favor. Agencies with a wide distribution among many different industries are considered less vulnerable to future unanticipated down turns.

- **Insurance Carriers—**several important questions must be addressed when looking at an agency's insurance carriers. The quality of the carriers (their financial strength and ratings) and the relationship the agency has built with the carriers over the years are key considerations. A thorough review of the agency 's carrier production reports for the past several years should focus on the premium volume distribution and profitability of the business placed with each of the agency's leading carriers. Dependency on any one or two carriers is usually considered risky as market conditions can turn quickly. At the same time, having too little premium volume spread thinly among too many carriers may result in strained or poor relationships with these carriers. A good rule of thumb is that no one carrier should represent more than 30% of an agency's total premium volume. Meanwhile the top ten carriers combined should represent approximately 80% of total premium.

- **Client Relationships and Account Retention History—**key to any agency risk analysis is a determination of any special relationships that exist between clients and the current owners/producers. The question to be asked is "how were these accounts originally produced?" Most agencies develop accounts from referrals, however, it should be determined if the accounts were based on business or social contacts. For example, if the selling owner produced a majority of his accounts through contacts he has made over the years as a member of the Lions, Knights of Columbus, or Rotary, will these accounts be retained if the buyer is not a member of these social organizations? Another area for investigation is the historical

retention history of the agency. Has the agency had a high level of account turnover? In general, the better performing agencies which provide the proper amount of quality service will maintain annual retention rates exceeding 90%. Finally, a review of the average age of the existing client population should be conducted. If the selling owner is in his or her late 60's, does that mean a majority of the clients are also in their 60's and 70's, and therefore, how long will these accounts remain in force?

- **Financial Analysis/Condition—**an in-depth review of the agency's general financial condition should be performed. This analysis should measure the agency's performance both historically, and as compared to similar "peer" agencies. The key to this analysis is to obtain a sense of how vulnerable the sustainable earnings capacity of the agency is to risks which can have a material impact on the normalized cash flow developed in the valuation analysis.

We have only scratched the surface of the risks analysis which is required to properly value a typical property-casualty agency. Next month we will continue this series on agency valuation with a review of how to determine the appropriate rate of return used in valuing a particular agency given its risk profile. We will also discuss several of the actual valuation methods used to appraise the value of an agency. More importantly, we will provide you with a simple methodology for estimating value which is more accurate than the "*times commission multiple"* rule of thumb common within the industry.

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