DETERMINING AGENCY VALUE—PART 6

FINAL CONCLUSION OF VALUE

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Last month we discussed several approaches to determine the value of an agency's total invested capital ("TIC"). We determined the value of total invested capital for our fictitious agency, ACE INSURANCE AGENCY, INC. ("ACE"), by using a multiple of EBITDA (earnings before interest, taxes, and depreciation/amortization) to calculate the value of the earnings capacity of ACE. We said the value of invested capital in an agency is comprised of the future earnings capacity of the existing book of business. An agency's book of business, an intangible asset, is normally its most valuable asset.

If a value of an agency's common equity is required (i.e. a stock purchase), the fair market value of the agency's assets, net of its liabilities, (net worth) is required. We will conclude our discussion on agency valuation with an analysis of ACE's balance sheet and how to calculate ACE's equity value after determining the required amount of tangible net worth available as of the valuation date.

DETERMINATION OF TANGIBLE NET WORTH VALUE

To get a better idea of how we should review the tangible net worth of an agency for valuation purposes, we will provide an example of a typical agency's adjusted balance sheet. We apply some commonly required adjustments to the reported net worth (accounting book value) to derive a tangible net worth value as of the valuation date.

There are basically four areas to be considered when adjusting a balance sheet for use in a valuation, these are:

1. Adjustments to reported account receivables.
2. Adjustments to furniture, plant, & equipment.
3. Elimination of intangible assets such as goodwill, covenants, etc.

4. Inclusion of liabilities that are not reported on the balance sheet.

These typical balance sheet adjustments, made to our fictitious agency, ACE, are shown on TABLE 2. The balance as of the date of valuation is adjusted to reflect the realizable value of each asset and liability. We made the following adjustments ACE, shown on Table 2:

1. $15,000 of accounts receivable outstanding were removed as uncollectable. We reviewed the Agency's receivable aging schedule and determined there is little likelihood of collecting these over 90 day receivables.

2. The book value of an automobile not used in the business was eliminated. This automobile is actually used by the principal's daughter. The automobiles used in the Agency are leased, and are not included on the balance sheet.

3. For valuation purposes we eliminate intangible assets from the balance sheet as the value of these assets are already captured in the earnings stream we have valued. ACE's intangible assets totaling $27,256 were eliminated. These intangible assets are from a prior asset acquisition of a small agency.

4. The final adjustment is made to retained earnings for the asset and/or liability adjustments made above. The adjusted total assets should equal the adjusted total liabilities and net worth.

After making the above adjustments to ACE's balance sheet, the reported net worth, of $111,192, is adjusted to a tangible net worth ("TNW") of $59,383.

The next step is to calculate the required TNW of the agency and any excess or shortage will be adjusted in the final conclusion of the Agency's fair market value. Agencies typically need between 30 and 60 days of cash expenses, in the form of tangible net worth to provide enough tangible assets/working capital to support the business. The selection of the proper number of days of cash expenses required for a particular agency is somewhat subjective, but should be based on a number of factors, including: the Agency's historical collection results, mix of business, and general cash management trends.

For our example we have used a 45 day TNW requirement for ACE's valuation. The exhibit below summarizes the calculation of the required TNW.

TANGIBLE NET WORTH (TNW) CALCULATION	
Normalized Annual Debt-free, Cash Expenses	$617,628
Divided By 365 Days	365
Daily Cash Expenses	1,692
Days of TNW Required	45
TNW Required	**76,146**
Actual TNW Available	**59,383**
TNW Excess/(Shortage)	**($16,763)**

As the above table indicates, ACE's normalized total debt-free cash expenses are $617,628 (total expenses minus interest and depreciation/amortization expenses; *see Table 1, June 2004 magazine).* Dividing this requirement by 365 days produces the average daily cash expenses of $1,692. When multiplied by 45 days, it equals $76,146 for the TNW requirement. The actual adjusted TNW for ACE is $59,383 *(see Table 2)* which is $16,763 short of the required TNW.

Final Conclusion of Fair Market Value

To calculate the final fair market value of the stock of ACE the TNW shortage is subtracted from ACE's value of total invested capital (TIC). The result is the fair market value of 100% of the equity of ACE as of the valuation date. Below is a summary of the final conclusion of value for ACE.

ACE INSURANCE AGENCY, INC. Final Conclusion: Range of Value as of December 31, 20XX		
Normalized EBITDA	$ 185,000	$ 185,000
Times: Selected EBITDA Multiples	5.0	6.0
Value of Total Invested Capital	**$ 925,000**	**$ 1,110,000**
Add: TNW Adjustment excess/(shortage)	(16,763)	(16,763)
Range of Equity Values	**$ 908,237**	**$ 1,093,237**
Value of TIC as a multiple of:		
Normalized Net Revenues ($802,000)	1.15	1.38
Normalized EBITDA ($185,000)	5.00	6.00
Value of Equity as a multiple of:		
Normalized Net Revenues ($802,000)	1.13	1.36
Normalized EBITDA ($185,000)	4.91	5.91

As the final conclusion of value indicates, the agency's fair market value falls within the net revenue multiples more commonly seen in today's marketplace of between 1.0 times to 1.5 times net revenue. It should be remembered that this fair market value presumes a hypothetical willing buyer and willing seller negotiated cash purchase price. Terms of a deal such as covenants, promissory notes and interest, etc. are not factored into this value.

From an agency owner planning point, increasing your Agency's value is a matter of increasing your normalized earnings capacity (i.e. EBITDA margins) and decreasing the inherent risk factors (increasing the EBITDA multiple) that a prospective buyer would consider for your Agency. Don't concentrate on the top line (Revenues); but rather concentrate profitability and quality.

This concludes our look at agency valuation. I hope this series of articles will help you understand the many factors that must be considered in an agency valuation, and why the old "*times commission revenue"* rules of thumb *do not* adequately capture the important risk and return aspects of agency valuation. While this short-cut method is certainly more appropriate for estimating an agency's value, it is not appropriate as a true methodology for an actual formal valuation by an independent appraiser. In those cases when an agency requires a truly independent valuation (i.e. estate and gift tax, shareholder disputes, divorces, ESOPs, Stock option plans, etc.) more rigorous methodology must be applied and thorough independent due diligence must be performed.

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ACE INSURANCE AGENCY, INC. **TABLE 2**
ADJUSTED BALANCE SHEET
FOR THE MONTH ENDED DECEMBER 31, 20XX

Assets	20XX Reported	Adjustments	20XX Adjusted
Current Assets:			
Cash/Cash Equivalents	$101,119	$0	$101,119
Marketable Securities	14,258	0	14,258
Accounts Receivable	91,926	(15,000)	76,926
Prepaid Expenses	3,488	0	3,488
Total Current Assets	**210,791**	**(15,000)**	**195,791**
Property And Equipment:			
Furniture and Fixtures	88,237	0	88,237
Computer	54,258	0	54,258
Automobiles	9,553	(9,553)	0
Total Property/Equip.	152,048	(9,553)	142,495
Less: Accum. Deprec.	(33,057)	0	(33,057)
Net Property/Equip.	**118,991**	**(9,553)**	**109,438**
Intangible Assets: (Net Amortization)			
Goodwill	0	0	0
Expirations/Covenants	27,256	(27,256)	0
Other Intangibles	0	0	0
Total Intangibles	**27,256**	**(27,256)**	**0**
TOTAL ASSETS	**$357,038**	**($51,809)**	**$305,229**
Liabilities & Equity			
Current Liabilities:			
Accounts Payable	$159,080	$0	$159,080
Payroll Taxes Payable	4,216	0	4,216
Current Portion of Long-Term Debt	16,510	0	16,510
Total Current Liabilities	**179,806**	**0**	**179,806**
Long-Term Debt (LTD)	66,040	0	66,040
TOTAL LIABILITIES	**245,846**	**0**	**245,846**
Stockholders' Equity			
Common Stk/Pd in Capital	18,964	0	18,964
Retained Earnings	92,228	(51,809)	40,419
Total Equity/Net Worth	**111,192**	**(51,809)**	**59,383**
Total Liabilities & Equity	**$357,038**	**($51,809)**	**$305,229**