Burke Ink

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View through the Windshield — Developments in Independent-Agency Value

I ended our last Burke Ink (*The Economy and the Outlook for Independent Agencies – October 2009*) with the comment that I would follow up with observations on the impact of economic trends on agency value. Here they are.

Independent-agency values are down, but not by so much as one might think. Most of the building blocks of value have been hit, and some pretty hard, but the demand for these firms remains strong.

Now, having led with the punch line, I'll explain it with a look at the basics.

The value of any operating company can be defined as the present (discounted) value of its expected net cash flows. That definition is pretty solid, standing up in both theory and practice. Academic types and institutional buyers actually use such language and do the present-value discounting math, as taught in finance courses. The streetwise, private buyers tend not to use the discounting jargon and algebra so much (even if they learned it in school), being more focused on the simple arithmetic of covering payments on deal-caused term loans, but nonetheless they come to their pricing decisions by projecting cash flows from the target firm.

So let's accept the definition but break it down. We have these elements: expected cash flows and factors by which to discount them (meaning to give them a present value). Essentially, cash flow is profit, but the various routines accountants use to arrive at "profit" in financial statements tend to blur that term, so cash flow is a solid substitute, and usually unambiguous. And we are talking *net* cash flows, meaning net-net to the buyer. Among other things, that means net of taxes too.

Note also that our definition has a critical modifier — the adjective *expected*. Business-valuation decisions are made mainly by looking through the windshield, not the rearview mirror. The windshield perspective is critical, particularly in early 2010, when uncertainty prevails on the future of such important items as contingent commissions, commercial-lines pricing, and group-health insurance. [But I do need to add that as important as the front view is, one should not try to drive the valuation vehicle without some skillful use of the rearview mirror too. Income projections that are not grounded in recent reality can lead to valuation conclusions that appear at best naïve and maybe contrived.]

Think of the *discount rate* as the buyer's required rate of return. *In order to commit capital to that acquisition, we would have to realize a net return on equity of 15%* is a refrain that might be heard from an institutional buyer. Thus, expected cash flows would be discounted at 15% per year. Smaller, private buyers, and their lenders, may not approach deals with rate-of-return language, but their pricing and lending decisions imply investment-return thresholds that are similar to, and usually a little higher than, those of institutional buyers.

People write whole books on discount rates, and there are lots of things to argue about, but there are two primary building blocks: the so-called risk-free rate (for which most people use the rates paid by short- and medium-term U.S. Treasurys) and the additional rate needed to compensate the investor for accepting more risk.

OK, so we have four things by which to review developments in agency value:

- Recent cash-flows — the rearview mirror;
- Expected cash flows (in the next few years) — the windshield view;

— continues —

More on the Economy

A few more comments on the subject of our last issue — the economy. Important information for you to keep an eye on is state-government finance. Last year's federal stimulus money masked a really hurtin' situation in many states. Two reasons for you to look closer. One is to assess the potentially direct impact on your agency. For some, this might be minor, but others, near state-supported facilities or insuring state-supported organizations, may have some significant exposure. The other reason is that it can be the best insight into what's really happening in the general economy. The bases for state-government revenue are sales, individual income, business income, and activities that have a fee, and they are not obscured by the confusing national income accounting in the GDP estimates found in the headlines and political speeches. As long as state tax revenues are down, we have not turned the corner. — BHB

- Prevailing interest rates; and
- The investment risk connected with an insurance-agency acquisition.

In the 2008 – 2009 timeframe, the only one of these four factors that changed in a way that was favorable to agency value was interest rates. And most agency owners and buyers wouldn't even think of the recent rate declines as a positive, knowing that short-term rates were forced down by the Fed in an attempt to prevent an even bigger economic slump. Developments in the other three were all unfavorable.

On recent cash flows, it's fair to generalize that across the board in that timeframe commercial-lines commissions were down, personal-lines commissions were down, and contingent commissions were down. Group l&h commissions were a mixed bag, but even the growth stories were at sharply lower rates than in recent years. Some agencies cut expenses in response, but in most situations the revenue trends trumped the expense actions, and profits (cash flows) were squeezed — in some cases by a lot. That's the view through the rearview mirror.

Through the windshield? Short answer for the near term: expectations are low. Longer term, we are bullish on agency income, but for the next few years, valuations based on optimistic cash-flow projections will have some 'splainin' to do. The 'splainin' might be effective. An agency with a sales culture and a good game plan can make real hay in this environment. But it would be the exception.

That leaves investment risk. Internal sources of risk, those stemming from the agency itself, are hard to generalize about because agency performance and quality are all over the lot, but a few comments are warranted. One, we don't see any *general* increase in risk related to staff and infrastructure. In some ways today's environment brings less risk of staff disruption than does a hot economy. Two, there is usually some increase in risk from the book of business, but we see that as externally sourced (discussed below). Three, the internal item that is most often clicking from favorable to unfavorable in our valuations is the portion of profit (EBITDA) attributable to contingent commissions. Good contingents are a beautiful thing and can enhance profits and value, but their weight in the profit mix is an important risk factor.

External risk (from the general economy) is something we have no problem generalizing about. Most appraisals as of year-end 2009 will contain assumptions about the unfavorable impact of the general economy on sales, payrolls, and property values, and thereby on agency revenue. But on top of what's baked into the projections, there is a risk component as well — the very real risk that things could break even worse than was assumed. This does not constitute a prediction on our part that that will happen, just a recognition of the reality that it might. Buyer/investor confidence is not what it was only a few short years ago and could be shaken still further, and possibly suddenly.

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So, to sum up — recent cash flows, expected cash flows, and externally based risk are all unfavorable when compared to a few years ago. Only interest rates have improved, and most people are spooked or confused by that development. So values must be down, right? The short answer is *yes* — not in every case, of course, but as of late 2009 and early 2010 it is reasonable to generalize that insurance-agency values are down from a few years prior. But the full answer is ... *yes, but not by all that much* … or ... *yes, but not by as much as the agency economics suggest.*

Why is that so? For one thing, independent agencies remain very desirable businesses. People are still eager to buy them for a variety of reasons, and there are fewer of them. Demand and supply. And that demand is often augmented in transactions by cooperation from growth-minded carriers. Another reason is that many agency transactions are consolidations of books of business, to one degree or another, with generally good economic effect, and as such they offer the buyer a viable alternative to hard-to-produce organic growth. Even if the internal economics of the seller are deteriorating on a stand-alone basis, indicating in theory a decline in value, its book of business might fetch a better-than-indicated price in a consolidating transaction.

If you are an agency owner with a long-term career view, we hope you have found this review to be mildly interesting but somewhat irrelevant and that you re-read the previous issue of Burke Ink and get aggressive about building long-term value. If you are a seller, be thankful that you have what is probably a highly marketable asset, but you should face the reality that its value is most likely down from a few years ago. If you are a buyer, we don't blame you — the business model is still a good one, and you should be able to put together a value-enhancing deal if you go about things right. But don't expect to find many bargains. There are problems out there, but no blood in the streets just yet. — *BHB*

Ink Spot

When it comes to giving to charity, some people stop at nothing.

What We've Been Up To

In addition to our ongoing work in valuation and transactions, the team at BHBCo has been involved in some other interesting activities. Some examples:

Jason Hoeppner

Jason has done numerous seminars and webinars recently on the effective use of social media — Facebook, LinkedIn, Twitter, and the like — in the independent agency, and he has been retained recently by a marketing-oriented agency that is determined to do more than dabble in this brave new world.

He is also in the process of helping two multi-location agencies with commercial- and personal-lines workflow improvements — one following a technology-transition (they went to a new system) and the other as part of a plan to improve productivity in the emerging environment of lower profit margins.

Dom Setaro

Dom has an ongoing engagement with an agency whose books were not in the shape the retiring principal wanted at the beginning of a major perpetuation transaction. Dad was living with things as they were but wanted a clean start for the successor family team. Accumulated clutter in receivables and payables, big discrepancies in the direct-bill receivables carried over to the financial statements, and some issues related to premium trust accounting. Lots of progress there, to everyone's satisfaction.

Everett Shaw

In addition to his work managing our valuation and annual Agency Performance Reviews and advising on transactions, BHBCo partner Everett Shaw is in the process of helping three parties put together a new and bigger agency. One of them just acquired a p/c agency in a perpetuation plan; another has been a sole-proprietor benefits producer; and the third is a bright young p/c producer who just left a financial institution, looking for an entrepreneurial shot. Everett's helping with design, compensation, and value sharing. Lots of moving parts.

. . . Back to Jason

Jason has been helping numerous agencies in Massachusetts comply with a new personal information security law. The legislation covers more than just the insurance-agency world, but, as you know, agencies are entrusted with lots of such information, and the handling of it in most offices would flunk an audit in a heartbeat. Jason has been working on this by webinar with the Mass agents' association (MAIA) and in individual on-site engagements.

Brian Burke

In addition to his valuation and transaction work at BHBCo, Brian has joined two agency boards and continues to serve as a director of InsurBanc.