Appraising Independent Insurance Agencies

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Definitions

The term **independent agency** usually refers to a **property/casualty** (p/c) agency that represents more than one carrier, not a life insurance agency or single-company agency. A p/c agency will usually receive commissions ranging from 10% to 20% of a policy's premium, and these commissions apply to first **and** renewal years. In p/c agencies that represent a single carrier, (State Farm and Nationwide being two familiar examples), the agent usually is a party to a contract with the carrier that prohibits the sale of accounts and intangibles to outside parties.

The sale of life insurance, on the other hand, usually involves high first-year commissions and lower, and personally vested, renewal commissions. Accordingly, although a life insurance agent may earn substantial income, his/her agency won't have the salable business value that a p/c agency will.

P/C insurance agency accounts are often called **expirations**. The term refers to the value of knowing the date of a policy's expiration and the insured's particular coverage needs and pricing, which can be complex.

Modified Liquidation Value for Smaller Agencies

One thing that simply goes with the territory of appraising p/c agencies is an awareness that many (probably most) smaller agencies, when sold, are purchased by a larger, neighboring agency. Accordingly, a smaller agency will frequently have a **modified liquidation value** that is greater than its value as a going business, in place. That is to say, the buyer will purchase the book of business and hire perhaps one or two service people but not take on substantial incremental overhead. These consolidation economies yield incremental profit margins to a buyer that are quite substantial and thus allow for a purchase price (perhaps better termed **total purchase consideration**) as high as two or more times annual p/c commission income. To pay such a value, however, the buyer will require favorable indicators of quality (mix of business, collection history, loss ratios, etc.) and will usually purchase no receivables and assume no liabilities.

The principal implication here is that before deciding whether the modified liquidation value is appropriate, the agency appraiser must understand and define the purpose of the appraisal assignment. This is a familiar admonition for an experienced business appraiser, but it is not always so for insurance agency consultants who are not well-schooled in business appraising.

Retention-Based Pricing

In actual deals large accounts, or other accounts whose retention by the buyer would be exposed to greater risk of loss than would the bulk of the accounts, are often purchased on an as-retained basis. Accordingly, when making an appraisal for a deal, the appraiser must understand what accounts are usually subject to such pricing and how to **carve them out**. When the appraisal is made for non-deal purposes, the appraiser needs to assess the impact such accounts have on risk of lost revenue.

Going Concerns

When appraising most larger p/c agencies, and smaller ones for which the modified liquidation approach doesn't apply, we use appraisal methods familiar to all appraisers of closely held operating companies. They are examined further below. As in most such work we find that the "**90% perspiration and 10% inspiration**" rule applies to agency appraisals. By this I mean that

time and effort spent completing a thorough, factual understanding and description of the subject agency far exceeds that spent on the value machinations themselves. In the appraisal of p/c agencies, the **perspiration** involves a thorough documentation of the following items:

Operating History

We usually chart a 5-year history of revenues and expenses and then make observations pertinent to value. Those observations usually fall into the following categories:

- How supplementary revenues—life insurance commissions, contingent commissions (which are special bonus commissions from carriers), and investment income (mostly float interest) augment base p/c commissions.
- How expense ratios are trending and how they compare to industry norms. In this section we also comment on productivity ratios that are familiar in the industry (such as commissions per employee, commissions per customer service representative, and commissions per producer).
- The level and trend of what is often called **owner compensation**—the combination of reported pre-tax profits and reported cash compensation paid to principal owners.
- Whether there are other items that will call for pro-forma adjustment (such as rent on principal-owned real estate, nonessential payroll, interest paid, special **perks**, etc.)

Financial Position

We also chart a history of assets and liabilities. In this portion of the work we make observations about tangible net worth, liquidity, and assets that may need to be revalued (such as agency-owned real estate) or adjusted (such as aged receivables).

In most insurance agency appraisals we value the income stream on a debt-free basis—sometimes referred to as valuing the left side of the balance sheet on a going-concern basis. Thus, to arrive at equity value, we subtract debt directly from the income-based value and make any other adjustments caused by a surplus or deficiency of working capital. Because of this, our review of the balance sheet does not include an assessment of risk created by financial leverage. As with many service businesses, most p/c agencies don't have large permanent-capital requirements.

Other Items Affecting Risk

We report on several key items that are important to a proper description of a p/c insurance agency business. Our purpose, other than to show evidence of thorough review, is to identify factors that will affect our assessment of risk—primarily, the risk associated with prospects of sustaining commission revenue. Because there usually are no major cost or expense risks, sustaining profits is usually associated with sustaining revenue. Some of the key items on which we make observations are:

- the existence of target or key accounts
- receivables aging and collection history
- loss ratios (i.e., the risk of lost carrier contracts)
- key-person risk, particularly the existence and effectiveness of producer contracts and covenants
- the regulatory environment (the California and Massachusetts auto-insurance problems are good examples)
- the industry outlook
- the general economic outlook
- the subject agency's trading area

Pro-Forma Cash Flow

We then construct a pro-forma statement of revenues and cash expenses. Pro-forma cash flow becomes the basis for all our valuation methods. Most readers of this article don't need to have this exercise explained in detail, but pointing out certain key items pertinent to insurance agencies might be helpful.

Supplementary Revenues

Such things as contingent commissions and life insurance commissions[1] tend to fall pretty directly to the bottom line and may thus explain a significant portion of operating profit (or cash flow). Because they can vary significantly from year to year, it is critical that the appraiser not be superficial and assume that the level of these revenues for the latest year or two is normal.

Management Compensation

To adjust discretionary compensation to a required or replacement level, we use a sliding-scale percentage of base commissions developed from our consulting experience. As one might expect, the scale is inverse to agency size. In most of our appraisals, pro-forma management compensation is between 8% and 16% of base commissions. Doing this properly, however, requires a proper allocation of a portion of management compensation to sales compensation. This allocation varies considerably with the sales activity of the subject agency's owner(s).

Occupancy

If the agency rents its space from a related party, we adjust to our best estimate of an arm's-length level. We have good comparative data for agency occupancy expenses.

Charges Related to the Balance Sheet

Because we use a cash-flow approach and because, as mentioned above, we value the income stream on a debt-free basis, we eliminate amortization and interest, and we make an equipment-replacement estimate in lieu of depreciation.

Valuation Methods

In our agency appraisals we usually apply the four methods identified below.

Discounted Cash Flow (DCF)

Because of our specialization in this field we have a good understanding of agency revenue and expense ratios, some of which are predictable within a fairly tight range. Accordingly, I have confidence in this method and place considerable weight on it. The income item we discount is after-tax cash flow. Because of deal-related experience and our staying current on tax issues, I prefer to discount after-tax cash flow rather than apply a higher discount rate to pretax returns. In an enterprise valuation I believe that fair market value is best estimated by acquisition-modeling of some sort, and thus my tax estimates involve a consideration of deal-related write-offs customary to insurance agency acquisitions.

Capitalization of Cash Flow

In an appraisal for which we do not have enough data to forecast confidently or if the forecasting involves smooth, linear trends in revenue and expense, the capitalization of normalized cash flow is a useful method. The required rate of return is the discount rate developed in the DCF model, and the expected cash-flow growth rate used is consistent with the trends in the DCF method, when that method is applied.

A Word on Discount and Capitalization Rates. The discount and capitalization rates we use in the above two methods warrant comment. At first blush, experienced private-company appraisers not familiar with insurance agency values might raise their eyebrows at the discount rates used by experienced agency appraisers. In a current (mid-1989) appraisal of an agency with a 'normal' quality and risk profile, a required rate of return of 25% would be slightly high. Yet most appraisers of local businesses with, say, $750,000 of revenue and an ostensibly thin capital base would call for a discount rate of 30% or more. Using a discount rate of 30-35% would almost surely produce an insurance agency value below what an informed person would consider reasonable. A generally lower discount rate is explained by the fact that because p/c insurance is a required purchase for virtually every household and business and (for reasons beyond the scope of this article) such policies renew at high and fairly predictable rates. Thus, p/c insurance agencies, compared to many other businesses of the same size, have low risk. Further, they are actively sought for acquisition. While consultants are frequently involved in insurance agency deals, the traditional find-a-buyer dimension of the brokerage function is not nearly so important as it is with the sale of other small businesses.

Most of our appraisals include discount rates of from 21% to 26%, which we develop from a risk-increment matrix and the 7- or 10-year Treasury-Bond rate. Our capitalization rates (i.e., after we subtract an expected growth rate) usually range between 13% and 20%. As with appraisals of most companies, the year-to-year commission-income growth used in the DCF method and the growth rate used to develop a capitalization rate in the second method are affected by such things as the subject's growth history and the general economic outlook. With p/c insurance agencies, however, another critical determinant of expected growth is the then-current position of the industry underwriting cycle and the percentage of the agency's business subject to that cycle.

Payback Method

This method has many variations.[2] Our version is designed to mimic the actual structure of deals for smaller agencies. Such deals usually involve a cash down payment ranging from 20% to 50% of the total value and deferrals paid in the form of notes, covenants, and post-deal benefits. Collectively, the deferrals are the financial equivalent of a 5-10 year secured note.

Although this method is less sophisticated and less scientific than, say, discounting models, I place a fair amount of weight on it for smaller agencies. In this method we subtract from pro-forma cash flow the cost of money required to support a reasonable down payment and then determine the debt that the remaining cash flow would support under terms customary in an agency deal. The income-based value is the sum of the down payment and the supportable debt. (If not applied with knowledge of what terms might be considered customary, this method goes from being simple to being simplistic, and thus questionable.) Because this method applies cash flow to debt principal, it effectively involves a return of, as well as on, investment. Accordingly, it will usually produce a lower value than will the discounting or capitalization methods. When it doesn't, the appraisal involves low-growth assumptions.

The reader may ask how we can select a **reasonable down payment** before we know the value. It is a good question. The answer is that the method involved is an iterative process.

Comparable Companies

There are several well-known public brokerages that are closely followed by the insurance trade literature. Thus, the search for possible comparables is not a search at all. Because Revenue Ruling 59-60 is explicit on the matter and because these brokerages are well-known to agency people, we usually apply their market data to our subject's income. We derive a

cash-flow multiple from the published earnings multiples of the smaller companies that have not had unusual charges to their earnings and then apply that to our best estimate of the cash flow our subject would have reported if publicly owned. After doing so, however, I usually give the result low weight. The factors that influence the passive investment in marketable minority interests of national brokerages are dissimilar to those affecting the active investment of a controlling interest in a local agency. The revenue trends and the earnings cycle may be similar for commercially oriented firms, but the similarity usually stops there. Seldom was this more vividly displayed than in late 1987. The prices of the public brokerages had plummeted in October, but we saw little impact on local agency acquisition prices.

Balance-Sheet-Related Adjustments

After settling on an income-based value, I make any debt adjustments called for, such as adding an unbooked liability for unfunded deferred compensation or revaluing debt from previous stock redemptions; and any asset adjustments, such as for aged receivables. I then determine a required level of tangible net worth for an agency of the size and make-up of the subject and add to that (or subtract from it) the agency's excess (or deficiency of) tangible net worth.

Valuing Expirations

Some agency appraisers include a wasting-asset method in their appraisal reports. This method is based upon estimating future profits from existing accounts. It requires assumptions about account and policy attrition and non-sales expenses, and involves discounting the diminishing returns to the present. We do appraisals of expirations, but those are always tax-related assignments in which we isolate the value of the accounts themselves, demonstrate that they have a limited useful life, and estimate that life for amortization purposes. When these appraisals are completed, they usually show that the expirations themselves represent from 40% to 70% of the total purchase consideration, the remainder being made up of goodwill, covenants, and intangibles. Thus, while we fully understand the purpose of such an appraisal for tax purposes, we do not believe that it is appropriate to include it in the appraisal of the overall going-concern value of an enterprise unless one also values the covenant, goodwill, and the tangibles.

Reasonableness Testing . . . Multiples of Commission and Cash Flow

As it is for most appraisers, the value's **smell test** is important to me. To test reasonableness, I usually divide the income-based value by pro-forma cash-flow and by base commissions. I agree with the general professional admonition against using rules-of-thumb multiples to calculate value, but they are very useful for **expressing** value and for reasonableness testing.

For example, if the derived commission multiple is comparatively low, say 1.0, I verify to myself that the pro-forma profit and cash-flow margins are thin and that there is a factual basis for their being thin; or that there are factors that contribute significant risk. Similarly, if the cash-flow multiple is high, say 7.0, I will verify that projected growth is high and that the facts support its being so.

There is a rule-of-thumb that is well-known in the agency business—namely, a value of 1.5 times commissions. Agency consultants and appraisers look askance at relying on such multiples, but one has to have some respect for a rule that seems to have so much staying power. I believe that its origin is based on there having been many actual deals over many years in which buyer and seller settled on a value that worked out to be six times an expected profit of 25% of revenues, even though they didn't express it or perhaps even think of it in those terms.

Most (but certainly not all) of our agency appraisals result in multiples of base commissions of between 1.2 and 1.8 and multiples of pro-forma pre-tax cash-flow of between 4 and 7. But that is a wide swath. Doing a good appraisal requires an understanding of agency operating ratios,

mix-of-business ratios, underwriting-loss ratios, the structure of p/c commissions, the sources of risk, and for commercial-lines agencies, an understanding of the industry's underwriting cycle.

NOTES

1. In agencies that do not have well-developed life insurance departments, life commissions tend to be modest and do not have much "expense baggage." However, some agencies, particularly larger ones, take the life and group business more seriously. In these cases we are able to allocate appropriate expenses, and thus we don't regard this revenue as "supplementary."
2. I believe I pirated the title from one of Shannon Pratt's books. This method was also at the heart of "The Benefits of Seller Financing in a Small Business Sale," an interesting article by Frank E. Beane, Jr., ASA, an associate of mine, in the February 1987 issue of Valuation.

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