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ENHANCING THE VALUE OF YOUR AGENCY

By Robin Frost, ACA

Nearly all of us have seen a painful deterioration in the value of our investments and retirement savings over the last year or so. Perhaps this has made you think about what you can do to protect the value of your investments in the future? While improving your investing strategies, "timing the market" and steering clear of ponzi schemes are all methods to potentially recoup some of these losses or avoid them in the future, an alternate approach for agency principals might be a renewed focus on an investment they can directly control, their own insurance agency. Given that most agency owners have a substantial portion of their personal net worth tied up in the value of their agency, focusing on that which they can directly influence may well yield timely and significant rewards.

Understanding Value

The first step in building value in your insurance agency is having a firm grasp on those factors which either enhance or detract from it.

The most critical concept to understand is that while watching "the top line" (i.e. revenues) is important, the real metric is the bottom line, earnings, most commonly measured as the earnings before interest, taxation, depreciation and amortization (or "EBITDA"). In order to derive a valuation, the sustainable EBITDA need to be estimated. The actual reported earnings of the agency are adjusted to derive the pro forma EBITDA, which should be indicative of what the normalized or sustainable earnings would be for an outside owner, given the current book of business. Examples of pro forma adjustments might include adjusting for any excessive owner compensation, eliminating non-recurring expenses, or adjusting certain other expenses for how they might look to a particular buyer. Certain other non-operating expenses, such as interest expense, depreciation expense, amortization expense and income taxes should also be eliminated to arrive at the pro forma EBITDA.

Once the pro forma sustainable earnings have been estimated, there are a number of differing ways to value these. While the net present value of future cash flows is probably the most theoretically correct technique, the prevailing method in the industry is a multiple of the pro forma EBITDA. The result is the "earnings valuation".

Once the earnings valuation is derived, the balance sheet is considered. Like the income statement, the balance sheet is adjusted to eliminate any assets or liabilities which would not be acquired or assumed by a prospective purchaser. The result of this process is the tangible net worth of the agency. The combination of the earnings valuation plus the tangible net worth gives us the agency valuation.

Typically, the majority of an insurance agency's value will come from its earnings valuation. This concept should "hold water" as the real value of an insurance agency is in its customers and employees. These are the real "assets" which would hold the interest of a potential acquirer.

Factors Impacting Value

The next step in building value in your agency is having a firm grasp on those factors which either enhance or detract from it.

As we can see from how value is derived, the key factor in building and ultimately sustaining the value of an agency is to increase its earnings. From the point of view of revenues, as we all know, in a soft market, agencies have to grow just to stand still, so this challenge is always upon us. On the expense side of the ledger, by far the largest expense in nearly all agencies is employee compensation.

Compensation: What is a reasonable level of staffing, and the associated compensation, required to run the agency? Often times, in preparing the pro forma income statement, the major adjustments are seen in the compensation expense lines.

Many agency principals object to the concept of value being determined on earnings, as opposed to top-line revenues, as each year they always report a net profit of zero, hence their value will be artificially low at zero. However, this usually masks the fact that any profit is being taken out as owner compensation or bonus distribution. Hence adjusting this compensation to the market rate for an agency manager will usually significantly boost the "sustainable" earnings level.

In regards to the production staff, is the commission basis in line with the local market? In a competitive employment market this is generally self-regulating, if you want a high quality sales force, you need to pay the going rate – right? Many principals have readily provided rich compensation schemes to their producers in an attempt to attract and retain a high quality sales force. However, most acquirers would seek to adjust this compensation downward to market levels in an acquisition, which most likely will create turmoil with the rank and file, especially if you assume the production staff are not owners, and accordingly, will not be recipients of the sales proceeds. In these situations, many acquirers will remove themselves from the bidding process given the uncertainty associated with reducing employee compensation. So, while it is important to adequately reward those who help you build your organization, it is equally important to keep your eye on the endgame as schemes which are too lavish may well detract from your value.

Account concentration: Is there one key account which is critical to the agency? Is there one industry sector to which the agency is inextricably tied? For example, let's consider an agency that had specialized in residential contractors in Florida. For many years, profitable growth should have been realized, assuming a mix of a quality production staff, well-targeted marketing, and of course, access to quality markets. Business must have seemed to just get better and better. However, that same agency must now be feeling the strain given the events of the recent collapse in the residential housing market and the sub-prime meltdown, and it is most likely struggling to maintain the same staffing levels given the recent reduction in revenues. In order to maintain the status quo, one would assume this firm would have had to forge a strategic push to expand into other industry sectors and broaden the client base.

When times are good, the prudent principal should consider if the agency is potentially overly dependent to any particular client, or to any particular industry. Clearly, any such over concentration increases the risk of an operation. A balanced approach to targeting new growth can help here, ensuring that the new sales focus remains diversified, and a good spread of industry sectors and client types is solicited.

Product mix: Another area in which over concentration risk needs to be considered is in the mix of products on offer. Although, there is much to be said for concentrating on your core strengths and doing what you do best, it should be borne in mind that a multi-line agency will generally be considered to have a lower risk factor than a pure benefits, or pure P&C shop.

Considering our agency specializing in Florida-based, residential contractors again, if the business had focused solely on the P&C insurance needs of the clients, the scope for diversifying to address the risk is limited. Now, if that agency had also been selling group benefits to retail contracting operations, there is the potential to relatively quickly expand this sales line into other sectors. Essentially it is simply following the “down home” advice of “not keeping all your eggs in one basket”.

Carrier appointments: Of particular concern currently is the credit rating of the carriers which an agency represents. Insurance companies are always keenly aware of their credit rating status and work to manage this; however, the exposure many carriers had to investments linked to the sub-prime market is an example of how quickly these can be negatively affected. Clearly if you represent a carrier whose rating suddenly slips below A-, if you do not have another alternative to divert business to, you most likely have had the unfortunate experience of watching some of your business walking out the door.

Also, in a similar manner to account and product concentration, over dependence on a particular carrier is seen as a risk and can reduce the value of an agency. This is often the case in benefits agencies where the agency may have the sole distribution rights for a particular geographic area for a life, health and benefits insurance company. While, this “exclusive” relationship certainly has value, it is wise for the agency to ensure that it has other lines of business, to mitigate the risk from losing this relationship or any decline in the standing of the particular carrier.

For the smaller agency there may be little that can be done in the short term here, but at least initial contact with new carriers can be made to start the process of increasing the carrier network representation.

Balance sheet management: Finally, good balance sheet management is always a sign of a strong back office. The balance sheet should have a history of being “in trust”, which essentially means that there are always more liquid assets and accounts receivable than company payables. Another way to look at this is to ask if the monies being collected from insureds are being used to pay the carriers first, or are they being diverted to pay for the working expenses of the agency? While not all do, many states mandate an “in trust” position in some fashion.

Take for example an agency where the revenues and earnings history are excellent, and based on this, a potential acquirer is ready to close the deal. However in due diligence, it is discovered that the cash position of the agency is over-stated and the accounts receivable include some invalid entries. Once these are adjusted in the pro forma balance sheet, the agency is “out of trust” and potentially liable to legal action from the state Department of Insurance. This factor alone may be a sufficient enough of a “red flag” to cool the interest of the willing buyer.

Assuming an agency is in trust, it is desirable to see higher liquidity, (i.e., more of the assets represented by actual cash than accounts due to be collected). Good collection practices also go a long way to enhance agency value.

Other factors: There are many other factors which go into assessing the risk of an agency operation. Other factors an agency principal should consider include existence of employee agreements, quality of the personnel, quality of the information systems, staff efficiency, and account retention levels.

Making your check list

The final step in maintaining your agency value is keeping a check on the circumstances that can be managed and periodically reviewing those factors that might be impacting value.

Given that sustainable earnings growth is the key to enhancing agency value, this surely is item number one on the “agency value check list”. Hopefully though, some of the factors considered above can help you fill out objectives two through ten on your list. A periodic check of how you measure up against these goals and objectives may help you protect the value of your agency. Who knows, while you have been spending time focusing on the value of your agency, you could have perhaps avoided transferring your retirement funds into a risky high pay-out fund, and saved yourself some money there too.

The author

Robin Frost is a Vice President of Mystic Capital Advisors Group, LLC, a national mergers and acquisition advisory firm that focuses exclusively on the insurance industry.