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Valuing Your Insurance Distribution Business:

If the multiples you are hearing about sound to good to be true, they probably are!

By, Mathew Klossner

You may have read an article recently where an industry consultant quoted current valuation multiples for acquisitions at 8 times EBITDA (Earnings before Interest, Taxes, Depreciation, and Amortization). Or maybe you heard through the grapevine that an Agency owner across town sold for 2.5 times revenues. Beware! Rumors of various multiples for sales are being tossed around more often than a football on a Sunday afternoon.

By quoting these valuation multiples, industry consultants and other experts are doing everyone a huge disservice. Misinformation can lead Agency owner's to have an inflated view of their Firm's value and can cause serious disappointment if they decide to sell their business. There are a number of factors that affect the value of an insurance distribution business and as such, the multiples they are worth. This article will discuss a few significant ones:

- **Asset vs. Stock deal**: The biggest value differentiator is the form of Corporation for which the business was established. All things being equal, "C" Corporations are worth less than "S" Corporations and Limited Liability Corporations ("LLC's").

  The primary reasons for this is that the owners of C Corporations need to sell their stock in order to realize capital gains treatment on the sale, while the owners of S Corporations and LLC's may sell the assets and realize favorable capital gains treatment. On the other side of the transaction, Buyers are generally averse to acquiring stock for two reasons: (1) Buyers want to avoid exposure to undisclosed liabilities and (2) stock deals do not allow buyers to capitalize on the lucrative tax benefit associated with the amortization of goodwill. Consequently, a C corporation owner's desire to sell stock, directly conflicts with a Buyer's desire to purchase assets. Ultimately, the Seller will need to realize a lower gross purchase price to compensate the Buyer for the foregone tax benefit associated with an asset deal and, the Seller will generally be required to provide indemnification to the Buyer for undisclosed liabilities for a period of time subsequent to the transaction.

- **Deal Structure**: An overwhelming majority of transactions include an earn-out or contingency component. Because future payments may be based on achieving/maintaining some level of performance, it is illogical to include the aggregate potential of such payments in a discussion of the price of the deal.

  Some consultants try to include maximum potential aggregate payments along with historical revenues in order to provide the illusion of a high multiple for a deal. Their hope is that this "fuzzy math" will entice potential sellers to contact them. The reality of most transactions is that contingent payments are not present value payments and the risks associated with the future unknown is not taken into account when a basic simple multiple is quoted. Generally, the actual purchase price has a much lower implied/realized multiple than the overly optimistic multiple that was quoted for the transaction.

- **Value of Balance Sheet**: Some articles fail to mention the value of the balance sheet when describing a transaction, while others have a footnote indicating that quoted averages include the value of the balance sheet. Generally, the value of the balance sheet, known as the tangible net worth, increases (if positive) or decreases (if negative) the value of the ongoing business dollar for dollar. Failure to extract the value of the balance sheet out of quoted deals, often leads to false indicators of value. To illustrate the great injustice of quoting an average without extracting the value of the balance sheet from the calculation, let's assume three deals, where all transactions have a gross purchase price of $800 and acquire an annual revenue stream of $500. All three transactions were quoted to have sold at 1.6 times revenues. However, for this illustration, each deal assumes a different tangible balance sheet. The first deal assumed in the purchase price $250 in value. The second assumed $100 in value. Finally, the third assumed $50 in additional liabilities. By extracting the value of the assumed tangible balance sheet, you will see that the actual revenue multiple of these three deals is different than the 1.6 multiple that was quoted. Obviously, any principal who was basing their estate planning on the 1.6 quote would be mislead.

Deal	Quoted Multiple	Gross Price	Revenues	Balance Sheet	Actual Multiple
A	1.6	$800	$500	$250	**1.1**
B	1.6	$800	$500	$100	**1.4**
C	1.6	$800	$500	($50)	**1.7**

Type of Business- Wholesaler vs. Retailer- Wholesalers (including MGA's, Program Administrators, E&S Brokers, etc…) have an entirely different business model(s) than Retail Brokers. Wholesalers have to share a piece of the commission revenue with the Retail Broker. Because of this revenue sharing process Wholesaler's margins are generally thinner, and they must operate more efficiently than Retail Brokers in order to get to the same level of profitability.

Another issue relating to Wholesalers is ownership of expirations. Retail Agencies have a relationship with a client who is an end user of insurance. Wholesalers generally only have a relationship with a Broker, and don't actually own the expirations. This lack of ownership will generally be viewed by a Buyer as more risky.

Because of these and a few other key business aspects (concentration of markets, loss experience, etc.), wholesale type operations will generally have a lower average value per net retained revenue dollar than a retail insurance operation. If you are a Wholesaler you would be ill-advised to use retail multiples in your estate planning process.

Overall, beware of cocktail party chatter and misinformation. Most deals that are done today are announced without describing the terms of the transaction. Read and listen to third party price chatter with a skeptical mind, because as you have most likely already realized, if it sounds too good to be true, it probably is.

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