MERCER CAPITAL

UNDERSTAND THE VALUE OF YOUR

INSURANCE BROKERAGE

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Soft market or hard market, it is important for insurance brokerage owners to have an idea of what their business is worth. A lack of knowledge regarding the value of your business could be costly. Opportunities for successful liquidity events may be missed or estate planning could be incorrectly implemented based on misunderstandings about value. In addition, understanding how insurance agencies and brokerages are actually valued may help you understand how to grow the value of your business and maximize your return when it comes time to sell. The purpose of this article is to provide an informative overview regarding the valuation of insurance brokerages and agencies.

WHEN DO YOU NEED TO KNOW WHAT YOUR BUSINESS IS WORTH?

SELLING OUT?

In the most obvious case, someone who is planning to sell their business needs to know what it is worth. Probably the hardest issue a business owner encounters is cashing-out their life's work. Beyond the myriad of emotional issues you will face is the raw economics of how you will sell and for how much. There are hundreds of issues that may arise in a transaction. Many of them ultimately affect the proceeds of the transaction to the seller. Knowing what you should be able to expect will let you evaluate whether or not an offer for your company is reasonable.

SELLING IN?

If you are planning on transferring ownership to your children or your management team, you will need to know what the interests in the business being transferred are worth. Depending on the circumstances, a small minority interest may be worth much less than a pro rata interest in the total value of the business. Ignoring this issue can cost you a lot of money.

BUY-SELL AGREEMENTS

Many business owners fail to understand the valuation implications of buy-sell agreements. If you have other shareholders in your business who are non-family, and maybe some who are, you probably have some kind of buy-sell agreement between the shareholders that describes how the business (or business interests) will be valued in the event of a shareholder dispute, death, or departure from the business (even on friendly terms).

In our experience, buy-sell agreements almost never sufficiently describe the mechanism to be used to value the business. The process looks simple when the buy-sell agreement is being drafted and a transaction is not on the table. However, when the day comes that a buy-sell agreement is invoked, you will want the process to be clear.

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VALUATIONS FOR FINANCIAL REPORTING

Have you made acquisitions of other agencies or books of business in the past? If so, how are those items recorded on your company's balance sheet? Does your agency have intangible assets such as customer renewals, expirations, non-compete agreements, or goodwill? Whether your business is a private company or a publicly traded firm, these types of assets require testing for impairment at least annually. For goodwill impairment testing, a valuation of the entire business may be necessary.

Maybe you're considering buying another agency in the future? Current accounting rules require that the consideration transferred be allocated to tangible assets, any identifiable intangible assets, and any excess to residual goodwill. In order to comply with these rules, a valuation of the specific intangible assets and possibly the underlying business itself may be required.

OTHER OWNERSHIP TRANSFER SCENARIOS

Most business owners are consumed with day-to-day activities of running the business. Many fail to acknowledge that life (and business) cycle events do happen to them, their partners and their families and that these events will require that their businesses be valued.

On the other hand, some business owners use business valuation as an essential tool for creating ownership stability and assessing management performance. Mercer Capital professionals have spoken for years about the "things that happen to you" and the "things you make happen."

The key take-away is this: an understanding of the value of your business or business interest is critical in preparing yourself for any of these eventualities. The following table illustrates the range of potential events that might trigger an ownership change.

The Business Transfer Matrix	**PARTIAL SALE/TRANSFER**	**TOTAL SALE/TRANSFER**
THINGS YOU MAKE HAPPEN	ESOP Outside Investor(s) Sale to Insiders/Family Combination Merger/Cash Out Going Public	Sale of Business Stock-for-Stock Exchange w/ Public Co. Stock Cash Sale to Public Co. Installment Sale to Insiders/Family ESOP/Management Buyout
THINGS THAT HAPPEN TO YOU	Death Divorce Forced Restructuring Shareholder Disputes	Death Divorce Forced Restructuring Bankruptcy

VALUE MANAGEMENT

Maybe you are not currently contemplating a transaction in your business. You do not plan to sell in the next few years, you are not planning on transferring it to your children, you are not entering into any buy-sell agreements or shareholder agreements based on the value of the business, nor do you anticipate any of the other events that might precipitate a valuation. Then why do you care? Because knowing the value of your business can be a tremendously effective management tool.

Ultimately, you will get two returns from your business – what we in the valuation community call "interim cash flows" and "terminal cash flows." Interim cash flows might be your salary, your benefits, and your dividends. You know what these are and what you can do to influence them. However, your biggest cash flow may be the terminal cash flow – when you go to sell your business. Are you managing your business in a way that increases its value or not? Do you know?

BASIC CONCEPTS THAT MUST BE DEFINED IN EVERY VALUATION

Before covering specific details related to the insurance industry, it is important to understand a few basic concepts related to valuation analysis.

It comes as a surprise to many business owners to learn that there is not a single value for their business. Numerous factors (legal, tax or otherwise) play important roles in defining value based upon the circumstances of the transfer of equity ownership. While there are significant nuances to each of the following topics, our purpose is to help you combine the economics of valuation with the legal framework of a transfer (either voluntary or involuntary).

THE VALUATION DATE

Every valuation has an "as of" date, which simply means that it is the date around which the analysis is focused. The date may be set by legal requirements related to a death or divorce, or be implicit, such as the closing date of a transaction.

THE PURPOSE OF THE VALUATION

The purpose of the valuation is important because it is linked to the transfer event (such as a sale, estate planning, etc.). A valuation prepared for one purpose is not necessarily useful or applicable for another.

THE STANDARD OF VALUE

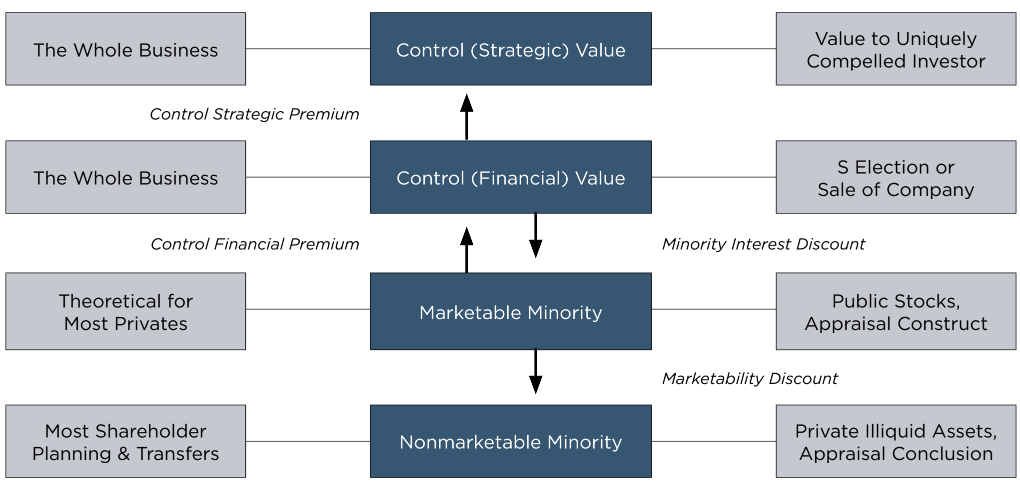
The standard of value is an important legal concept that must be addressed in every valuation assignment. "Fair market value," most commonly used in tax matters, is the most familiar standard of value. Other important standards of value include "fair value" (financial reporting purposes under GAAP), "investment value" (purchase and sale transactions), "statutory fair value" (corporate reorganizations), and "intrinsic value" (public securities analysis). Using the proper standard of value is crucial in obtaining an accurate determination of value. The standard of value will influence the selection of valuation methods, as well as the level of value.

THE LEVELS (PREMISE) OF VALUE

Does it make a difference in value per share if you own 10% or 75% of a business? You bet it does. The former is a minority interest and does not enjoy the prerogatives of control that the latter does. How does this affect value per share? The minority owners are relegated to bearing witness to a process over which they have no control or discretion. In effect, they often play the role of silent partners. They cannot control compensation or distributions, and they certainly cannot dictate the strategic direction or operational management of the business. Thus, the fair market value per share of a minority owner is likely worth less per share than the shares of a 75% owner.

To add further insult to injury, a minority owner of a private business likely has no ready market in which to sell their interest. Minority ownership in a publicly traded company enjoys near instantaneous liquidity given that such interests can be traded on organized and regulated exchanges. The unique uncertainties related to the timing and favorability of converting a private, minority ownership interest to cash gives rise to a valuation discount (marketability) which further distances the minority owner's per share value from that of a controlling owner's value per share.

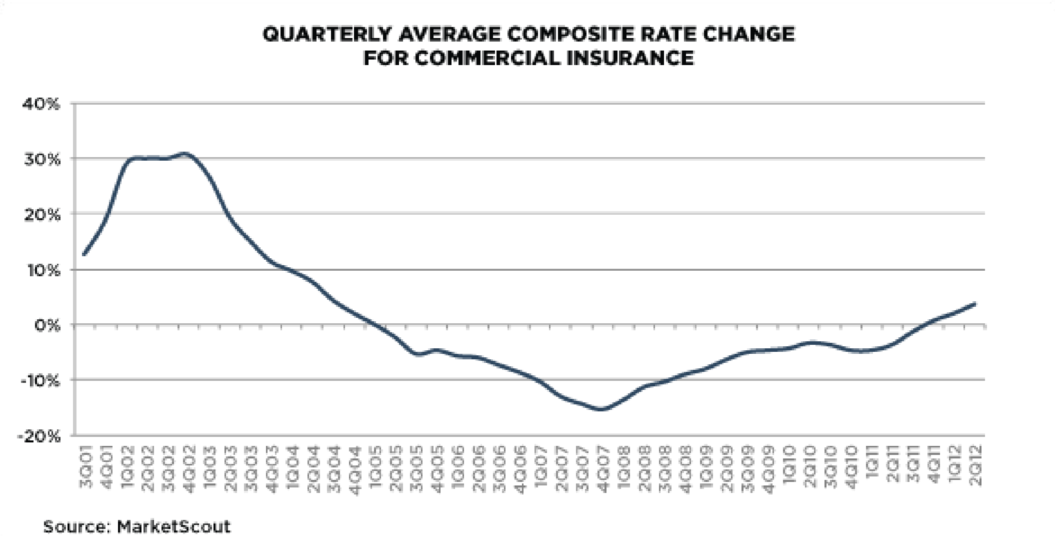
The following chart provides perspective of the various levels of value. In most cases a valuation is developed at one level of value and then converted to another level of value by way of a discount or premium. Knowing when to apply such adjustments and quantifying the size of these adjustments is no simple matter.



What does all this have to do with your business? A lack of basic knowledge of these concepts can leave you short of the required vocabulary and understanding needed to comprehend the context with which the value of a business interest is developed.

FINANCIAL CONSIDERATIONS

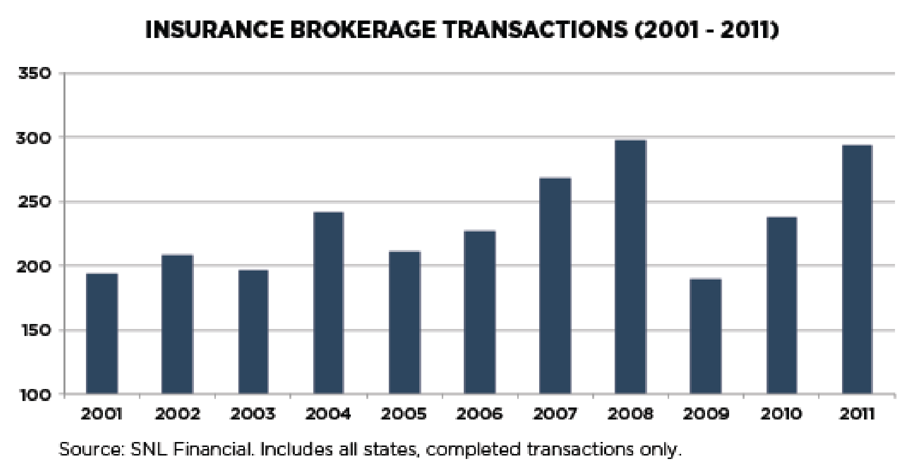
The financial health and outlook of an insurance agency should be assessed in the context of the overall insurance market. The trajectory of revenue and earnings have a lot to do with the timing in the insurance cycle. As the insurance market hardens, profitability is often enhanced in the short term, especially for renewals. On the other hand, softening markets tend to cause revenues to slow or contract – and when combined with weak macroeconomic conditions (such as rising unemployment), the negative effects are exacerbated.



As a professional service firm, much of the value of an insurance brokerage is inherently contained in the firm's customer base (or expirations) and in its producer workforce. Unless these types of assets have been booked in conjunction with an acquisition, a snapshot of a company's balance sheet may not reveal the true value of the company. So for many agencies, the most valuable assets of the business are not even carried on the balance sheet.

For companies with an active acquisition strategy, it is also important to measure revenue and earnings growth on an organic basis. Too much focus on top-line revenue growth can lead a firm to neglect its existing customer base and forgo valuable cross-selling and organic growth opportunities. Firms that rely too heavily on acquisition-based growth will find themselves standing still or declining when the M&A environment grows cold.

The average age of the typical insurance agency owner/producer continues to increase as well. Those agencies that have invested in training the next generation of producers and managers tend to stand out among their peers. Likewise, those agencies and brokers that have invested in new technology will be more attractive to new carriers, new customers, and even potential acquirers. As shown below, the pace of insurance brokerage transactions is returning to pre-financial crisis levels.



HOW DOES VALUATION WORK?

Without offering a full dissertation on business valuation, you need to understand that there are fundamentally three commonly accepted approaches to value: asset-based, market, and income. Approaches refer to the basis upon which value is measured.

Each approach incorporates procedures that may enhance awareness about specific business attributes that may be relevant to determining the final value. Ultimately, the concluded valuation will reflect consideration of one or more of these approaches (and perhaps several underlying methods) as being most indicative of value for the subject interest under consideration.

THE ASSET-BASED APPROACH

The asset-based approach can be applied in different ways, but in general it represents the market value of a company's assets minus the market value of its liabilities.

Investors make investments based on perceived required rates of return, and only look at assets as a source of rate of return. For an insurance brokerage, it is the income generated by these assets that typically drives the value of the business. For this reason, the asset-based approach is typically not the sole (or even primary) indicator of value.

THE MARKET APPROACH

The market approach utilizes market data from comparable public companies or transactions of similar companies in developing an indication of value. In many ways, this approach goes straight to the heart of value: a company is worth what someone is willing to pay for it.

In many industries, there are ample comparable public companies that can be relied on to provide meaningful market-based indications of value. In the insurance brokerage space, there are several publicly traded companies (think Marsh, Arthur J. Gallagher, or Brown & Brown), but comparing these large, diversified, increasingly global businesses to the typical private, independent brokerage can be problematic.

Acquisition data from industry acquisitions (typically a median from a group of transactions) can also be utilized as a multiple on the subject company's performance measures. This will often provide a meaningful indication of value as it typically takes into account industry factors (or at least the market participants' perception of these factors) far more directly than the asset-based approach or income-based approach. Given the large volume of transactions in the insurance brokerage industry, the comparable transactions method should be considered, particularly when valuing a controlling interest.

However, the market approach is not a perfect method by any means. For example, industry transaction data may not provide for a direct consideration of specific company characteristics. Say a company is a market leader and operates in a prime geographic market. Since the market and the specific company are relatively more attractive than the average transaction, the appropriate pricing multiple for this company is likely above any median taken from a group of industry transactions. Clearly, the more comparable the transactions are, the more meaningful the indication of value will be. Finally, caution must be exercised when utilizing data from market transactions since the circumstances surrounding each sale are often unknown.

THE INCOME APPROACH

The income approach allows for the consideration of characteristics specific to the subject business, such as its level of risk and its growth prospects relative to the market. The most common valuation methods under the income approach are the single period capitalization of earnings method and the discounted cash flow method. Under the single period method, the analyst estimates a base level of annual earnings and then applies a multiple to those earnings based on market returns. Under the discounted cash flow method, the analyst develops a discrete projection of future revenue, expenses, and cash flow, and then discounts those cash flows to the present at an appropriate discount rate.

So what about the old "1.5x revenue" rule of thumb for valuing an agency? A revenue-based multiple makes for a good shorthand way of expressing value, but it is rarely the method that acquirers with full information will actually use. Most buyers tend to focus on earnings and margin rather than on top-line revenue. When buyer and seller disagree on price, multi-year earn-out structures are often used to bridge the gap and align the interests of all parties to the deal.

SYNTHESIS OF VALUATION APPROACHES

A proper valuation will factor, to varying degrees, the indications of value developed utilizing the three approaches outlined. A valuation, however, is much more than the calculations that result in the final answer. It is the underlying analysis of a business and its unique characteristics that provide relevance and credibility to these calculations. This is why industry "rules-of-thumb" (be they some multiple of revenue or earnings, or other) are dangerous to rely on in any meaningful transaction. Such "rules-of-thumb" fail to consider the specific characteristics of the business and, as such, often fail to deliver insightful indications of value. A business owner executing or planning a transition of ownership can enhance confidence in the decisions being made only through reliance on a complete and accurate valuation of the business.

Agencies located in a fast-growing area or those with a unique industry and/or product niche can command premium valuation multiples. Exposure to certain types of business may also attract or repel certain buyers. For instance, agencies that place benefits products with small businesses may face additional risk given the uncertainty regarding the implementation of the Affordable Care Act and related health care reform measures.

From a valuation perspective, potential buyers are most often interested in some measure of earnings before unusual or non-recurring expenses, discretionary owner expenses, and owner compensation (in excess of market rates). The smaller the agency, the more likely there are to be normalizing adjustments to the company's income statement. The ability of a particular buyer to take advantage of synergies or operational improvements can also have an impact on value.

The historical growth rate of the business may not reliably indicate its future growth potential, or the risks of achieving that growth. Assessing the risk of an agency involves, among other things, looking at the overall quality of the book of business, the health and age of key employees, customer/carrier concentrations, investments in technology, and internal systems. Owners and managers that concentrate their efforts on improvement in these areas, rather than sheer revenue growth, will be well on their way to maximizing the value of their business.

CONCLUSION

Mercer Capital has long promoted the concept of managing your business as if it were being prepared to sell. In this fashion you promote the efficiencies, goals and disciplines that will maximize your value. Despite attempts to homogenize value through the use of simplistic rules of thumb, our experience is that each valuation is truly unique given the purpose for the valuation and the circumstances of the business.

Mercer Capital has valued many insurance brokerages, underwriters, and ancillary service providers over the years. We hope this information, which admittedly only scratches the surface, helps you better shop for business valuation services and understand valuation mechanics.

We encourage you to extend your business planning dialogue to include valuation, because sooner or later, a valuation is going to happen. Proactive planning can alleviate the potential for a negative surprise that could complicate an already stressful time in your personal and business life.

For more information or to discuss a valuation or transaction issue in confidence, do not hesitate to contact us at 901.685.2120.

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ABOUT MERCER CAPITAL

Mercer Capital is a national business valuation and financial advisory firm. We provide insurance agencies, brokerages, and underwriters with corporate valuation, financial reporting valuation, transaction advisory, and related services.

Since 1982, we have provided thousands of valuation opinions for corporations of all sizes in a wide variety of industries. Our suite of services includes corporate valuation, financial institution valuation, financial reporting valuation, gift and estate tax valuation, M&A advisory, fairness opinions, ESOP and ERISA valuation services, and litigation and expert testimony consulting. Our valuation opinions are well-reasoned and thoroughly documented, providing critical support for any potential engagement.

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