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BUSINESS VALUATION &
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How to Value Your Insurance Brokerage

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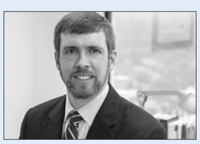

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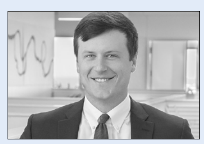

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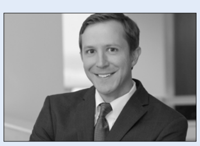

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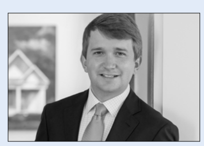

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An Introduction to Valuation

Many business owners tend to rely on industry rules of thumb when estimating what their company is worth. Aren't insurance agencies worth 2.0x revenue? Or is it 7x EBITDA? A platform agency must be at least 10x EBITDA, right? A lack of knowledge regarding the value of your business could be costly, leading to missed opportunities or inadequate wealth planning.

On a practical level, understanding how insurance agencies and brokerages are actually valued may help you understand how to increase the value of your business and maximize your return when it comes time to sell or perpetuate your agency. The purpose of this article is to provide an informative overview regarding the valuation of insurance brokerages and agencies.

When to Obtain a Valuation?

Insurance agencies exist within a mature industry characterized by cyclical pricing and headwinds or tailwinds based on local economic conditions. But whether the market is soft or hard, it is important for insurance brokerage owners to have an idea of what their business is worth.

Selling Out?

In the most obvious case, someone planning to sell their business needs to know its worth. One of the hardest issues a business owner encounters is cashing-out their life's work. But beyond the myriad of emotional issues you will face there are the raw economics of how you will sell and for how much. Hundreds of issues may arise in a transaction that will ultimately affect the proceeds to the seller. A valuation of your business will allow you to know what you should expect and to evaluate whether or not an offer for your company is reasonable.

Selling In?

Transferring ownership to your children or management team requires you to have a complete understanding of what the transferred interests 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

If your business has other shareholders, there is likely a buy-sell agreement between these 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). Many business owners fail to understand the valuation implications of buy-sell agreements.

In our experience, buy-sell agreements almost never sufficiently describe the mechanism to be used to value the business. The process always looks simpler when the buy-sell agreement is drafted and a transaction is not actually on the table. But when the day comes that a buy-sell agreement is invoked, a clear process and accurate understanding of value will allow for a much smoother undertaking.

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

Some business owners use business valuation as a tool for creating ownership stability and assessing management performance. However, since business owners are often consumed with the 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. Events like these will require that their businesses be valued.

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

Even those not currently contemplating a transaction in their business have a reason to consider a business valuation. Why? Because knowing the value of your business can be a tremendously effective management tool.

Ultimately, you will get two returns from your business – we in the valuation community call these "interim cash flows" and "terminal cash flows." Interim cash flows include things like your salary, your benefits, and your dividends. You know what these are and what you can do to influence them. However, your greatest cash flow may be the terminal cash flow (i.e., the value when you 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, we will first explore a few basic valuation concepts. Some business owners may be surprised to learn that their business does not have a single value, but rather, that its valuation is determined by numerous factors. Tax, legal, and other elements play important roles in defining value based upon the transfer circumstances. While there are significant nuances to each of the following topics, our purpose is to help you combine the economics of valuation with the relevant legal framework.

The Valuation Date

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

The Purpose of the Valuation

The purpose of the valuation is linked to the transfer event at hand (such as a sale, estate planning, or buy-sell agreement trigger). A valuation prepared for one purpose is not necessarily useful or applicable for another.

The Standard of Value

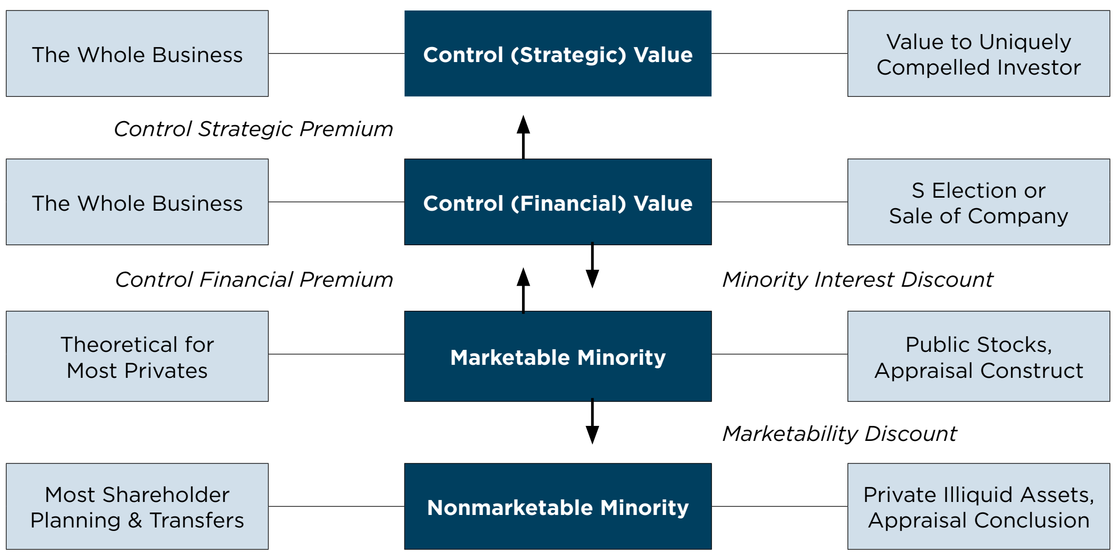
The standard of value is an important legal concept that must be addressed in every valuation assignment, as it influences the selection of valuation methods as well as the level of value. "Fair market value," most commonly used in tax matters, is the most familiar standard of value. Other important 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 Levels (Premise) of Value

Does it make a difference in value per share if you own 10% or 75% of a business? It absolutely does. A minority interest does not enjoy the same prerogatives of control that come with a majority holding. Minority owners are relegated to bearing witness to a process over which they have no control or discretion, and they, in effect, play the role of silent partners. Without the ability to control compensation, distributions, or to dictate the strategic direction of the business, the value per share of a minority partner is likely worth less 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.



What does all this jargon have to do with an agency valuation? Simply put, a basic knowledge of these concepts provides you with the required vocabulary and understanding needed to comprehend the context under which a valuation of a business interest is developed.

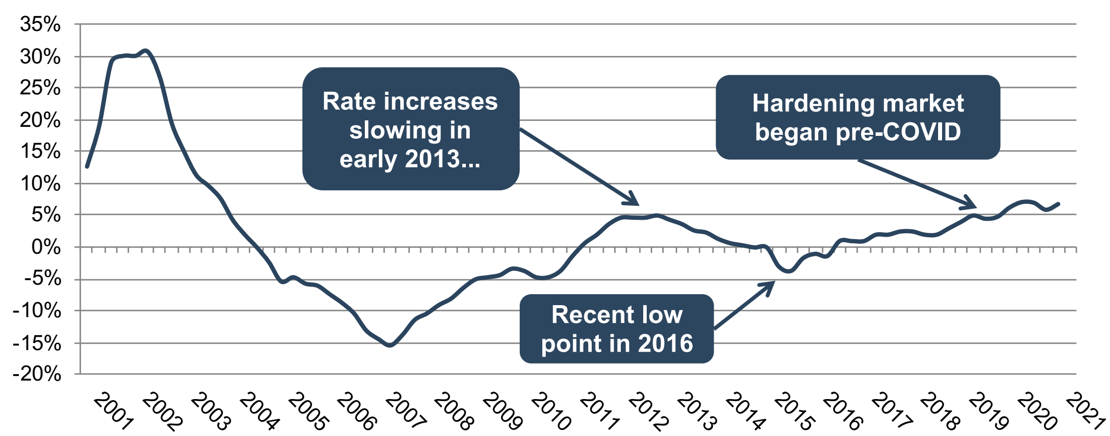
Industry Considerations and Issues

Beyond the valuation basics, there are certain characteristics of the insurance industry that need to be considered. A few of these characteristics are discussed below.

Hard Market or Soft Market

The trajectory of agency revenue and earnings is influenced by the current position in the insurance cycle, though not all products/services follow the same trends. 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, like rising unemployment, the negative effects are exacerbated. The chart below depicts quarterly rate changes for commercial insurance pricing, which has been firming since early 2017.

Quarterly Average Composite Rate Change for Commercial Lines Insurance (Yr/Yr % Change)



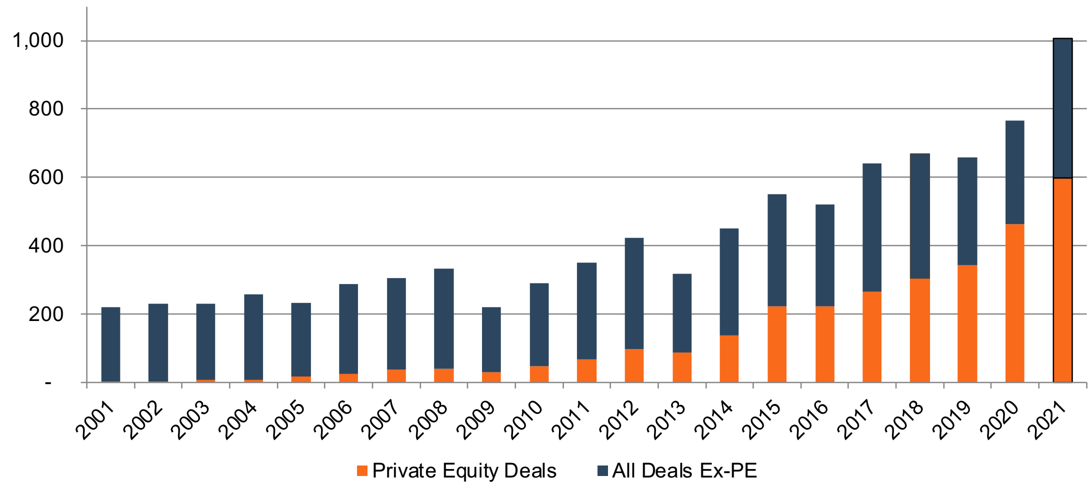
Source: MarketScout (2001 - Q3'2021), Mercer Capital analysis

M&A Environment

High multiples in an industry can cut both ways – higher multiples are obviously good for selling agencies, but they make growth via acquisition more expensive for buyers. For companies with an active acquisition strategy, it is 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 organic growth opportunities. Firms that rely too heavily on acquisition-based growth will find themselves slowing when the pipeline dries up or hampered by debt obligations from previous acquisitions.

Transaction activity has accelerated in recent years, driven by favorable industry dynamics, low interest rates, and aging owner demographics. Private equity's participation in the insurance brokerage industry has also driven demand and valuation multiples, with PE-affiliated deals now accounting for about 60% of overall industry M&A activity. Annual transaction volume set a record in 2021, with over 1,000 deals recorded for the first time.

Insurance Brokerage Transactions (2001 - 2021)

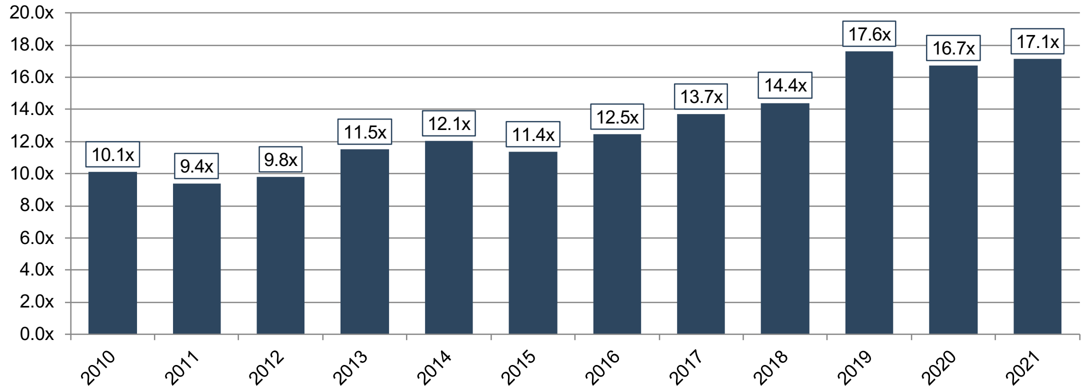


Source: S&P Global Market Intelligence (data through 12/31/2021)
Includes US deals, completed company & asset transactions only

Public Company Multiples

Comparisons of public company pricing multiples to smaller private agencies should be made with caution. Differences in size, growth, diversification, and risk can lead to valuation differences. For larger private agencies, though, market sentiment toward insurance brokers (as expressed through valuation multiples) should be considered. The observed average multiple of EBITDA for the public companies has moved higher since 2015, driven by a favorable macroeconomic trends, improving organic growth rates, stable/growing margins, and lower corporate tax rates. Public company multiples dipped slightly in 2020 given the uncertainty created by the COVID-19 pandemic; however, valuations have rebounded in 2021.

Public Broker Multiples (EV/EBITDA)



Source: S&P Global Market Intelligence, Mercer Capital analysis. Median multiple of Enterprise Value (EV) to Earnings before Interest, Taxes, Depreciation, and Amortization (EBITDA) . Includes AON, AJG, BRO, MMC, WTW

Other Factors to Consider

On an individual agency level, culture, leadership, and modernization matter. The average age of the typical owner/producer continues to increase and the agencies that have invested in training the next generation of producers and managers tend to stand out among their peers. Agencies that have invested in new technology (modern agency management systems, social media, web and mobile-friendly marketing, etc.) can further differentiate themselves from the competition.

Insurance technology (InsurTech) companies dominate the headlines and have been a favorite for venture capital and certain corporate investors, due to their differentiated take on a mature and established industry. While these companies have yet to upend the existing insurance distribution system, several startups have raised the bar when it comes to efficiency and improving the overall customer experience. According to CB Insights, InsurTech funding activity reached record levels in 2021, with global investment totaling $15.4 billion, an increase of 90% over the $8.1 billion recorded in 2020.

How Does Valuation Work?

There are three commonly accepted approaches to value any asset (or business): asset-based, market, and income. The approach refers to the basis upon which value is measured.

Each approach incorporates procedures that enhance awareness about certain business attributes, which 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) based on those most indicative of value for the subject interest.

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 act based on perceived required rates of return and only consider assets as a source of rate of return. For an insurance brokerage, it is the income generated by these assets rather than the assets themselves 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 some 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 Arthur J. Gallagher, Marsh, or Brown & Brown), but comparing these large, diversified, increasingly global businesses to the typical private, independent brokerage can be problematic.

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 can 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 will usually be considered, particularly when valuing a controlling interest.

However, the market-based 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. Some prospective buyers, particularly private equity firms, distinguish between platform agencies and bolt-on or fold-in targets. Pricing multiples for quality platform agencies can sometimes meet or exceed those observed for the public brokers. Clearly, the more comparable the transactions are, the more meaningful the indication of value will be, but 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. There are two common valuation methods under the income approach. Under the first, called the single period capitalization of earnings method, the analyst estimates a base level of annual earnings and then applies a multiple to those earnings based on market returns. In the second method, 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 sophisticated buyers tend to focus on pro forma EBITDA and margin rather than on top-line revenue. The goal of the income approach valuation is to determine what benefits the owner(s) will derive from a given company. When buyer and seller disagree on price or the level of "true" EBITDA, multi-year earn-out structures or hold-backs can be 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. However, a valuation 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" (like a multiple of revenue or earnings) 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, they often fail to deliver insightful indications of value. A business owner executing a transaction or planning an ownership transition can become more confident in the decisions being made with the benefit of a sound agency valuation.

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. The mix of carrier appointments can lead to new opportunities for a particular buyer or opportunities to consolidate business under a common carrier and qualify for more favorable commission and/or compensation arrangements.

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 will 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 agencies, 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.

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