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Agency Valuation Models

Business valuations are interesting especially given how valuation methods are abused, misused, misunderstood, butchered, and quite often manipulated.

I have spent a lot of time and brain cells on the subject of business valuations. To obtain my Certified Business Appraiser designation, I had to prove I thoroughly understood many valuation methodologies and even different conversion methods. Then I had to explain why different methods arrive at different results, which theoretically means, when different values are determined using the same valuation definitions, something is wrong with the analysis and/or one of the models, or a model does not apply to the situation.

The sky-high values of agencies today, along with some interesting footnotes in 10k's and press releases, causes me to wonder if buyers are using valuation models in such a way that an agency is valued one way for specific purposes and another way for other purposes. I'll begin with the basics.

1. Multiple of Revenue = Multiple of EBITDA. These are one in the same, except that people have convinced themselves and inadequately educated sellers, that multiple of EBITDA is "more sophisticated." Multiple of EBITDA is far more easily manipulated than multiple of revenue because revenue is usually one of the few numbers on which everyone can agree (other than should revenue include contingencies?). One should not forget that EBITDA is easily manipulated. In fact, EBITDA is <u>always</u> manipulated. It is always manipulated because it is ALWAYS, when done correctly, a pro forma EBITDA. Pro forma adjustments mean manipulating the numbers. The EBITDA used is not the actual EBITDA in the private market.

   Anyone who believes these are truly two distinct methods is inadequately educated. If an agency has a 25% EBITDA, and a value of 6.7X EBITDA, that is the same thing as 1.3X revenue. The only difference is that after analyzing the agency to determine cash flow, someone backs into the value as a multiple of revenue or a multiple of EBITDA.

2. Business valuations are not supposed to be like houses. Houses are valued as market comparables because houses do not generate cash flow. Especially with repairs, houses seem to consume cash flow.

   Businesses are ultimately supposed to generate cash flow. The value of that cash flow is the value of the business. The value of that cash flow depends on when the cash flow is realized and the risk that the cash flow will not be realized. The former is a function of the time value of money. The latter is a function of risk. Combined, the measure is known as a risk rate. A risk rate may be a capitalization rate, a discount rate, or an internal rate of return. The simplest is a capitalization rate.

   When valuing a business using a capitalization rate, one assumes (the formula demands this assumption -- it is not a choice) future cash flow is a straight annuity. The basic formula is:

   Cash Flow/Capitalization Rate = Business Value

3. Multiple of EBITDA = Capitalization Method. Multiple of EBITDA is nothing but the reciprocal of the Capitalization Method. If the EBITDA multiple is 6.7, the reciprocal is a (rounded) 15% capitalization rate. In both models, cash flow is anticipated to last forever without changing. How realistic is this?

4. A bastardization of the multiple of EBITDA method has definitely occurred with many users thinking this is a market method ("Hey, what are agencies going for these days? I heard 8 times EBITDA!"). The reality is that most sellers do not understand the Capitalization Method, so smart buyers flipped the formula to create Multiple of EBITDA. Most people don't understand the details there either, meaning they can be manipulated because they think they understand this method. The possibilities of being taken advantage of are significant.

5. The way actual honest and smart finance people do business valuations is usually a more elaborate form of the Capitalization Method (growth is at least addressed in this method as a constant or a version of the Discounted Future Cash Flow Method is used) because they recognize business cash flows are not permanent annuities. Give this some thought. If a buyer buys an agency and assumes no change in cash flow, ever, what are the implications?

   a.) No growth. The purchased agency will never grow.
   b.) To offset client losses over time, expenses have to be cut to maintain the same cash flow.
   c.) The result, with silent admission, is a wasting asset because client losses occur.

6. The opportunities then for every agency not selling should be obvious.

7. Returning to valuations, the key is determining what the Capitalization Rate (or its reciprocal, the multiple of EBITDA) should be. A couple of recapitalizations of private equity funded buyers suggest their multiple of revenue is valued at four times. If one assumes an EBITDA of 25% (the average operating profit of the publicly traded brokers for the last five years is just shy of 15%, with a before tax profit of 13%, and profit available to common stockholders of 11%), this equals a multiple of EBITDA of 16X! The reciprocal of 16X EBITDA is a capitalization rate of 6.25%.

8. 6.25% is an interesting number. It actually coincides with some recent market information I gained showing one private equity fund supplier (a large percentage of private equity fund suppliers are pension funds, often governmental pension funds). They stated their goal was around 3.5% plus inflation. Inflation was approximately 2.4% in 2018, for a total goal of 5.9%.

9. Here is the problem with the intersection of those two numbers: Someone is using a return goal for their capitalization rate rather than their actual cost. Maybe finance textbooks are wrong but Finance 101 stipulates the risk rate is not your goal nor even your actual cost of capital. Buyers are supposed to use, per finance bibles at least, the actual risk. Pitchbook's benchmarks suggest the IRR should be around 11%-12%. That puts the multiple of EBITDA at around 8.5 - 9.0 and the multiple of revenue at around 2.2.

Minor differences in value using different models are to be expected. Major differences must be explained. Either the model used is inadequate, the numbers used are wrong, or something is being manipulated. Significant suspicion is being given by many analysts and watchdogs to how these acquisitions are being accounted for now that Fair Value (absolutely <u>not to be confused</u> with Fair Market Value) has been adopted. Fair Value acquisition accounting has many, many problems but possibly the most important is that firms get to do their own valuations and they get to use loose standards.

Another interesting aspect is, using the publicly traded brokers' 10k's, their weighted average interest rate on their debt in 2017 (I haven't had the time to analyze their 2018 data) was approximately 4.5%. With a capitalization rate of 6.25%, the difference between their interest rate and a 6.25% capitalization rate is too small to account for the extra risk implicit to equity. Using the Butler-Pinkerton model and algorithm, they estimated the cost of equity for these brokers at between 10%-12% depending on the date. This is a much higher rate (meaning lower values) than the rate being used to value acquisitions and recapitalizations.

As of 1-1-19, the publicly traded brokers' average multiple of revenues was 2.9X suggesting the market has settled halfway between the Butler-Pinkerton estimate and the recaps. Maybe though the privately held and also private equity backed buyers are worth much more than their publicly traded peers, or maybe the valuation models are indicating something is amiss.

Either way, agents selling are hopefully more aware now of what they need to know. Agencies not selling now should have a good idea of their opportunities. Carriers needing growth should be able identify the issues they have to solve given the money behind consolidations and how that money changes growth models.

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Have you had your website audited for E&O?

If not, I recommend you do. Why? Advertising has a tendency to trump strict E&O standards of care.

You probably have heard ad nauseam that agents do not have duties to this or that, such as provide advice, check policies, find the best coverage or even find appropriate coverage, etc., etc. Technically, the attorney providing such advice may be correct but remember this: consumers do not need agents who do not provide these professional services. They really do not need them. Such advice plays into the commoditization of insurance. By not providing these services, you are defaulting to a commodity. Their advice is worse than worthless if you want a good future and want to avoid becoming a commodity.

Instead, advertise loud and proud everything you do. The only real catch is that you actually need to do what you advertise. Otherwise, you create an E&O exposure and possibly a false advertising issue. Understanding that if an agent really wants to follow those E&O attorneys' advice so that your standard of care is so low that you have no standard of care, and if you have no standard of care that means customers do not need you whatsoever, this also means you cannot advertise that you offer the best rates, the best coverage, professional services, expertise, risk analysis, or really, anything of substance. I suppose you can advertise you are nice and represent a bunch of companies or that you are amateurs and do not want to take any responsibility for helping your clients get the coverages they need.

I see a lot of agency websites promising all kinds of great things the agency does not provide or provides with little consistency. This is why websites need to be audited. A third party truly needs to see, with clear eyes, if promises from the consumers' perspective are being made that are not being consistently fulfilled by the agency. Advertising applies to all readers, not just the customers an agency likes best.

The most common advertising exposure I see results from hiring a third party marketing company that does not know insurance (or buying a site from one of the canned web site vendors). These firms want to make the agency look good so they create great taglines advising the agency provides this service or that service or high quality service when in reality, the agency does not provide those services. The agency owner is so impressed with the result, they forget they do not actually provide those services so they agree to greenlight the new website.

Another example of creating unnecessary advertising exposures is exactly the same mistake agents see their own clients make. The clients claim to provide specific services to look more sophisticated, but they do not actually provide those services. Then the agent sends an application to the carrier where the underwriter looks up the client's website and sees that the services shown on the website do not match the services shown on the application.

Agents do the same thing all the time, except that when agents advertise more sophisticated services, they create a higher standard of care requiring them to actually provide those services. Only advertise what you actually do, for all your customers, all the time, and at the quality level that matches your actual quality level.

Never greenlight a website without looking closely and determining whether the agency actually does everything the website promises -- unless you enjoy E&O suits. I find too that most agency personnel and agency owners do not see their own sites with adequate clarity to complete this evaluation themselves. Hire a third party qualified to do E&O website reviews (like my company). I can only speak for the way my company does these audits and we do them from the perspective of a plaintiff attorney which is of great value. Having a de facto friendly plaintiff attorney examine your advertising is a whole lot better than having an attack dog plaintiff attorney questioning you in a deposition or on the stand.

However, an even better solution is to actually improve the quality of your services so that your quality matches the advertising rather than diminishing your advertising to match your actual services. When agencies improve their game, lots of good things happen. First, your reputation improves because the quality of your service improves and it matches your advertising promises versus poor quality that falls far short of advertising promises.

Second, with better service the agency's customers are happier and happier customers are less likely to sue. Also, they have less reason to sue because service matches promises.

Third, with care, your services can often be stated in ways that achieve your advertising needs without increasing your E&O exposures. It takes some wordsmithing at times but this achievement is possible.

The funny thing about a good website audit is that agencies have the opportunity to reduce their E&O exposures and simultaneously improve their advertising and client engagement. The alternative, really, is to not have your advertising audited thereby remaining at a heightened risk of an E&O suit and dissatisfied or less satisfied clients. This latter issue may not matter to some since they are not being sued today. But just in case it does matter, most readers are in the risk management business which means proactively managing risks, so doesn't it make sense to get your site audited before you receive suit papers?

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Outsourcing - How agents can benefit by Norma Milne

This is not "new news" to you...the insurance industry and agency principals are currently experiencing a tsunami of retirements, challenges in recruiting and retaining qualified insurance professionals, the rapid evolution of technologies required to operate efficiently, all while complying with more stringent operational or regulatory requirements, and simply too much to accomplish within their workweek. You, as a businessperson looking to grow your agency, need to deliver on your "promises," often pronounced in your social media feeds/on your website, such as: "*Want personal, prompt and courteous service? We deliver!" "We understand your exposures to risk and provide comprehensive coverages." "Leave your insurance worries to us, at XXX."*

How can you also manage the costs of delivering on these commitments, and keep current with all these new requirements?

One way is by partnering with experienced professionals outside of your organization, so you and your internal staff can focus on tackling the risk management needs of your clients, growth opportunities, employee development and, hopefully, an improvement in client retention.

Outsource Accounting Functions?

While you expect large corporations to outsource, small and mid-sized agencies may benefit the most. When you’re looking to control costs, outsourcing an essential, but secondary function like accounting is a cost-effective option. You eliminate or reduce the expense of training, employing, and providing benefits to an in-house accountant, while gaining access to an entire team of accounting specialists. And, you spend less to get more. If you’re an insurance agent, you want to focus your energy and time on sales and service. You're running an insurance agency, not an accounting firm. By outsourcing your accounting and bookkeeping responsibilities, you're free to focus on your field of expertise and increase the productivity of your operations.

When you choose to outsource to a firm, you gain the expertise of an entire team. This ensures timeliness and reliability. Issues can be discovered sooner and resolved quicker due to the increased cross-checking of data. This minimizes errors overall and strengthens internal controls.

Risk Management: Consider the risk of theft and embezzlement. Fraud of this type can be committed only when the opportunity exists. An outsourced firm typically wouldn't have the same opportunity or access that an in-house bookkeeper does. When an objective third-party manages and monitors your financial transactions, it reduces that risk and its potential impact.

Outsourcing Customer Service?

Similarly, outsourcing routine insurance customer service and/or back office processing can provide a multitude of benefits. While cost reduction is one consideration, an agent adds capacity and flexibility by outsourcing. Hiring a firm that provides "customer service team members" allows your agency's in-house staff to focus on new business, marketing, account rounding and revenue enhancing goals.

Why not have those service needs handled via a website? Despite the perceived benefits of requesting policy service via an agency's website, there are many circumstances when insureds need to speak with an experienced customer service representative. Time is of the essence; insureds often have a pressing need for delivery of required documents, so they can go on to their next priority. The opportunity for the insured to ask questions, and the team member to make coverage suggestions, or identify gaps in the account, results in a positive outcome for both insured and agency. Prompt and personal service is handled in one call, leaving the insured very satisfied.

Outsourcing your IT and Systems?

Agencies have always been dependent on technology. Today, keeping your systems running and protecting your agency from Cybercrimes has become more difficult. Agents need to have monitoring of key systems in real time to identify issues as soon as they occur. If your current staff does not have this skillset, you really should consider outsourcing your IT.

Agencies of all sizes have the same fundamental needs when it comes to technology: staying connected and keeping company data secure. Outsourcing technology is an affordable and scalable way for agencies of all sizes to meet these needs on a continuous basis.

While all business models are different, insurance agents use the same tools to get their job done. Agency management programs, carrier websites and rating tools are all in your systems toolkit. Finding a company that can effectively manage your network security, and who has experience working with your software vendors and carriers is a Win-Win.

How to evaluate an Outsourcing Partner

The quality of a relationship with the firm you select will depend upon the time invested upfront, by both parties. Here are key considerations when outsourcing:

- **Expertise**: Look for a firm with credentialed leadership and staff expertise. Are they qualified to interpret accounting data, read financial reports, and explain these to your agency leadership and CPA? For insurance customer service, what level of insurance experience do the team members have in your territory and with your agency management system. For technology, ensure your IT partner has broad experience working with agencies similar to your own.

- **Internal controls/Best Practices**: The firm should have workflows that provide a review process by different staff members. Is there a Written Information Security Policy in place that ensures computer equipment is professionally monitored for threats, such as virus, phishing and malware intrusions? Cyber liability and professional liability insurance coverage should be in force. Make sure the IT firm has a local help desk; this will greatly increase your level of service and speed of issues resolved.

- **A proven track record:** Look for a firm that has been providing services in this space for several years and has a stable plan for the long term. Ask for agency references that match with what services you are seeking. Personally Identifiable Information is a huge risk for insurance agencies, so be sure to find a technology partner who employs best practices for information security.

- **Continuing education:** Ask how the firm handles team member education and expertise on your agency management software. For systems outsourcing, because IT is an ever-changing industry, select technology professionals who will recommend the latest tools to help improve your agency.

- **Expectations:** Define what duties/tasks you want the firm to perform. This process does take time and a commitment on both sides. Ensure you have a good fit, culturally and in expertise.

- **Communication:** Remain in regular contact with your new partner, seeking feedback and resolution as any questions arise.

- **Flexibility:** A quality firm will adapt to your business's needs and adjust to accommodate changes.

About the author, Norma Milne
Norma Milne, CIC, is the Business Development Coordinator for Virtual Insurance Professionals or " VIP". Prior to joining VIP, she was a Regional COO for a national insurance brokerage firm. She began her insurance career as a CSR in a twenty employee insurance agency.

Headquartered in Manchester, New Hampshire, VIP is a full-service firm that helps guide agency principals through the process of outsourcing their agency's customer service.

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Selling Insurance

Insurance is a complicated product. Period.

No debate use to exist relative to whether insurance was a complicated product. Complication was (is) obvious given the length of the policies, legal terminology, excessive use of prepositions, and the aspects that get insurance nerds excited: inclusions within exclusions and exclusions within inclusions.

Moreover, no one wants to buy insurance. 2+2=4. That is simple and the simple part is that when complexity is combined with massive reluctance and resentment to purchase, this equals consumer misery.

One solution for mitigating consumer misery is to make insurance seem simple. "15 minutes will save 15%" makes insurance seem exceedingly simple. "The average consumer saves $X when switching to..." makes insurance seem simple. The "commoditization" of insurance that has received so much press is really a misnomer. Insurance is not a commodity. A complex good, because it is complex, generally cannot be a commodity. A true commodity is a product that is always identical. Red winter wheat from one farm is the same as red winter wheat on another farm. With GMO seeds, the product is literally identical. Silver is silver once processed.

Insurance policies and claim practices between companies are not nearly the same. This is why agents actually still need to read the policies they are selling to avoid E&O claims. This is why it matters if a policy is an ISO policy versus a non-ISO policy. Policies are not identical and therefore, fail the test for commoditization. Is the goal the same? Yes, but the means and values are different. Therefore, the product is not a commodity, even in personal auto.

Instead, insurance is more easily sold by a certain kind of company/agent if that company/agent can convince the public that all policies are the same and therefore, the only difference is price. In other words, these vendors need to convince the public insurance is indeed a commodity, even though it is not a commodity. And they are pretty good at doing this.

Rather than commoditization, the result is really better described by the economist Carl Shapiro in his fantastic study, "Consumer Information, Product Quality, and Seller Reputation" (*Bell Journal of Economics 13*, no. 1 (1982): 20-35). He describes how, when a product is complex from the consumer’s perspective, mediocre vendors will always take advantage of the consumer and vendors providing higher quality services/products.

They do this by causing consumers to think they are getting the same product for a lower price. They may do this in a number of ways and often in the financial world, will reduce a quality decision to one number. This number may be a rating such as a rating company's rating of an insurance company. They know insurance agents and consumers and regulators look at one number/letter. Then they work backwards to figure out how to get to that number with a product/service that really does not deserve that rating but they qualify because they manage to check all the boxes. This may have happened many times in the credit crisis and was arguably a leading cause of the credit crisis.

I think this may be happening with some insurance companies today, but that is for another article. Relative to commoditization, the "one" number is a price. The silent message is that all insurance is the same and the consumer should not spend any time considering the coverage differences or claims practices. Then they go one step further and truly abuse the proper use of statistics because they only cite quotes that save money. For example, take the $300 saved when switching. The statistic may be correct, and statistics do not lie. The pictures people paint with statistics can mislead though. If 100 people get quotes from this company and 95 quotes result in premiums higher than they are already paying, but five do save money, then technically the tag line is correct because it includes the word "switch." If instead, all quotes were included, I am guessing the average savings would be less and the average savings of all quotes is a rather important point.

Another example is the focus on new business quotes vs renewal pricing. This is a rather interesting point because so many companies jack renewal rates. Therefore, new business quotes vs renewal pricing is really an apples to oranges comparison. Theoretically, with true actuarial based pricing, this difference should not exist. Consumers inherently get this but the companies play it to their advantage in two fascinating ways.

The first is that by advertising the consumer is saving $X on new business, they cause the consumers to think new and renewal pricing is the same. The difference creates an opportunity to gain new business on price.

The second interesting play is that companies are not exclusively, and maybe not primarily, using actuarial based pricing on either the new or the renewal. Instead, what they do at renewal is increase the price based on their price elasticity curve. A few insurance company people actually learned economics in college. They increase the renewal pricing knowing they'll lose a percentage of clients (to other companies encouraging insureds to switch for $X savings on average switch). The damage, if the pricing is designed well, is negligible because the extra money made with those who stay more than makes up the difference for those that are lost. Then they create stickiness in the initial sale because by saving a consumer so much initially, the consumer is likely to think they are always saving more with this company and will not shop as often resulting in paying more than if they shopped all the time.

These companies that focus the consumer on one number and the concept that all coverages and claims practices are the same are smart. As Shapiro stated, companies that focus on causing consumers to think they are getting more quality that they really are is an inevitable outcome of a free economy.

What are the rules for successfully selling a non-commodity financial product as a commodity?

1. The right kind of advertising is crucial. This means keeping it simple. Avoid all indication of complexity or differences between products.

2. Barely mention "insurance."

3. Use bad humor employed by cartoonish actors/animated characters.

4. Repeat, repeat, repeat, repeat, repeat, repeat, repeat, repeat, repeat. According to a report by *Coverager*, Oct. 16, 2018, Geico averaged 9.83 views per household of just one of their television commercials. They determined that to create enough sales and existing consumer brand knowledge, every household had to see that one advertisement almost 10 times.

5. Spend huge amounts of money on advertising. According to the same *Coverager* report, citing Alphonso & Statista (TV advertising data companies), Geico spent $232 million on television advertising alone (not including online advertising) in the last quarter of 2017. It is estimated in the article that Geico spends another 20% or so online. Call it $250 million plus per quarter which extrapolates to $1 billion plus per year. According to A.M. Best, the Geico subgroup rating unit (002933) writes approximately $30 billion in DWP annually. Advertising expense then is only between 3% and 4%. Advertising for Geico then is incredibly affordable.

   (Note: I am using Geico because I have access to these data points and because they have a successful strategy. I am not picking on them and I am not advocating for them. With the data available, I can more easily explain the market using their data versus other carriers although those carriers may be more aggressive, less aggressive, better/worse, more expensive/less expensive, and/or use all the strategies described or none. I also do not know with certainty if Geico uses the strategies described, and I do not mean to imply they do by including their specific results.)

Barring a few billion dollars available, and remember those billions have to be used on high quality adverting and corporate leadership, competing directly is not a wise decision. How then does an agent/company win with true quality and care for the consumer?

In Shapiro's analysis, the masses are lost in these situations involving complex products. Marketing is about the masses. So the solution involves selling. Selling is about the individual. Selling is about treating people as individuals. Selling is about taking the opportunity to custom tailor coverage for each individual. Selling is about identifying clients who care about the right coverages (the masses are lost) and converting those who would care if someone took the time to explain why they, the consumer, should care. Selling is about matching consumers' needs and budget with a policy that best fits their needs. Selling, in this environment at least, is about having the knowledge required to create a custom policy. The producer who does not know their coverages is like a tailor that cannot measure. The suit may not be off the rack and may technically be "custom," but it is mostly worthless.

If you want to learn coverage on a deep, custom and live basis, and learn to take the mystery out of the buying experience for clients, contact Burand Education and especially look into Three Dimensional Training®.

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Chris Burand is president and owner of Burand & Associates, LLC, a management consulting firm that has been specializing in the property/casualty insurance industry since 1992. Burand is recognized as a leading consultant for agency valuations, helping agents increase profits and reduce the cost of sales. His services include: agency valuations/due diligence, producer compensation plans, expert witness services, E&O carrier approved E&O procedure reviews, and agency operation enhancement reviews. He also provides the acclaimed Contingency Contract Analysis® Service and has the largest database and knowledge of contingency contracts in the insurance industry.

Burand has more than 30 years' experience in the insurance industry. He is a featured speaker across the continent at more than 300 conventions and educational programs. He has written for numerous industry publications including *Insurance Journal*, *American Agent & Broker*, and *National Underwriter*. He also publishes *Burand's Insurance Agency Adviser* for independent insurance agents.

Burand is a member of the Institute of Business Appraisers and NACVA, a department head for the Independent Insurance Agents and Brokers of America's Virtual University, an instructor for Insurance Journal's Academy of Insurance, and a volunteer counselor for the Small Business Administration's SCORE program. Chris Burand is also a Certified Business Appraiser and certified E&O Auditor.

Burand & Associates, LLC is an advocate of agencies which constructively manage and improve their contingency contracts by learning how to negotiate and use their contingency contracts more effectively. We maintain that agents can achieve considerably better results without *ever* taking actions that are detrimental or disadvantageous to the insureds. We have ***never*** and would not ever recommend an agent or agency implement a policy or otherwise advocate increasing its contingency income ahead of the insureds' interests.
