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Deal or No Deal

Understanding Valuation Multiples and the Value of an Insurance Brokerage

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The sale of an insurance brokerage and rumours of what “multiple” it transacted at spread fast, especially for those deals that boast abnormally high values or those that go for a ‘steal.’ Most people active in the insurance industry have likely heard stories of sale transaction multiples ranging from one to three times annual commission revenue. Is one, two or three time commission revenue a deal, or no deal?

It depends. Blindly applying multiples of commission revenue to arrive at a “guesstimate” of an insurance brokerage’s value is dangerous and relying on rumoured transaction multiples to set your own selling price could dramatically affect your retirement!

To the sceptics out there, we emphasize that no two sales transactions are the same. The terms and variables of a deal are numerous, complex and unique to each situation. Transaction terms can have a profound impact on price and, as such, adjusting price for the unique terms specific to the individual deal is critical in understanding the true price or multiple.

Still not convinced? Consider the difference between two deals that both transact for 2.5 times commission revenue with commission revenue being \$1 million. The one deal is orchestrated by Mr. Muskoka, a share arrangement with \$2 million up front and a contingent bonus paid after one year. The other is cobbled together by Mr. Trailorpark, an asset sale deal paid in three equal annual instalments with the same contingent bonus arrangement.

Compare the impact of the payment terms. Any deferred payment should be discounted by a rate approximating what one could otherwise earn on that money. Selection of a rate is the source of great debate in valuation circles, however, a rate of 5 per cent is a reasonable starting point (and makes the calculation easy). The impact of this is a 5-per-cent price adjustment for each year of payment deferral and an adjusted multiple from two to 1.9 – not a monumental shift in value, however, based on a \$2 million transaction, that is roughly \$100,000, which would cover the cost of a pretty nice boathouse in Muskoka.

Review also the difference between a share sale versus the purchase of a company’s customer list (asset purchase). The ability of the vendor to utilize the \$500,000 lifetime capital gains exemption saves a significant amount of tax expense, which might otherwise be paid to the public tax coffers. Based on the top marginal personal tax rate of approximately 50 per cent and a 50 per cent capital gains inclusion rate, the impact of this incentive from the government is roughly \$125,000 (depending on provincial tax rates) –

and is not available to Mr. Trailorpark (who is selling the customer list). The result affords a set of his and her jet boats to complement the boathouse for the vendor selling shares.

Finally, think about the affect of the contingent bonus payment as a component of the purchase price. For our Muskoka friend, life is good and his contingent bonus payment materializes. As luck would have it, Mr. Trailorpark's business erodes and he does not collect. Let's chalk up \$500,000 (\$475,000 when discounted) for Mr. Muskoka and now he can afford the lakefront property with cottage for his retirement years.

In review, Mr. Muskoka received gross proceeds equivalent to \$2.5 million and his after-tax proceeds are approximately \$2 million. Mr. Trailorpark, unfortunately, received the equivalent of approximately \$1.9 million and his after-tax proceeds are roughly \$1.4 million. That represents a variance in the effective multiple of commission income of more than 30 per cent and a variance in after-tax proceeds in excess of 40 per cent.

If you identified the flaw in the preceding example, well done. (You can't buy a lakefront property in Muskoka for \$475,000!)

As you can see, comparison of two transactions without knowing the terms is like comparing apples to oranges. Using commission income multiples to value a brokerage has its limits but with an understanding of the assumptions that the valuation multiples are premised on, it can be a very powerful tool.

To get an understanding of the value of an insurance brokerage, we need to assess the meaning and concept of value. We will then look at public market valuations and published transactions and finally follow up with a discussion of commission income multiples.

MEANING OF VALUE

Value is a financial concept and has numerous definitions depending on the context. For our purposes, let's assume that value of the future cash flows expected from a prospective investment – a purely financial investment. Certain insurance brokers may perceive additional "value" through ownership of a reputable name or being a prominent individual in the business community, however, these are difficult to quantify and are not common for every situation. This financial meaning mimics what one would use to define the value of a stock as a silent investor and excludes any emotional or impulse influences on value.

To quantify the present value of the future cash flows expected from a prospective investment, certain variables must be determined. These include a determination of cash flows (which requires an estimate of the profitability and applicable income tax rates) and an appropriate discount rate to reflect the time value of the money. To effectively estimate profitability, one has to determine an appropriate commission revenue base and corresponding expenses. Looking at historical operations as a proxy is a good starting point but if being absorbed into other existing operations, an analysis of only those incremental costs would be appropriate.

EBITDA (earnings before interest, taxes, depreciation and amortization) has been adopted as the most common measure of pre-tax profitability. Estimated taxes would then be applied to EBITDA to arrive at after-tax profitability. Depreciation and

amortization are excluded because they are non-cash items and because insurance brokers do not require significant investments in capital (albeit technology is becoming an increasingly important investment). The determination of an appropriate discount rate must not only reflect the time value of money, as discussed earlier, but must also quantify the risk that is associated with generating the projected cash flows. Both of these processes (determining profitability and determining a discount rate) require rigour and demand the use of realistic assumptions. Information and guidance about this process is readily available but is beyond the scope of this discussion.

The process of discounting future cash flows can be simplified if an assumption can be made that the earnings will remain stable or exhibit a constant growth rate. In an established industry like that of insurance brokerages, this assumption is considered valid and commonly employed. As such, rather than present valuing all years by using a certain discount factor, the constant earnings stream can be capitalized.

Mathematically, capitalizing an earnings stream is accomplished by taking the estimated future annual cash flows and dividing it by the discount rate. A 10 per cent capitalization rate (5 per cent for the value based on the above example and 5 per cent to reflect risk) would mean that future annual cash flows are multiplied by 10 times (or divided by 10 per cent.) A capitalization rate of 15 per cent results in annual earnings being multiplied by approximately 6.7 times (dividing by 15 per cent produces the same result).

VALUATIONS

The publicly available data presents a fairly consistent valuation landscape in Canada based on a review of valuation metrics for both Western Financial Group Inc. (WFG) and Hub International Ltd. (HBG) over the years 2000 to 2005. The valuation metrics include both commission revenue and profitability (or earnings) multiples. The commission revenue multiple is calculated by dividing the enterprise value (representing the equity value plus debt) of the company by its annualized revenue, and the profitability multiple is calculated by dividing the enterprise value of the company by its EBITDA (earnings before interest, taxes, depreciation and amortization).

Both commission revenue multiples and earnings multiples are common methods of valuing and communicating value for service businesses, and in particular, insurance brokerages.

The revenue and EBITDA multiples averaged two times and 10 times respectively and both traded in a tight range within approximately 10 per cent of these levels over this period. For an industry known by its troubling market cycles, valuation stability prevailed over a period of hardening markets portrayed by rising premiums and reduced capacity.

The financial details of most transactions involving insurance brokers are not publicly available as the brokerage industry is characterized primarily by private entities that are not required to disclose the details of their financial operations to the general public. Transactional information from public entities operating in the business, including WFG and HBG, is limited (and subject to the inherent limitations as identified above), however we have determined that the implied revenue multiples of many of HBG's acquisitions since 2000 (including most recently the acquisition of brokerages from Citizens Financial Group, Inc. in the United States) have been transacted on average in the one to two times commission income range. Royal and SunAlliance's subsidiary Johnson Inc. also bought

an Alberta brokerage, Morgex Insurance Group, for nearly three times commission income. EBITDA multiples was not available for these transactions however HBG has indicated that their target price for acquisitions is five to seven times EBITDA.

PUBLIC MARKET VALUATIONS, PRIVATE BROKERS

In summary, the market has valued the public insurance brokers at approximately two times commission income and 10 times EBITDA. Publicly announced deals in the brokerage industry have transacted at multiples of commission income slightly below this level.

A few comments should be made to better understand the relevance of these public market valuations and transaction multiples as they relate to the value of privately-held insurance brokerages.

- Public companies typically trade at higher multiples than their private counterparts because they have more capital and a liquid market for their capital or stock.
- Offsetting this somewhat is the fact that the valuations of public companies represent minority interests and as such trade at discounts because of the inability of any one individual to control any of the affairs of the company.
- Acquisitions represent the value of a controlling interest in a company and as such, often exceed the stock trading value of a given company. Further, potential synergies resulting from a transaction can increase transaction values even further from the stock trading value.
- The EBITDA multiples are based on actual, historical EBITDA results and as such, the valuation multiples represent current value relative to past performance rather than future or anticipated performance. This tends to suppress the multiples of growing businesses and does not mirror the definition of value identified above (being the present value of future cash flows).

COMMISSION REVENUE MULTIPLES

Commission revenue multiples are more generically known as rules-of-thumb (ROT). Various industries, including the insurance brokerage industry, have broadly accepted value measure. Rather than determining value based on the company's profitability or earnings as discussed above, value is based on certain operating or activity ratios, such as commission revenue.

Other industries and businesses that commonly employ ROT include radio and television stations, newspapers, laundries and dry cleaners, hotels and funeral homes. ROT approaches have evolved in industries where there is a high incidence of similar suppliers, customers, common business methods, and where costs and revenues are fairly predictable – as such insurance brokers have developed ROT based on levels of commission revenue.

Since economic, social and business environments constantly change, the current application of a value factor may produce incorrect results. For the insurance brokerage industry, the impact of insurance cycles, the current interest rate environment and the

extent of government regulation (insurance coverages, premium rates and competition from financial institutions), all can have a dramatic affect on the valuation landscape and the prices that are realized in the industry.

At the risk of stating the obvious, not all insurance brokerages are alike and as such, the use of a generic multiple would not reflect the unique characteristics specific to the particular brokerage. While two insurance brokerages may have the same gross annual commission revenue, certain factors that often influence value because of their impact on cost ratios and profitability, brokerage risk and marketability include:

- Mix of business (types of policies and the inclusion of sub-broker and life and other financial products with marginal renewal commissions).
- Volumes of business.
- Insurers and the relationship with those insurers.
- Existence of group programs.
- Number, size and age of customers.
- Location, competition, history and growth prospects.

CONSIDERATIONS

Based on our experience and knowledge of hundreds of sales transactions with multiples ranging across the board, we offer the following considerations when using multiples:

- Value positively correlates with earnings. The more profitable a business is, the more it is worth. A solid understanding of the operating margins on the existing business and prospective operations are necessary. The importance of this point cannot be overemphasized.
- Value is based on prospective earnings. Client retention is critical in achieving strong levels of future earnings. Retention rates of approximately 90 per cent are set as targets for transitioning business. Having the prior owners agree to management contracts over a transition period with corresponding non-competition and non-solicitation agreements in place positively affect retention levels.
- A multiple of commission revenue should be used to assist in the determination of the goodwill value represented by the customer list only, and not the value of the entire brokerage. Assets or cash reserves, in excess of those required to meet the current obligations of the business (such as a \$500,000 GIC or real estate property not used in the business), are not considered or reflected in the value concluded through the use of multiples of commission income. As such, it is necessary to incrementally add the value of any net assets to the value of the brokerage.

IN THE EYE OF THE BEHOLDER

Let's assume that ABC Brokerage may be "worth" two times commission revenue and is earning a pre-tax profitability (or EBITDA) of 20 per cent commission revenue. This

implies that the business has been valued at eight times EBITDA. At the other end of town XYZ Brokerage is earning profitability (or EBITDA) of 40 per cent. Using the same eight times EBITDA multiple, this implies that the brokerage should be valued at four times commission revenue. So, as ABC Brokerage at two time commission revenue, or XYZ Brokerage at four times commission revenue, a deal?

Like beauty, value is often “in the eye of the beholder.” Just make sure you have your glasses on! While it is always prudent to get a second opinion from a trusted advisor or an industry expert whenever assessing the value of a brokerage acquisition or sale, there is no substitute for personal confidence that comes through a genuine understanding of value when considering strategic options.

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