# Valuation Issues Related to Insurance Agency Operations

Def$^{n}$: **Valuation**: A process of determining the worth of a business entity on the basis of cash flows derived from operations.

# Reasons for Insurance Agency Valuation

- Determination of a Buy/Sell Agreement for Ownership Parties
- Expansion of the Business creating additional value
- Family Financial Planning Considerations
  - Retirement
  - Transfer of value to family members
  - Estate Planning / Change in Tax Law
- Change in Marital Status
  - Marriage
  - Death
  - Divorce

# Reasons for Insurance Agency Valuation

- Unexpected acqusition offer
  Another Agency, Insurer, or Financial Institution

- Transition of the Insurance Agency to up and coming family members
  E.G. Son or Daughter gets insurance degree begins work in the Insurance Agency

# Current Financial/Economic Trends Contributing to the Interest in Insurance Agency Valuation

- Increasing Use of Computer/Communication Technology to enhance policyholder Services: Capital Requirements, Economics of Scale, Financial Risk Reduction

- Movement towards Consolidation of financial Service: Repeal Glass Steagall Act Consolidation of Insurers, Banks, Brokerage, Real Estate Firms
  - Interest in acquiring Agency Cash Flows

- Demutualization within the Insurance Industry / Causing Insurers to seek to acquire well run agencies.

- Aging of the Post Baby Boom Population Stimulating interest and use of insurance products / financial planning

- Demographic transition within the Independent Agency System - As agents move towards retirement, focus may be on developing a stable plan to transfer the value of the business

# Methods of Valuation and Their Informational Requirements

3 Different Approaches

① **Discounted Cash Flow Analysis**

Finding the present value of expected future cash flows at an appropriate discount rate.

- Determination of cash flows relevant to each area of the business

e.g. 1st year & Renewal Commissions
Differences between P/C & Life Only
Product mix Considerations

- Calculation of a discount rate directly tied into the cash flows derived from the Agency
  - Cost of equity when valuing the equity only
  - Cost of capital when finding the value of the firm

② **Relative Valuation Approach**

The value is determined by pricing comparable assets of other firms / industry average using standardized common variable such as, earnings, cash flows, P/E, profit or commission multiple, revenues or Book Value

- Finding a Strong Comparable Rel=ship

Informational Considerations:

Private Agency vs. Public Information

Market Difference

Control Premium Issue

Differences in Product Mix

Difference in Growth Potential for Various Regions & Demographic Characteristics

- Using fundamental Variables to Calculate Value

Establish multiple to the fundamentals about the agency being valued - growth rate of earnings, cash flows, P/E, price to Sales, price to book value.

- Using Comparable Agencies operating in a way Similar to the Agency being Valued.

Key issue: What are the measures that need to be Comparable? You would like to be able to control for each Variable that determines value. However, given the dynamic nature of the insurance business that is not completely possible

E.G. Cincinnati Eating Disorders Clinic
- new idea / no direct comparable

Limitations of Using Multiples

- No two agencies are exactly the same
- Potential for biased results depending on the set of comparable

③ Contingent Claim Valuation

Valuation is based on pricing the option to purchase the assets of an agency at a specified price for a specified period of time. This method uses option pricing theory to calculate value.

An option price depends on the Current Value & the Variance in Value of the assets, the Strike price, time to expiration of the option, and the risk free rate of interest.

## Practical Informational Requirements

1. Market for the underlying assets and a historical record of Value to find The Variance

2. A market for the option - buyers and sellers along with an outside guarantor of option performance

③ Relatively Short time horizon –

Assumptions about constant Variance & dividend yields are not likely to hold up over periods of 6 month or longer.

## Common Myths & Misunderstandings About Valuation

Lies we tell each other

① Since Valuation Models are quantitative, Valuation is objective

When Valuation is being done by another party, the biases of the analyst needs to be considered.

② A well-researched and well-done valuation is timeless.

A valuation is impacted by firm specific, as well as, market wide variables that change over time.

③ A good valuation provides a precise estimate of value.

With any valuation there will be uncertainty about final numbers, influenced by assumptions that are made about the future of the company & economic conditions.

④ The more quantitative the model, The better the Valuation.

Models are Segments of reality – their usefulness is limited according to the applicability of the inputs to approximate reality. More data $\neq$ necessarily Better information

⑤ The market is generally wrong

The benchmark Comparison for many Valuations is market price. When a Valuation differs from market price either the Valuation is wrong, and market price is right or Vice versa. The presumption Should be That market price is right – Analyst needs to prove otherwise.

⑥ The End Result of Valuation (the Value) is more important than the process of Valuation.

Focusing on just the outcome of Valuation may obscure the determinants of Value and what make an insurance agency important.

Understanding Valuation Based on the Perspective of the Market Participants

**Franchise Buyers**: Concentrate on owning a few businesses they understand well & attempt to acquire undervalued firms.

E.g. Berkshire Hathaway

Value may vary markedly due to differences in taxes, cost of capital, time horizon between buyer & seller

Information Traders: Focus on the relationship between information and changes in value, rather than on value per se.

(Buying on good news in hope that further better than expected news will increase the price of the business)

E.g. Dot.com stocks in 1999-2000.

Whether one utilizes this perspective may depend on status as a buyer or seller

A seller may be able to take advantage of a market premium during prosperous times. A buyer runs the risk of overpaying particularly if the purchase price > fundamental value.

Efficient Market Participants: Believe that the true value of an enterprise is embedded in its price. The market price at any given time is the best estimate of firm value.

E.g. Stock prices for large cap firms with high trading volumes

Limitations:

The Market for Insurance Agencies/ Businesses may be inefficient due to:
(1) Informational Asymmetric (Some people know more than others) (2) Proprietary difference (3) Economic Barriers to Entry (4) Unique Services and/or Key Personnel

Note: Efficient Markets is a good theoretical concept to explain market clearing and competitiveness. However, it may not be too practical when applied to valuation of firms in thinly traded markets, with unique features.

Question: If the stock market is efficient why can there be such a large, consistent discrepancy in returns from some individuals vs. market?

| | Book Value/shr. Berkshire Hathaway | S&P 500 with Dividends |
|---|---|---|
| Avg. Annual Gain 1965-2000 | 23.6% | 11.8% |

# Issues to Be Considered When Valuing An Insurance Agency.

① Fit the Features of the Agency to an Appropriate Model rather than Vice Versa Selecting a model and then fitting the agency into it. (round peg, square hole)

Discounted Cash Flow Models:

Potential Cash Flow Streams to be Used:

- EBT
- EBIT
- Free Cash Flow
- NI
- NOI

Commission Income

Discount Factors: Cost of Capital
Cost of Equity

Selection of these variables relates in part to the way the Agency is

(1) Owned - Proprietorship, Partnership, Corporation

(2) Financed - Debt / Equity / Leased

(3) Taxed - marginal rate, corporate rate

(4) Generating Income - mix of business, agency contract, ownership of business

② When using the relative valuation method seek comparables that closely approximate the operating conditions of the target valuation agency.

Similarities in terms of:

- Size
- Mix of Business
- Leverage / Liquidity
- Efficiency / Profitability
- Market Area

The model should not be driven by the availability of data, but whether the comparables fit to the valued firm.

If none of the comparables fit don't commit to using them.

③ Valuation is more art than science. A good valuation should lay out assumptions and value under a number of alternative scenarios. Sensitivity analysis may provide useful information about the dynamic nature of a business firm's valuation.

E.D. Baldwin-United - Interest Rate Sensitivity

Good Assets / Bad Assets

(4) If possible a valuation should be completed under a number of different methods with varying assumptions offering a range of value. A case then needs to be made why one value may be superior to another. In addition, the valuation should be placed in the context of agency being valued.

E.G. The preamble to the valuation should clearly state the purpose and use of the analysis.

Dubuque Data