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Valuing a UMA OR SMALL BROKERAGE

There comes a time in the life of every underwriting management agency (UMA) or small brokerage when the option of selling the business may be considered. When this situation arises, one of the biggest challenges is valuing the company and agreeing on a selling price with an interested party.

According to Douglas Haig, corporate finance consultant at Lireas, the key is to realise that the value of any business is what someone else is willing to pay for it. Negotiation is therefore the only way to bridge the gap between the buyer's valuation and the seller's price.

"Negotiations should always be conducted openly and honestly. Although the seller is entitled, indeed expected, to put his best foot forward, all significant issues should be disclosed upfront. Nothing sours deal negotiations faster than undisclosed issues making a late appearance," says Haig.

Haig lists the following as common mistakes owners make when valuing their UMA or brokerage.

1. Believing that there is a magical formula that determines the value of a business. Every business deal is unique and therefore the valuation should take account of buyers, sellers and the purpose of the deal.
2. Only looking at past performance and ignoring the company's current structure and future prospects.
3. Applying a hockey-stick sales growth forecast approach. This often occurs when a constant premium growth rate of say 15 per cent per annum is forecast, which then in effect compounds the Rand growth annually. Forecast growth should always be linked to the actual activities that will drive the growth; for example new products, price increases or marketing campaigns.
4. Not testing the valuation assumptions rigorously enough. Often owners can get so engrossed in the detailed calculations that they forget to assess the reasonableness of

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the outputs. A good way of stress testing the assumptions is to put yourself in the other party's shoes: would you pay that much if you were buying a similar business?

5. Falling for an unrealistically high initial valuation. This technique is usually employed by aggressive buyers to entice unwitting sellers. However, once the deal negotiations get underway, the buyer uses any number of reasons to whittle down the value.

Haig says a major challenge for owners is using the emotion that can come through from the seller's perspective in a positive way. "Although business decisions need to be made rationally, the blood, sweat and tears required to make any small business successful means that this element can never be fully eliminated. Passion is a key part of any successful business and this passion needs to flow through to the deal. A buyer will be more inclined to pay a higher price if he experiences the passion in the business first hand. "That said, an independent professional valuation is the best way to get a realistic view of what your business is worth. This will not eliminate the emotion in a deal, but it does give a solid platform from which to negotiate." He adds that when using the services of a professional valuator, be sure to use someone who understands the industry and has experience in valuing similar businesses. "Remember that the price must still be agreed between the parties involved.

A professional valuation will act only as a guide." Another key consideration is to decide on which valuation method to use. "There are a number of methods used in practice, each with its benefits and drawbacks. At Lireas we believe a good approach is to apply at least two valuation methods and see how far apart the resultant values are. This is a good way to check a valuation," adds Haig.

Price-earnings multiple

The most commonly used method of checking a valuation is the price-earnings multiple, where an industry-related multiple is applied to the previous year's profit after tax. Although this is a very simple method, it is backward-looking and does not place any emphasis on a business's future cash flow prospects, which, in essence, is what is being sold.

A sensible enhancement of this methodology is to use the weighted average profit after tax over the previous three to four years and next year's budget. This ensures that one-off items such as profit commissions and cyclical fluctuations are smoothed out, and allows the current YTD performance and budget to be considered. Each period is given a different weight according to its significance (most recent years would normally carry highest weightings). Lireas has concluded many deals over a number of years and PE multiples of 3.5 – 6 appear to be the market norm in this sector.

Discounted cash flow method

Conceptually, the discounted cash flow method (DCF) is the most correct method and will usually always be included in a professional valuation. The overriding principle is very simple: the value of the business is the present value of the future cash flows it will generate.

The DCF is dependent on the following key inputs:

- A forecast of future cash flows. This is generally a five-year forecast, which represents the future performance of the business given its current structure, expense ratio and future prospects, including any synergies arising out of the deal. The forecast is done on a cash basis, therefore not influenced by accounting adjustments such as depreciation or deferred income.
- A discount rate to determine the present value of future cash flows. This is essentially the rate of return that the buyer requires on the investment, and takes account of the risk that the forecast cash flows will not be achieved (15 to 30 per cent is currently the norm).

The benefit of using a DCF valuation is that it demonstrates very clearly to the buyer the return on investment that can be expected given a specific price.

Book of business method

This is a very common method used when valuing brokerages. It is similar in concept to the price earnings method, except that it is the gross annual premium that is applied to an industry-related multiple rather than the net profit. In this way, the book of business or customer base of the business is valued.

This method is useful when the seller's business structure and cost base will be dissolved and absorbed into the buyer's operations. Haig says owners should be aware of the main factors that can increase or decrease the perceived value of a small business. "Factors that generally increase value include a sound succession plan, a competitive edge or unique sales proposition that will drive future growth and synergies that can be achieved. The concept that 1 + 1 = 3 is always a key driver of mergers and acquisitions and therefore identifying potential synergies makes the deal even more attractive. Factors such as a new distribution network, achieving critical mass, or just administrative cost savings all have a value that can be used to increase price."

Factors that generally decrease value include a lack of resources in the company or limited prospects, poor accounting records, outstanding tax, legal or employment issues and poor historical performance.

Due to the current market conditions in the insurance industry, Lireas believes that merger and acquisition activity will increase significantly in the short term. Business owners would do well to bear some of these principles in mind when embarking on the journey of buying or selling.