INS Capital Group

Commission vs EBITDA Multiples?

Finding the best method to value an insurance agency

The level of knowledge regarding insurance agency acquisitions in the industry has increased significantly since I started to do deals 10 years ago, which is encouraging. However, several times a month I still have conversations with sellers or buyers who say, "I would never sell my agency for less than 2.5x commissions" or "You should never pay more than 2x revenue, that's crazy."

While these discussions are less frequent, they still happen far too often. Over the years, I have read articles that do a nice job of explaining the differences between buying/selling an agency for multiples of commissions vs multiples of EBITDA (Earnings Before Interest Taxes Depreciation and Amortization). What I don't see are articles that explain ***why*** the differences in the two methods really matter.

Below are examples that show why it is so important an agency is priced using the proper methodology. Also, think like a buyer while you are reviewing the information to gain the most insight.

Assumptions	
1	Buyer Cash Down = 10%
2	Seller Note = 20% (5 yrs at 5%)
3	Bank Financing = 70% (10 yrs at 7%)
4	Tax Rate = 35%
5	Asset Sale vs Stock Sale

The first scenario represents two hypothetical agencies with identical revenues, where both sell for 2x commissions. At a quick glance, it is obvious why the commission multiple methodology fails when looking at Agency B. Oversimplifying the value of an agency, or any business for that matter, can lead to disastrous results for a buyer. Failing to understand the amount of cash flow an acquisition target is generating could put the buyer in a bad place before the honeymoon period is even over.

Commission Multiple Example				
		Agency A		Agency B
Revenue	$	1,000,000	$	1,000,000
Expenses	$	650,000	$	800,000
EBITDA	$	350,000	$	200,000
Price (2x Commissions)	$	2,000,000	$	2,000,000
Price (EBITDA)		5.71		10.00
Buyer's Net Income*	$	24,000	$	(73,000)
Buyers ROIC		12.0%		-36.5%

**after paying debt service & taxes*

A key point to understand is that Agency B likely would not sell at $2M since banks don't lend money to facilitate a deal that doesn't generate enough revenue to pay back the loan. It is possible the seller gets lucky and finds a buyer with cash. If that is the case, please refer the buyer to me so I can sell them a piece of Indianapolis' most exclusive oceanfront property.

A cash buyer for Agency B could restructure the expenses of the agency and come up with a scenario in which he or she cash flows and most buyers will do this to some extent. However, Agency B's initial asking price of $2M, based on their EBITDA level, would prohibit most serious acquirers from even entertaining the exercise, as it is likely an act of futility.

Let's look at a second scenario with the same two agencies. This time, the asking prices are based on multiples of EBITDA.

EBITDA Multiple Example				
		Agency A		Agency B
Revenue	$	1,000,000	$	1,000,000
Expenses	$	650,000	$	800,000
EBITDA	$	350,000	$	200,000
Price (6x EBITDA)	$	2,100,000	$	1,200,000
Price (Comm. Multiple)		2.10		1.20
Buyer's Net Income*	$	14,000	$	8,000
Buyer's ROIC		6.7%		6.7%

**after paying debt service & taxes*

A couple of numbers jump out when looking at the figures above. First, there is a dramatic difference in the prices of the two firms. Agency A's purchase price is $900,000 higher than Agency B. The reason? Agency A's EBITDA is 75% higher. At the most basic level, a business that generates greater cash flow should be worth more than a peer who is generating significantly less, right?

The second figure that stands is the buyer's Return on Invested Capital (ROIC - in this scenario is the amount of cash they put down at closing). The ROIC is the same for both businesses, which was not the case when we used commission multiples in the first scenario. This shows that when all other variables are equal, using the same EBITDA multiple to price different businesses allows the buyer to see the highest amount they could pay to receive their desired ROIC for each firm.

Why should a seller care?

If you are a seller reading this, you may be asking yourself, "Why should I care what a buyer's return is? It doesn't help me." If your agency's selling price is based solely on receiving a certain dollar amount to finance your retirement, you need to rethink your strategy. There is no correlation between the value of a business and a seller's retirement goals. It is estimated that 80% of

businesses for sale ultimately do not end up selling[1]. Based upon my experience in reviewing M&A transactions, a clear majority of those businesses are listed for an unrealistic price. In the end, sellers waste valuable time and money trying to "pitch" buyers on why their agency is worth their inflated asking price, without ever considering how a buyer analyzes the opportunity to purchase their agency. In addition to the inevitable toll it takes on a seller's wallet, it also leads to a considerable amount of stress.

However, the most damaging result of this mistake is that sellers are alienating the most probable buyers for their firm. Too often I work with clients who cost themselves the chance to get the most value from their business by eliminating the most obvious buyers from their pool of candidates. In many instances, the buyers moved on to a better target, or did not want to waste their time and resources taking a second look at an agency that was overvalued from the start.

What could be worse than alienating potential buyers? Underestimating the value of your firm. By using a commission multiple, you may be leaving a large amount of money on the table by not understanding how potential suitors are going to evaluate the opportunity to purchase your business.

In summary, while M&A knowledge has come a long way in the last 10 years, there is always room for improvement. Hopefully this article provides a better understanding of not only the differences between pricing a business using commission vs EBITDA multiples, but also ***why*** there is such a substantial difference between the two methodologies.

About INS Capital Group

INS Capital Group, LLC is an M&A and Capital Solutions advisory firm specializing in the insurance industry. Over the past 10 years, our advisors have been a part of over 150 insurance transactions representing over $250M in transaction values. Our clients include Retail Agents, MGAs and Program Administrators. To find out more visit our website, www.inscapitalgroup.com, or contact us at info@inscapitalgroup.com.

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[1] https://www.bizbuysell.com/buyer_resources/industry-statistics-every-buyer-should-know/14/