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Noncompete Agreements, Cash Flow and Loss Ratio Are Key to Insurance Agency Valuations

WEYMOUTH, MASS. — Having a healthy cash flow and loss ratio of less than 50% in addition to having noncompete agreements in place are among the key drivers of insurance agency value, according to Michael Ryan, CPA, of Donovan Sullivan & Ryan CPA.

Ryan discussed agency merger and acquisition (M&A) trends at the South Shore Independent Insurance Agents Association (SSIIAA) monthly meeting. He was joined by his nephew Christopher Ryan, CPA, MST, who discussed how recent tax law changes will affect insurance agents.

With the pace of insurance agency M&A showing little sign of slowing down, Michael Ryan receives numerous calls from independent insurance agents looking to have valuations of their agencies conducted. Typical agency valuations are designed for agency owners to bring to a bank or to use for estate planning purposes. As such, they are conducted based on the assumption that the agency is going to continue just the way it is — not what an agency will sell for. To conduct a valuation for a sale, agents and their accountants need to look at a number of factors.

Cash Flow

Calculating what the cash flow of an agency is on a regular basis is important. "Each buyer does their own calculation of earnings before interest, taxes, depreciation and amortization (EBITDA), but they can come up with different numbers because they can bring different things to that agency," said Ryan.

As an example, consider an agency principal that recently sold his agency. The agent's commission was $500,000, and he received $1.5 million in the sale, which is three times the amount of commission. In analyzing the agency, other buyers might factor in a couple of more points on the book with some additional revenue, so it will increase profit sharing. For that buyer, the $500,000 figure may be closer to $600,000. If so, the buyer bought a $600,000 book for $1.5 million, so that's 2.5 times. Every buyer does their own math, noted Ryan.

"EBITDA is key. You want to be profitable, but for a lot of small agencies, someone is just going to buy your book. They're not too concerned about EBITDA, especially if they are going to roll the agency into one of their locations."

Loss Ratio

Ryan said he has learned that buyers who pay the most money for agencies want books of business that have good loss ratios. "They're not interested in buying books that are going to hurt their profit sharing, unless it's a turnaround situation they feel they can clean up," he said.

What is a good loss ratio? About 50% or less, according to Ryan. If the loss ratio is above that, the agency becomes less attractive for buyers. Doing a good job of keeping your loss ratio down is vital.

Employees

Staffing is another important factor in agency valuations, particularly given how difficult it is to find qualified staff and customer service representatives (CSRs). Buyers typically tell sellers not to worry about their staff, according to Ryan. "They want and need your people. They want the people that have relationships with customers, so good, qualified employees are a real plus." However, if the average employee age is unusually high, that would be seen as a negative to many buyers.

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Noncompete Agreements

In many agencies, the topic of noncompete agreements often isn't addressed until the time of a sale. "No one ever does what they should, which is to have all employees sign these key contracts. What happens is if there is a key person at an agency, and the buyer comes along and wants to make sure that employee isn't going to leave and bring the book with them, they are going to want to sign noncompete agreements. If employees don't go along with it, the buyer won't buy the agency because there is too much risk involved."

Ryan recommended that agency owners should have these agreements in place long before they even think about selling their agencies. In a sale, attorneys for the buyer may want new noncompete agreements signed, but agency owners will have more leverage if there is already one in place, noted Ryan.

Antipiracy agreements are limited to one year now, but Ryan believes that offers enough protection.

Industry Specialization

Sometimes having a niche agency can be problematic for buyers, particularly if it is the owner who is the key employee and he or she wants to retire. Specialized agencies may find that the buyers who are interested are people that already have some expertise in that area. So, it can limit buyers when there is a specialization. Straight property and casualty agencies with personal lines are the easiest agencies to market, according to Ryan.

Location

Will the purchased agency remain a stand-alone location or will it be merged into the buyers' other locations? Most buyers set a minimum of $600,000 in commission to be able to support keeping a stand-alone location, noted Ryan. Anything less than that will probably be rolled into the buyer's existing location. "When buyers can do that, it's the most profitable situation for them, and therefore, they can pay more for the agency — which is clearly a plus."

South Shore Independent Insurance Agents Association President John Hegarty with Mike Ryan and Chris Ryan of Donovan Sullivan and Ryan C.P.A.

Another factor to consider is whether the owner plans to remain at the agency. Sometimes it is necessary to stay on for a little while if there are large commercial accounts that need to be protected. In those cases, sellers can be more selective about buyers because they aren't necessarily looking for the highest price tag they could get in this situation. They may be more interested in finding a buyer who is the right fit with employees.

The M&A Trend

An SSIIAA member asked Ryan if he thinks the multiples will continue the trend of remaining high or if they will start to decrease. Ryan thinks the numbers will hold steady because demand is still high, and there are a lot of major players looking to buy agencies.

"Like so many industries, the trend is going to be continued consolidation. There aren't many stand-alone drug stores anymore. This business is so perfect for consolidation. You buy a book that someone had for $500,000, roll it into a location and add a couple CSRs. How much of that flows right to the bottom line? It lends itself to economies of scale, so I don't see it stopping. I don't know if we'll see prices as high as they are now, but it's been pretty steady," said Ryan. He added that he thinks venture capital money will continue to flow into the insurance industry.

"I don't think tax law changes will affect private equity firms' decision making. I find that the really big buyers are more financial results driven than tax driven. For small businesses, taxes drive our decisions but not large companies. They're just looking for returns and performance."

Tax Law Changes

Beginning on January 1, 2018, as part of the Tax Cuts and Jobs Act, owners of pass-through entities (S-Corporations, partnerships, sole proprietorships and Schedule C filers) are provided a tax deduction of 20% of their pass-through/ Schedule C income, depending on the industry in which they work and their total personal taxable income.

Recently proposed regulations provided clarity on the tax law, indicating that insurance agencies are considered qualified businesses for purposes of the deduction. Christopher Ryan detailed the tax deduction in the October 12, 2018, issue of **The Standard** and talked with SSIIAA members about how tax law changes relate to insurance agencies.

Details of the Law

There are two categories of business in the tax law: specified services and non-specified services. Specified services included law firms, accounting firms, medical and dental practices as well as financial services, including insurance agencies. For a specified service, the deduction is 20% of the pass-through that goes to the owner of the business on a personal return. If business owners are married and filing joint tax returns with taxable income less than $315,000, they would be allowed to take the 20% deduction. If single, the threshold is $157,000.

"If your taxable income on your personal return is under the threshold, you can get the taxable deduction regardless of what industry you are in. If over that threshold, you can still get the deduction but the calculation changes," said Ryan.

If over the threshold amount, take the lesser of the following: Twenty percent of K-1 income from the agency or the greater of 50% of wages paid to employees of the agency or 25% of wages paid to employees of the agency plus 2.5% of unadjusted basis of qualified property (furniture and equipment).

For example, consider an insurance agent who has total taxable income of $200,000 and is filing a married, joint return. The agency is organized as an S-Corp. The owner is paid $75,000 in wages from the agency. On the K-1 form, the owner gets a pass-through profit from the agency of $100,000 and has other income (dividends, interest) around $75,000 plus deductions that amount to $50,000.

When combining all of that, the owner's taxable income is $200,000. That figure is under the $315,000 threshold, so the owner qualifies to take the pass-through deduction. It is the K-1 income of $100,000 x 20% = $20,000 that can be taken on the owner's personal return, explained Ryan.

In a more complicated example, an agent has total taxable income of $600,000. The agent is married and filing a joint return over the $315,000 threshold. The agency is organized as an S-Corp, so the owner is eligible for the pass-through deduction, but the calculation changes and the limits differ.

The owner's wages from the S-Corp are $150,000, the income amount on the K-1 Form from the insurance agency is $400,000, and other income totals $50,000. When over the threshold, there are three different calculations that need to be done to determine what the deduction is:

1. K-1 Form pass-through income of $400,000 x 20% = $80,000

2. W-2 wages from the insurance agency of $500,000 x 50% = $250,000

3. W-2 wages x 25% + 2.5% of the property in the agency (furniture, equipment, etc.) = $130,000

Compare the calculation of the $250,000 to the $130,000 and use the greater of those two numbers. Then, compare that calculation with the $80,000, and use the lesser figure. "It brings us back to the $80,000 deduction, which is the pass through times 20%," said Ryan.

The Takeaway

The main point is that the proposed regulation states that insurance agencies qualify for the tax deduction for the most part, regardless of how high taxable income is on the personal return. "If you are a physician, attorney or an accountant, making over the $315,000, you do not qualify for this deduction, or you're getting a phased out version of it. In other industries, such as insurance, you are getting the deduction; it's just a matter of how the calculation changes," explained Ryan.

Tax Planning

Heading toward the end of the year, tax planning questions naturally start to arise. "There are tax planning opportunities to optimize the deduction by looking into the wages of your insurance agency, the income, the pass-through level of the income, etc. Some businesses outside of insurance that are on the cusp of $330,000 to $350,000 in taxable income are trying to drive down that taxable income number to take advantage of the deduction," said Ryan.

The deduction applies to pass-through entities — partnerships, S-Corps, sole proprietors who file taxes for their agencies on Schedule C as well as trusts. Consider an example of an insurance agency that is organized as an S-Corp. The owner receives wages of $200,000, and the pass-through amount was also $200,000 because the owner wanted to have a higher wage number for the withholding. With the wage number, the owner is not eligible for the deduction, so the owner decides to take only $20,000 for wages in 2018.

"You definitely don't want to do that. It will be a huge red flag for the IRS. It must be 'reasonable compensation,' according to the law. I think the IRS will be paying more attention to that wage number now since there is such an incredible incentive to reduce that," cautioned Ryan. ■