Agency Valuations: Which Definition is Best for You?
By Chris Burand

When asked to complete an agency valuation, experience has taught us the first question we should ask is, "What definition of value would you like to use in your agency valuation?" This may sound esoteric but it is a key question, one all agency owners should consider before having their agency valued because different definitions lead to very different values and different definitions are appropriate for different situations.

Below is a summary of the most common definitions of value, their strengths, and their weaknesses. Each definition requires its own set of assumptions and adjustments. This is simply a summary and is not meant to be all encompassing nor is it meant to be used without further guidance.

Fair Market Value

Definition

Fair Market Value (FMV) is based on the "the price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell; both parties having reasonable knowledge of the relevant facts."[1] Additionally, a landmark ruling states, "The willing buyer and the willing seller are hypothetical persons, rather than specific individuals or entities, and the characteristics of these hypothetical persons are not necessarily the same as the personal characteristics of the actual seller or a particular buyer."[2]

Furthermore, FMV assumes the buyer is an "arms-length, financial" and not a "strategic" buyer. A strategic buyer is a buyer who could bring "value-added" benefits which would enhance the agency and/or enhance the buyer's other business activities through the acquisition. Examples of a strategic buyer who could bring "value-added" benefits are another insurance agency, an insurance company, or a bank. Also excluded are buyers who are already a shareholder, or related or controlled entities who might be willing to acquire the interest at a higher or lower price due to considerations not typical of the motivation of the arms-length, financial buyer.

Other common FMV assumptions include:

1. The business will continue as a going concern and the current owners, if they are managers, will be replaced upon the sale of the agency.

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[1] Internal Revenue Ruling 59-60, 1954 C.B. 237, Section 2.02.

[2] *Pabst Brewing Company v. Commissioner*, T.C. Memo 1996-506 (November 12, 1996), summarized in *Shannon Pratt's Business Valuation Update*, January, 1997, p.7.

2. The Appraisal Foundation's definition of Fair Market Value states that "payment is made in terms of cash in United States dollars or in terms of financial arrangements comparable thereto...."[3] This means the agency is being purchased on a guaranteed cash price rather than a renewal basis or with debt.

3. The seller will stay with the agency after the sale for a reasonable amount of time to smooth the transition of accounts and improve retention.

4. The valuation is based on 100% controlling, closely-held basis.

Uses

FMV is probably the best known definition of value and therefore, the most commonly used. FMV valuations are popular for buy/sell agreements, estate planning, some mergers, internal perpetuation, and anything that might involve the government such as taxes. FMV may be appropriate in other situations too.

Strengths

FMV probably has the most precise definition of value because the IRS has specified standard rules for completing FMV valuations. Further strengthening its definition is a considerable case and tax law history. It is also the least biased method because it does not generally favor the buyer or the seller.

Weaknesses

FMV's precise definition and assumptions have a huge effect on an agency's value. Because the buyers and sellers are hypothetical, the agency's actual future expenses are not a concern. As a result, the FMV may not be appropriate for some situations, such as an internal buyout or when an external buyer is known. For example, the hypothetical financial buyer defined by FMV would probably not continue to employ an experienced producer with a $100,000 commission book upon which he was being paid 50% of renewals. The result is the pro forma (adjusted) profit margin is going to be much higher than the agency's real profit margin, which in turn will result in a higher valuation. If the actual sale is internal between partners, then the valuation may be so high, the buying partner cannot afford to buy his or her partner's share.

Modified Fair Market Value

Definition

Modified FMV is based on how the agency really operates, not how a hypothetical buyer would operate it. Certain expenses are still adjusted as are revenues when required, but other adjustments typical of a FMV are not. For example, the experienced producer with a $100,000 commission book making 50% on renewals might not have his compensation adjusted under the modified FMV definition.

Uses

[3] *Uniform Standards of Professional Appraisal Practice* (Washington, DC: The Appraisal Foundation, 1998), p. 163

Modified Fair Market Value is most appropriate for internal perpetuation and buy/sell agreements. Other practitioners call this a going concern valuation but most valuations (except a liquidation valuation) are "going concern" valuations. Therefore, I avoid using such a misleading title.

Strengths

Because modified FMV is based on how the agency currently operates, the resulting value may be more realistic, fair, and affordable for internal perpetuations and buy/sell agreements.

Weaknesses

Modified FMV opens the door to grand disagreements between the buyer and seller regarding what expense and revenue adjustments should be made. This is because it is biased toward the current ownership, often resulting in the selling partner getting a lower price than if FMV is used.

Buyers and sellers can resolve this by agreeing to use the judgement of an appraiser or by agreeing to every income and expense adjustment, item by item. Either way, a modified FMV still often results in a lower value than FMV.

Fair Value

Definition

Generically, fair value means the value of the stock (or assets) without discount for the abuse a controlling shareholder(s) may cause non-controlling shares. In other words, small shareholders should get the same price for their shares as majority shareholders. Under FMV, the valuation industry and the IRS generally recognize that the per share value of small stockholders of private and closely-held companies is worth less than that of majority or controlling shareholders because the controlling shareholder controls the corporation.

Uses

Fair value is often used in law suits, particularly divorces and minority shareholder suits.

Strengths

Fair value protects minority shareholders, spouses, and non-controlling shareholders from getting poor values for their stock, even if the poor value is the fair market value.

Weaknesses

Fair value is not as well defined as FMV. So before using it, an attorney should help draft the specific definition for the situation. The definition of fair value can literally change from one jurisdiction to another. In a lawsuit, *never get fair value and Fair Market Value confused.*

Investment or Strategic Value

Definition

Strategic value is the value of a business to a particular buyer. To determine value, adjustments are made to future income and expenses based on a known buyer's operation. Strategic value considers any economies of scale the buyer might be expected to achieve.

Uses
Strategic value should be used for acquisitions, or if selling, to determine how much a particular buyer can pay. It may also be applicable to some mergers.

Strengths
It is the specific value of an agency to a particular buyer at a specific time. Of the major methods, it is usually the only one to consider economies of scale.

Weaknesses
Buyers in all industries have a strong tendency to overestimate their economies of scale.

Minority Ownership Discounts and Majority Ownership Premiums

Definition
Minority discounts and majority premiums account for the disparity between the per share value of controlling and non-controlling shares in a closely, privately held corporation. For example, the per share value of 5% ownership in a closely, privately held corporation is worth less than 51% ownership. In other words, if each share is valued at $100 each for 100% of the stock with 100 shares outstanding, then five shares are probably not worth $500 and 51 shares are probably worth more than $5,100.

Uses
Discounts and premiums are used for estate taxes, law suits, buy/sell agreements, internal sales, and rarely in our industry, an actual sale.

Strengths
Most people recognize the logic of these premiums and discounts. Discounts are useful in internal perpetuations and buy/sell agreements because they may be applied to a FMV, which is the most unbiased, well-defined definition, to make the FMV more affordable. This is a simple, clean way to make internal sales more affordable.

Weaknesses
Minority discounts and majority premiums are probably the two most litigated valuation issues, especially with the IRS. The contestable point usually is not whether a discount/premium should be applied but rather, how much of a discount/premium should be applied.

Other Common Definitions

Other common definitions of value include, liquidation value, book value, and intrinsic value, but those detailed above are the most common.

Other Considerations

Many sellers want to know what their agency is worth to the highest bidder. They really do not care about FMV, modified FMV, fair value, or any discounts. This is an understandable goal but it may be difficult to ascertain unless the agency is put out to bid because we do not know who might want to buy the agency and we do not know whether the prospective buyers’ passions or brains will rule. If this is your goal though, make sure your appraiser knows what you want. Depending on the situation, it is conceivable an agency might need different valuations using multiple definitions. In most cases, many appraisers can calculate additional values using different valuations definitions at minimal additional cost.

Summary

Many agencies have encountered problems because they did not know multiple definitions of value exist and/or they unfortunately did not choose the best definition for their situation. Because the field is complex, I recommend hiring someone knowledgeable and experienced in valuations to advise you before taking any actions that involves your agency's value. I also strongly recommend hiring someone that specializes in insurance agencies. Choosing the right definition can make for fewer and less intense disagreements with partners, facilitate transactions, and save all parties money.

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August 2001