Voodoo Valuations
by Chris Burand

Deep in the Louisiana swamps there lies the legend of the voodoo queen, Marie La Veaux, who provided simple but costly answers for people in search of hope.

According to legend, she would concoct a potion that caused a man's heart to change with just one short kiss from a young girl's lips. Forever after, he would be devoted only to her. For 1,000 Spanish bits or possession of the woman's first born, Marie would undo the spell. Marie became a rich woman.

People pay dearly for simple answers, and a lot of insurance agencies pay dearly for similar voodoo valuations. Voodoo valuations are powerfully attractive. They offer a quick and cheap way to pacify an agency owner's curiosity and worry. Agency owners are often desperate for a simple, quick answer. Unfortunately, they inevitably pay for their haste. And, they pay dearly.

Voodoo valuations are not easy to recognize. They are often disguised as legitimate valuations. Here are a few keys to recognizing voodoo valuations:

The final price does not consider terms. I have seen many agents agree to terms like "1.5 times commissions based on retention" and they end up earning less than 1.0 times. They never would have sold for 1.0 times even if the deal was cash, but they were told a good multiple and that was all they needed to hear. The answers they sought were simple. Unfortunately, the right answers were complex. The right answers involved a complete valuation, thorough due diligence, and an analysis of cash flow and ROI based on different terms and scenarios. It is funny how in the long run, the complex answers would have actually earned those sellers a higher multiple.

I recently researched a group of sellers. These sellers all received excellent prices–but they all received significantly less money than they expected. They did not consider the terms of the deal and the result was great financial pain. Not one had hired anyone beyond their local accountant.

The valuation is not accurate. We expect answers to be just a mouse-click or phone call away. Many valuation practitioners pretend valuations are simple affairs and they use customers' desires for a quick, simple solution to turn a swift buck. They give agents a simple formula to use or suggest agents can do their own valuations by completing a canned spreadsheet. The answers are quick, but seldom accurate.

So many agency owners are desperate for simple solutions, hardly a week goes by where I do not get at least one email from an agency owner asking, "Is 1.5 (or whatever multiple) still the appropriate multiple?" Oh, how I could get rich quickly if I were willing to dispense quick, easy sugar pills or cajun spells!

Agents should recognize practitioners who do not understand the complexity of valuations. For

example, before a valuation is even started the correct definition of value must be agreed upon. An agent should consider it a tip off that there is a lack of understanding about the process when the practitioner never discusses the appropriate definitions of value. If the appropriate definition of value is not discussed, the agent should consider seeking assistance elsewhere.

In my experience, I have helped several agencies dig themselves out of deep financial holes resulting from a series of acquisitions. When these agencies did happen to hire a consultant, the original consultant used the wrong definition of value for the acquisition targets, they did not consider working capital which caused the buyer to severely deplete their own capital, and they did not complete adequate due diligence. But the consultant did supply seemingly simple answers!

I once saw a sign in a retail business which read, “50¢ for an answer. $2.00 for the correct answer.” Why pay even 50¢ for an answer if it is wrong?

The buyer’s financial strength is not considered. A large proportion of agency sales contain a seller-carry loan and/or are based on retention. This means sellers are incurring significant risk when they sell, yet very often they do not adequately adjust their price for this risk. Again, this is the result of searching for simple answers.

If the buyer’s risk of default is high and they are not paying cash up-front, then the buyer should pay more to compensate for that risk. For example, a fair price for an agency with $750,000 in revenue might be $900,000 for a buyer with strong financials and a minimal risk of default. However, if the buyer has poor financials and is requiring a seller-carry note and/or a retention factor, then the price should be at least $1,000,000 and maybe more depending on the buyer’s financials.

Two financial aspects worth careful consideration are cash flow and companies that stress EBITDA (earnings before interest, taxes, depreciation, and amortization). I have recently met several buyers possessing what I consider extremely weak financials. They each touted their positive EBITDA while downplaying their negative cash flows. A January 24, 2002 *Wall Street Journal* described the risk well. In the article titled, “How to Predict the Next Fiasco in Accounting and Bail Early,” the author wrote, “A telltale sign of trouble is negative cash flow from operations while the company’s so-called EBITDA is positive.” These are words worth noting.

The SEC recently released a warning to investors regarding companies that report or stress pro forma earnings or EBITDA earnings. If a seller is carrying risk, then the buyer should have a positive operating cash flow. Otherwise, they probably have financial problems. When buying an agency, the buyer must achieve positive cash flow, not just positive income, within a very specific period to make the acquisition profitable.

Getting big for big’s sake. Quite a few agency owners dream of going public. Others just want to get big. Other owners are tired of running their agencies and/or selling insurance. Instead, they decide to go after bigger fish, so they begin acquiring other agencies. Acquisitions can be exciting. They drive the ego. One study of acquisitions involving publicly traded companies

“noted that the undeserved premium paid is linked to the number of magazine covers the acquiring boss has graced before the deal.” (*The Economist*, January 9, 1999). It does not require much skill to buy an agency if a person is willing to overpay (which a lot of buyers seem willing to do).

Michael Eisner, CEO of Disney, recently commented, “I spend my life being Odysseus. I tie myself to the mast, and I don’t listen to the Sirens. The Sirens in my business are agents, investment bankers, the media, people saying that your testosterone level is gone because you haven’t made an acquisition in the last ten minutes.” (*Fortune*, January 7, 2002) Many agencies feel the same pressure to grow by acquisition regardless of profitability. This may explain why every study I have seen, read, or heard in the last 27 years has shown that 50% to 80% of all acquisitions fail. If being profitable concerns you, be strong in your convictions to grow profitably.

Marie La Veaux made a lot of money giving simple answers to desperate people. Her magic potions were hard to resist. Agency owners are often just as eager for voodoo valuations, but the cost for quick, easy answers is often steep. You have the experience, wisdom, and alternatives. Do not purchase or practice voodoo valuations.

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