Down But Out

The M&A Marketplace for Insurance Agencies and Brokerages in 2009

The Market has Changed, Not Closed

During the last three years, the mergers and acquisitions market for insurance agencies and brokerages has been marked by strong deal volume and soaring valuations. From 2006 through 2008, aggressive buyers were plentiful and selling firms were ready and willing to accept lofty prices in exchange for their agencies.

And then, in late 2008 and early 2009, conditions changed. Buyer interest waned. Sellers pulled back. Valuations fell. The M&A market for insurance agencies and brokerages slowed dramatically. What happened?

Fundamentally, the core drivers of M&A activity in the insurance distribution industry have not been altered. The industry is still fragmented. There are still benefits of consolidation and scale. There are many agency owners approaching retirement that need to sell their firms. Acquisition activity is still important, especially in times of lean organic growth.

But during 2006, 2007 and 2008, there were three extraordinary factors that became perfectly aligned, combining with the core drivers of consolidation to produce a frenzied M&A market. What were these extraordinary factors? Strong public broker valuations in a soft market, abundant debt and equity capital, and bank entry and expansion.

These three have all but vanished in recent months, leaving the M&A market low on fuel and short on momentum. As buyers and sellers approach transactions today, they are doing so in an environment where capital is an issue and where uncertainty over future performance is causing both sides to hesitate.

This paper reviews the recent history of the M&A market and breaks down the forces at play today. It discusses the active buyers, the options for sellers and current deal valuations.

While the market has indeed changed, it certainly has not closed.

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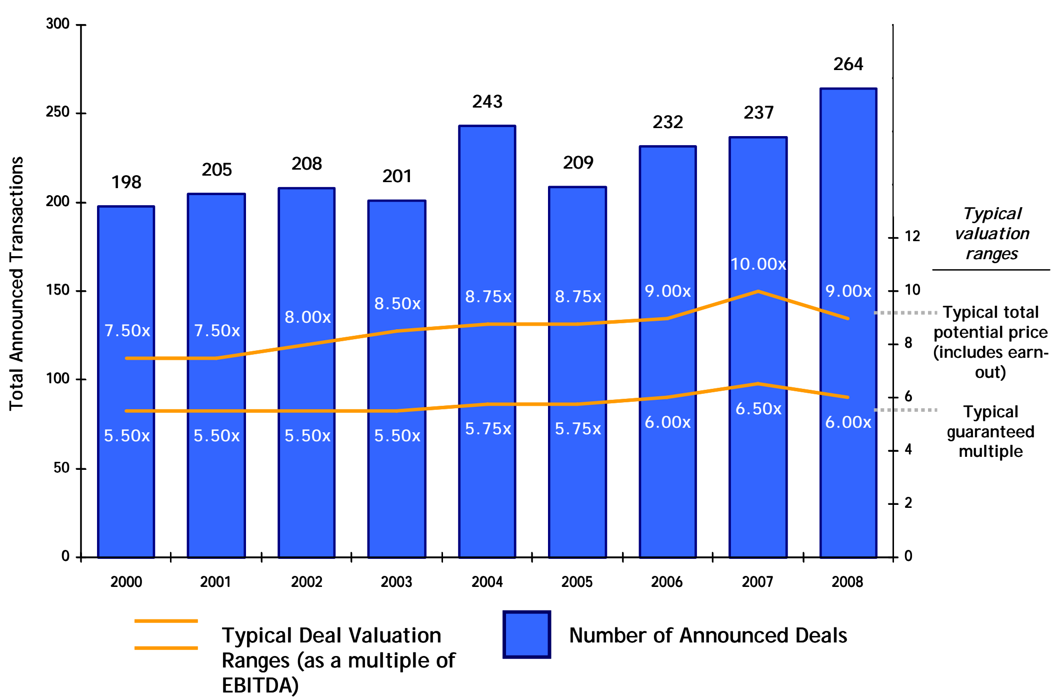
Understanding the Past

Any understanding of the current M&A market for agencies and brokerages needs to start with the context of the last few years of activity. From 2006 through 2008, the market produced an increased number of deals and very strong valuations. Deal activity for the years 2000 – 2005 hovered around 200 announced transactions per year, except for 2004, which produced 243 deals. However, 2006 and 2007 deal activity was 15% above this 200-deal-per-year baseline and 2008 activity was 30% over the 200-deal-per-year baseline. While deal volume jumped, deal pricing also increased, driving guaranteed multiples to as much as a full point of EBITDA higher than during the first part of the decade (see chart below).

Valuations and Deal Activity Increased During the Last Three Years



Source: SNL Financial; Reagan Consulting analysis

The increase in activity and in value was driven by three primary factors. *First, the public brokers, the most active buying group, enjoyed strong market valuations during a soft commercial P&C market.* This combination was a significant driver of M&A activity. The soft market put pressure on organic growth, forcing the public brokers to turn to acquisitions to meet Wall Street growth and earnings expectations. The resulting acquisition activity was facilitated by strong public broker stock market valuations, which allowed for multiple arbitrage as the public brokers bought agencies across the country. Public brokers could pay 6 – 9 times EBITDA for an agency when they were getting credit in the public markets at 9 – 12 times EBITDA in their own valuations.

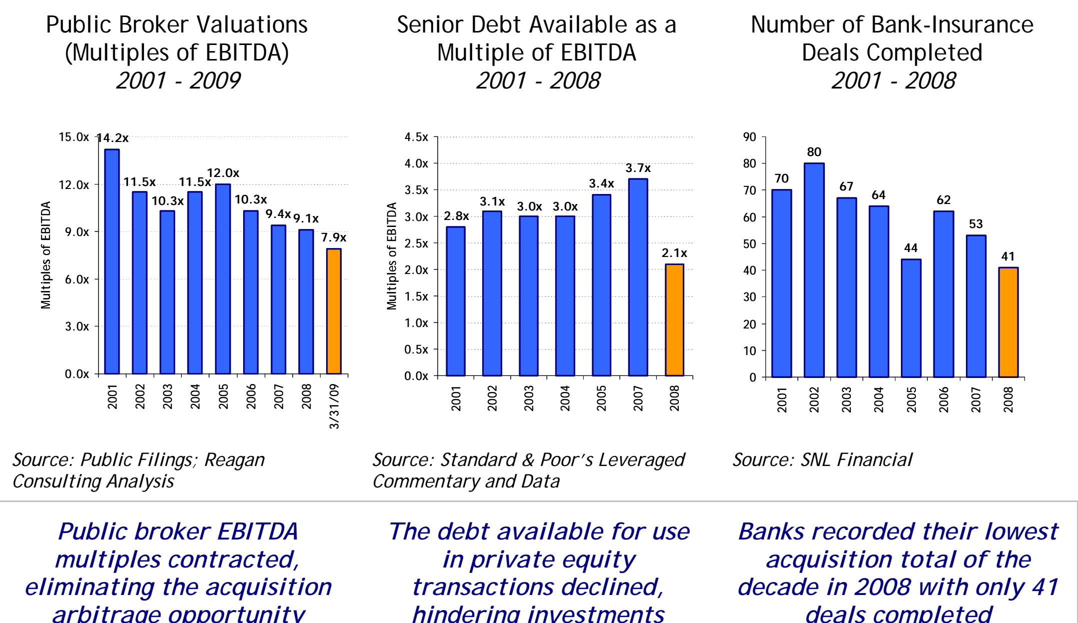
Second, the availability of equity capital and low borrowing costs made leveraged acquisitions an attractive means of generating high investor returns. Private equity investors used this access to capital to invest heavily in the insurance distribution space, acquiring USI Holdings Corporation, Hub International Limited and several other high-profile agents and brokers. By the end of 2008, four of the top 20 brokers were owned by private equity firms.

Finally, banks were continuing their acquisitive entry and expansion into the insurance distribution space. Banks were often high-multiple buyers, paying premium valuations for platform agencies. While many bank entries took place during the early part of the decade, fold-in acquisitions and the acquisitive growth of larger bank players created significant activity over the last three years.

Any one of these factors had the ability to influence the market and to increase deal activity and valuations. However, what drove the market to new heights and created a palpable sense of urgency in deal-making was the confluence of the three. Together, these dynamics created intense competition for deals between public brokers, banks and private equity investors. Sellers responded to the aggressive buyers by entering into transactions in record numbers at record valuations.

However, due in no small part to the national liquidity crisis and recession, and to the accompanying stock market decline, each of these three driving forces faded in late 2008 (see chart below). Public broker valuations fell, all but eliminating the arbitrage opportunity. Leverage became scarce and expensive, restricting private equity buyers. Banks, already starting to slow acquisition activity, were at ground zero during the financial crisis and were preserving capital and refocusing on their core operations of lending and cash management.

The Extraordinary Drivers of Recent Agency and Brokerage M&A Receded in 2008



Source: Public Filings; Reagan Consulting Analysis

Source: Standard & Poor's Leveraged Commentary and Data

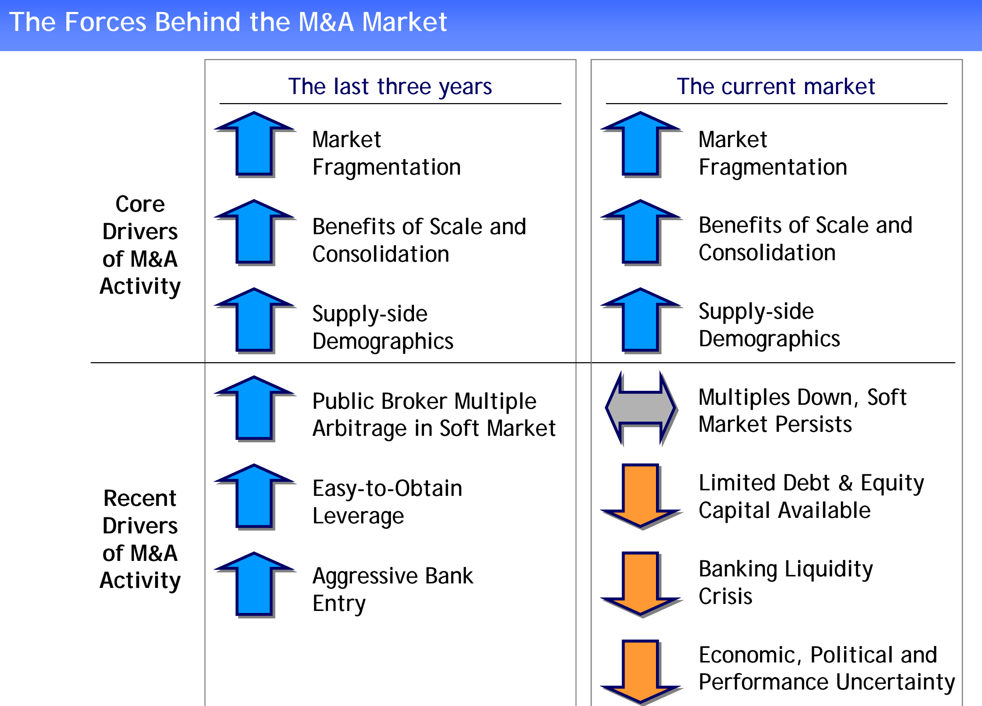
Source: SNL Financial

Public broker EBITDA multiples contracted, eliminating the acquisition arbitrage opportunity	*The debt available for use in private equity transactions declined, hindering investments*	*Banks recorded their lowest acquisition total of the decade in 2008 with only 41 deals completed*

Without these extraordinary forces in play, the M&A market retreated. Each of the major buying groups was forced to scale back deal activity. Competition for deals decreased and the urgency in the marketplace dissipated.

The Topsy-Turvy Market of Today

Without the afore-mentioned extraordinary factors, M&A activity now rests on the fundamental drivers of consolidation in the insurance distribution industry: a fragmented market with benefits to scale and a steady supply of selling agencies. These factors are more than enough to generate solid deal activity. However, the economic and insurance environments have produced two additional extraordinary forces that are now influencing M&A activity: capital conservation and uncertainty. These two forces are acting as a governor on deal activity, slowing the natural tendency toward consolidation (see chart below).



As a result, the market is unpredictable. It doesn't mean that M&A has ceased, and it doesn't mean that all deals are being done at bargain valuations. But it does mean that buyers and sellers are more deliberate and more cautious today than they were just 12 or 24 months ago, when both sides were eagerly wading into the market. Today, it is more difficult to predict when sellers will market their agencies and where buyer interest will come from when they do.

Fundamentally Sound

According to Reagan Consulting research, the overall number of agencies nationwide hasn't changed in the past couple of years, holding steady at around 37,500. This suggests a mind-boggling level of fragmentation – fantastic fodder for consolidation. However, upon closer examination, the sought-after acquisition targets within this universe of independent agencies are a smaller, but still sizeable, group.

Of the 37,500 independent agents and brokers, 31,500, or about 84%, have annual commission revenues of less than $1.25 million. Industry buyers are generally not pursuing these firms, but are typically setting their sights higher, looking to acquire the local and regional players with over $1.25 million in revenues. There are nearly 6,000 local and regional acquisition targets generating between $1.25 and $500 million in annual revenues. In aggregate, they control a mountain of revenue,

roughly 43.7% of the market. This represents a substantial amount of market share still available for consolidation.

The Fragmented Market for Agents and Brokers

Category	Revenue Size	Number of Firms	% of Population	Aggregate US Revenues	Market Share
National / Global Brokers	> $500 million	10	0.03%	$16.2 billion	31.1%
Regional - Large *	$10 - $500 million	290	0.77%	$7.9 billion	15.1%
Regional - Mid-Sized *	$5 - $10 million	600	1.60%	$3.9 billion	7.5%
Local - Large *	$2.5 - $5.0 million	1,200	3.20%	$4.2 billion	8.1%
Local - Mid-Sized *	$1.25 - $2.5 million	3,900	10.40%	$6.8 billion	13.1%
Small Local Firms	< $1.25 million	31,500	84.00%	$13.1 billion	25.1%
Total		37,500	100%	$52.1 billion	100.0%
* Summary of Sought-After Acquisition Targets	$1.25 - $500 million	5,990	15.97%	$22.8 billion	43.7%

Source: Reagan Consulting Analysis, includes multi-line agencies

The national and global brokers, though each above $500 million in annual revenues, control only 31.1% of the US market. These brokers, the most active acquirers of agencies, still have a large runway of market share growth available to them, which will fuel consolidation for years to come. Active buyers in the regional and local categories can also look down the ladder at plenty of acquisition opportunity.

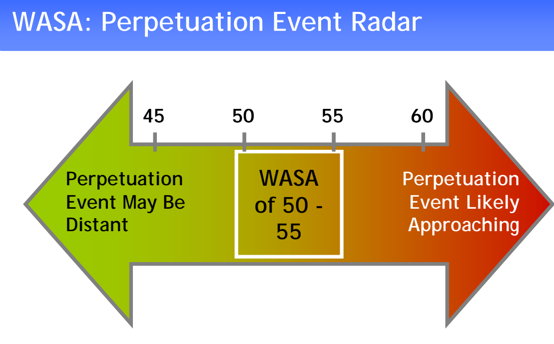
The fragmented market provides opportunity for consolidation, but not the reason for it. In insurance distribution, bigger is frequently better, at least economically. Insurance carriers are looking to consolidate their distribution force: they want to deal with fewer, larger agencies. Carriers have tried to make this happen through economic incentives, specifically by rewarding agencies for handling increasing books of business. Contingent income agreements, a major source of profitability for agencies, are increasingly tiered based on volume, encouraging larger books with carriers. Additionally, scale can bring increased overhead leverage and an increased ability to attract talent, both important attributes in value creation for insurance agencies and brokerages.

With fragmentation and the benefits of scale driving demand for insurance agencies, it is important to assess the supply of potential acquisition targets. As discussed above, the sheer number of acquisition targets is promising, but these agencies are generally driven to sell by demographics. When agency owners approach retirement, they evaluate their perpetuation options. Research indicates that although internal perpetuation is the preferred option for most agency owners, not all

agencies will be prepared to perpetuate internally. In those cases, and in others where the pricing or opportunities associated with a third-party sale become too attractive, agencies enter the M&A market as sellers.

Examining the age of the independent agency shareholder base provides evidence for the steady supply of agencies that are contemplating perpetuation. Reagan Consulting has created a metric to gauge the relative youth of an agency's shareholder base. This metric, the weighted average shareholder age, or WASA, can be calculated by taking the average of all shareholders' ages weighted based on each shareholder's ownership percentage. The WASA can be used as an indicator of (1) an agency's ability to perpetuate internally and (2) the proximity of a perpetuation event – internal or external.

WASA: Perpetuation Event Radar



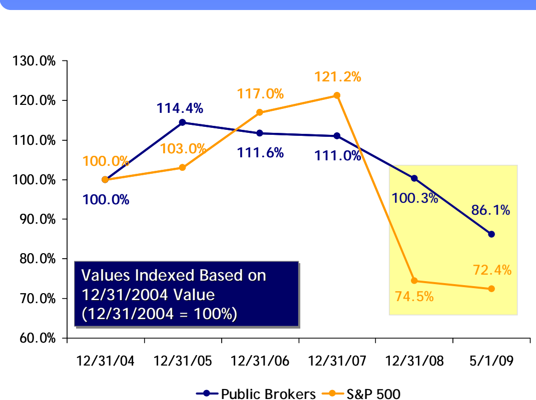
When analyzing the WASA of independent agencies and looking at their perpetuation events and strategies over a number of years, it became apparent that a large number of agencies with a WASA over 55 were approaching an external perpetuation event, and firms with a WASA between 50 and 55 were running out of time to perpetuate internally. Today, there are many agencies with a WASA approaching or exceeding 55. In fact, most agencies are now owned largely by the Baby Boomer generation, individuals born between 1946 and 1964. These owners are currently between 45 and 63 years old, and will move out of the workforce over the next 20 years, creating many opportunities for M&A transactions.

With the fundamentals of consolidation holding, deal activity in the insurance distribution industry will continue. However, the current M&A market must content with two additional dynamics.

Capital is an Issue

The financial meltdown that hit Wall Street in September, 2008 has turned the easy money available for much of the past three years into very difficult money – for all buying groups. Private equity firms and banks have seen their capital constrained and are finding new capital difficult and / or expensive to obtain. Public brokers have also become increasingly conservative when it comes to deploying capital, though it hasn't been quite as bad for them as for banks and private equity.

Public Broker Stock Prices Have Fallen



Source: Reagan Consulting analysis

The public brokers, however, have felt the financial crisis along two fronts: First, their stock prices have come down, making the use of stock as an acquisition currency more difficult (see chart at left). Second, corporate borrowing costs have skyrocketed and lending standards have tightened dramatically, making debt expensive or, at worst, unavailable. Marsh Inc. announced in March 2009 that it is raising $400 million in 10-year senior notes to replace its notes coming due in June. The new notes have an interest rate of 9.25%, a 215 basis point jump from the prior debt. Willis Group Holdings announced in March 2009 that it raised $500 million in 7-year senior notes with a whopping borrowing cost of 12.875%. Some

acquisition activity can be financed through cash on hand or from operating cash flow, but the use of stock and debt is important to continued deal flow and these sources of capital are currently limited.

Private equity firms and banks know the restrictions imposed by the liquidity crisis all too well. For many banks, capital has become a precious asset to be used for shoring up balance sheets, rather than for investing in non-core acquisitions. Private equity firms have started 2009 on pace to raise only half of the capital raised in 2008, and the amount of debt that is available to leverage investments has plummeted. Without access to capital, deal flow has suffered.

Restrictions on capital for any one of the major buying groups would put a dent in acquisition activity. However, the current environment is limiting both debt and equity capital for all buying groups, making funding acquisitions difficult for some and impossible for others. And in cases where acquisitions are being funded, there is pressure on deal valuations.

Uncertainty Rules

Accompanying the credit crisis are an economy in recession and a P&C market that continues to be soft. Further, there is significant instability in the political arena, which could change the regulatory landscape for both P&C and health insurance. There are enough meaningful uncertainties in the marketplace right now to dampen acquisition activity. The main unknowns are as follows:

"One thing about the insurance cycle is that it's not usually correlated to the general economic upturns and downturns. This time, they've come together on the same wavelength."

Ken Crerar,
The Council of Insurance Agents & Brokers

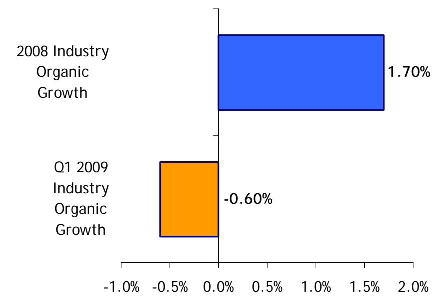
Economic uncertainty. The U.S. is mired in a recession. National GDP dropped by 6.4% in the last quarter of 2008 and by 6.3% in the first quarter of 2009. The shrinking economy has yet to show signs of turning around.

Political uncertainty. Policymakers in Washington, D.C. have discussed two initiatives that would significantly impact mergers and acquisitions activity: health care reform and capital gains tax increases. While these issues have been discussed, there is no clarity as to what new legislation will bring, and the ensuing uncertainty has kept deal momentum in check.

Soft market uncertainty. The commercial property & casualty market has been soft since 2004, making the first quarter of 2009 the 21st consecutive quarter of pricing decline in the industry. The market has showed some signs of moderation of late, but still remains soft overall. There is speculation that the market has to harden in the face of declining carrier profitability, but no one is certain if, or when, this might materialize.

Performance uncertainty. Since agency buyers evaluate deals and set pricing based on a projection of growth and profitability, valuations and deal activity suffer when agency performance is weak and uncertainty about the future is high. Recent data indicates that the current combination of soft pricing and weakness in the economy is pushing broker growth into negative territory. In late 2008, Reagan Consulting launched a new industry-wide benchmarking survey to measure organic growth and profitability for large agents and brokers. Over 100 firms participated in the survey, which is now conducted quarterly. For the first quarter of 2009, the results indicated that the typical insurance agency actually shrank – with organic growth contracting by 0.6% (see chart at right). Buyers and sellers are both less aggressive in this period of declining revenues and future performance uncertainty.

Organic Growth is a Struggle



Source: Reagan Consulting Organic Growth & Profitanility Survey (OGP)

The lack of clarity on these important variables, including agency performance, is holding back deal

activity. There is nothing a market dislikes more than uncertainty. Selling agencies are wary of consummating a transaction when a declining economy and soft pricing may prevent them from earning a significant portion of any contingent pricing, or earn-out. Buyers, too, are hesitant to invest their limited capital in an uncertain performance environment. And if they are willing to invest, it may be at a lower valuation.

The River is Low, But Still Navigable

The deal rapids of 2006 – 2008 have slowed. Today, uncertainty and capital constraints have limited deal activity, but market fundamentals will keep the current flowing, albeit at a lesser pace. With each passing day, more owners of the 5,990 agencies between $1.25 million and $500 million will reach retirement age and begin to consider perpetuation options for their firms. And when they do, there are still buyers that will view the acquisition of that firm as a strategic opportunity to gain market share and to create value. In today's market, however, matching the right buyer with the right seller is taking more time. A seller may need to look at more buyers, and at less traditional buyers, to find the perfect strategic and financial fit. While the current M&A market is less active, more deliberate and marked by uncertainty, it is still functioning. Both sellers and buyers have opportunities today to meet strategic objectives through mergers and acquisitions.

The Evolving Buyer Group

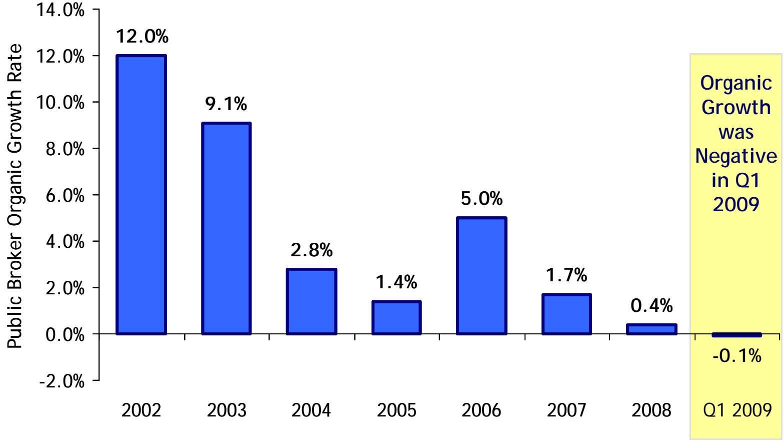
A symptom of the uncertainty and change in the current M&A market is the buying group, which has been transformed. Several anchor tenants remain, but an independent agency looking for an acquirer is faced with a very different list of potential buyers than just a year or two ago. Three formerly public brokers are no longer publicly-traded. Many acquisitive bank-insurance agencies have been acquired themselves. New private equity investors have emerged. A stable, predictable buying group no longer exists and agencies must look beyond the old standbys to a different group of acquirers.

The Public Brokers Fight On

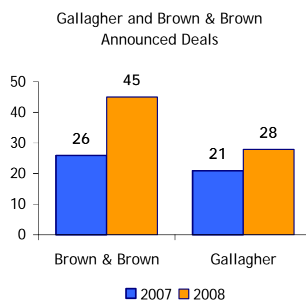
The public brokers have seen their ranks thin recently. Hub International Limited and USI Holdings Corporation were acquired by private equity investors in 2007, shifting them from the public broker group to the private equity group. In addition, Hilb Rogal & Hobbs Company was acquired by Willis Group Holdings in 2008. Currently, there are only five publicly-traded insurance brokers: Aon Corporation, Arthur J. Gallagher & Co., Brown & Brown, Inc., Marsh Inc. and Willis.

The challenge for these firms is that their investors want growth, but the U.S. insurance market is not growing. Since 2004, public brokers have struggled with organic growth, reaching a new low of just 0.4% in 2008. 2009 may be even worse, with public broker organic growth contracting in the first quarter (see chart below).

Public Broker Organic Growth Rates Have Steadily Fallen



Source: Public Filings, Press Releases



Generally, a difficult organic growth environment creates an acquisition imperative for public brokers as they seek to meet Wall Street expectations. But of the five remaining publicly traded brokers, only Gallagher and Brown & Brown were reliable acquirers of independent agencies heading into 2009. Brown & Brown, fresh on the heels of a record-breaking and industry-leading number of acquisitions in 2007 (26), continued to lead the acquisition pack with 45 announced transactions and $120 million in acquired revenue in 2008. Gallagher, the fourth-largest broker in the U.S., set an all-time high for the firm, announcing 28 transactions in 2008, up from 21 in 2007, and ended the year as the second most-active buyer in the industry. These two brokers accounted for 27.7% of total announced transactions in 2008. Both brokers also believe that deal activity will continue in 2009. “Our acquisition appetite in 2009 continues to be robust,” stated Hyatt Brown,

"Our acquisition appetite in 2009 continues to be robust."

Hyatt Brown,
Brown & Brown

"Our goal is to be recognized as a top five middle-market agency within five years."

Dave Eslick,
Marsh & McLennan Agency

Chairman and CEO of Brown & Brown. Gallagher Chairman, President and CEO Pat Gallagher echoed those sentiments: "We are going to continue to add merger and acquisition partners because we think there will be great opportunities there and we offer our new partners great opportunities to grow and prosper." *(Arthur J. Gallagher & Co. Q4 2008 Earnings Call Transcript, www.seekingalpha.com)*

The acquisition picture for the other public brokers is slightly cloudier. However, there is a lot of discussion about both Marsh and Aon making acquisition inroads into the middle market. "Marsh and Aon, in spite of previous failures, are going to make a push into the middle market," projects Hub Chairman and CEO Marty Hughes. "If they do it right, they can be formidable competition."

Marsh has been the most explicit about its strategy, announcing the formation of the Marsh & McLennan Agency, an initiative designed to penetrate middle-market accounts smaller than Marsh's current account profile. Dave Eslick, formerly with USI, was tapped to run the new venture. "Our goal," says Mr. Eslick, "is to be recognized as a top five middle-market agency within five years." This aggressive growth goal suggests a material amount of acquisition activity. Aon has not announced as aggressive an acquisition strategy, but has been vocal about deal activity in its middle-market business unit, Aon Preferred. In the May 2009 issue of *Independent Agent Magazine*, Peter Breitstone, CEO of Aon Preferred, said "There are no shortage of brokerages. My funnel is exploding right now . . . we are extremely acquisitive."

The entry of Marsh and Aon as significant acquirers of independent agencies would only fortify the public brokers as the leading buying group. Willis, excluding its acquisition of HRH in 2008, has not made many acquisitions in the U.S. middle market. Currently, Willis is integrating the HRH deal, and it is not clear if Willis will resume HRH's middle-market acquisition strategy at some point in the future.

There are two other publicly-traded brokerage operations that we have not mentioned in our analysis. First, National Financial Partners Corp., a network of financial advisors, has historically been a player in the acquisition of firms specializing in corporate and executive benefits, life insurance, wealth transfer services, financial planning and investment advisory services. NFP completed 20 acquisitions in 2008 and 26 in 2007, but was hit hard by the stock market turbulence in late 2008, making future acquisitions difficult. Additionally, Meadowbrook Insurance Group, Inc., a publicly-traded firm that primarily acts as an insurance carrier, also holds an insurance agency operation. Meadowbrook has made a few acquisitions in the agency and brokerage space but has not been a major player.

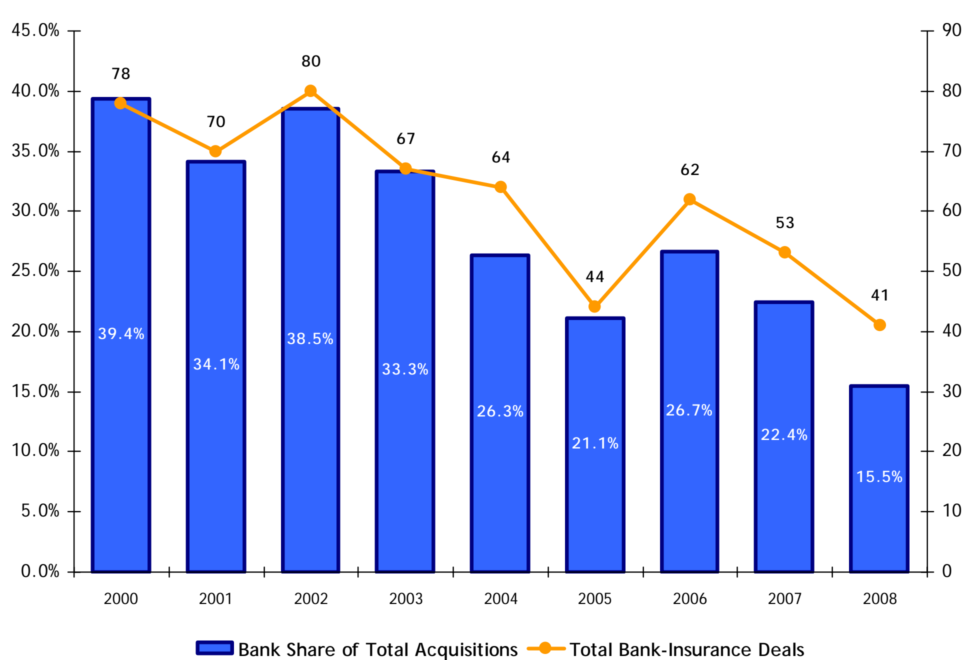
Despite the disappearing multiple arbitrage opportunity and the reduction in the number of public brokers, the outlook for public broker buyers is strong, especially if Marsh and Aon generate significant deal activity. It is important to note, however, that although they have been and will continue to be the most active buying group, the public brokers have also been the most vocal about declining agency M&A valuations.

The Bank-Insurance Shift

In the late-1990s, banks exploded onto the agency acquisition scene. Armed with an abundance of capital and the belief that the financial services marketplace was ready for one-stop shopping, the banking industry pushed hard for its long-coveted opportunity to sell insurance. As depression-era regulation was chipped away, banks flexed their muscle. By 2002, banks were completing almost 40% of announced agency acquisitions.

However, since then, bank-insurance acquisitions have been on a steady decline, culminating with only 41 bank-agency deals in 2008, or just 15.5% of all announced transactions (see chart below).

Bank Deals and Deal Market Share Declining



Source: SNL Financial

Obviously, the current capital crisis has made insurance acquisitions difficult for some banks. However, the trend in acquisition activity was moving downward before the full force of the credit crisis. Bank-insurance acquisitions were becoming more concentrated among few buyers – in 2007 and 2008, the top three bank buyers accounted for approximately one-third and one-half, respectively, of all bank-insurance acquisitions. In addition, bank-insurance divestitures were commonplace. Bank of America, Webster Bank and Union Bank of California all sold their insurance operations, each of which was listed among the 70 largest agencies in the U.S.

The steady down-shift in bank-insurance acquisitions and the growing list of divestitures, coupled with massive capital restrictions, suggest that the bloom is off the bank-insurance rose. However, there are several reasons why this may not be the case.

Size, Not Strategy: Prominent divestitures of bank-insurance agencies were less about performance and more about relevance. As an example, Bank of America sold its insurance agency, not because the agency was under-performing, but because its contribution of less than one percent of non-interest income was simply irrelevant. Agency operations have to reach sufficient scale to make meaningful contributions to their bank parent, and those that fall short of the relevance threshold can become targets for divestiture.

"We will continue to look for good strategic matches as we always have."

Wade Reece, BB&T Insurance Services

Major Players: Two of the industry's largest and most acquisitive brokers are banks: Wells Fargo and BB&T. Both are listed among the top 7 brokers in the U.S., and their commitment to continued growth through acquisitions will continue to drive significant bank-insurance deal activity. Combined they completed 18 acquisitions in 2008.

Non-Interest Income is Critical: According to Brad Milsaps, Managing Director at Sandler O'Neil + Partners, L.P., "If banks stick to their knitting and try to make money just on spread business, they're going to have a really hard time." Why will banks look to insurance distribution to help drive non-

In 2007, Banks that distributed insurance products average an ROE of 10.4% while those that did not averaged an ROE of 7.4%.

The Michael White – Symetra Bank Fee Income Report, 2008 Edition

interest income growth? Because insurance products are generally compatible with banking products and are a more natural extension than are most, if not all, alternatives. In addition, banks that sell insurance outperform those that don't in key measures of profitability. For example, recent analysis published in *The Michael White – Symetra Bank Fee Income Report, 2008 Edition* found that banks that reported earning insurance brokerage income averaged a higher return on equity (ROE) than those that did not. Banks distributing insurance averaged a return of 10.4%, those that did not averaged a return of 7.4%.

Community and Regional Players: It may be that community and small regional banks will lead the M&A resurgence for banks. These smaller banks still trail larger banks in the development of sustainable, well-established non-interest income sources and insurance distribution can help close the gap. Further, community banks have the greatest potential to reach scale and relevance through agency acquisitions.

Like the rest of the M&A market, the fundamental reasons to pursue bank-insurance acquisitions, primarily the establishment of compatible non-interest income, are intact. Liquidity issues will continue to depress bank acquisition activity for some time, but the industry shouldn't write the bank-insurance obituary just yet. It remains to be seen whether regional and community banks can lead a steady resurgence when the financial crisis subsides.

Private Equity Subdued

Private equity investors were the talk of the industry in 2007, when they took two publicly traded brokers private in transactions with double-digit EBITDA multiples. The private equity investors involved in those transactions were large private equity funds, but funds of all sizes were investing in the insurance distribution space. Several large insurance agencies were acquired by private equity firms and other private equity firms invested in mid-sized agencies or backed insurance executives who began "roll-up" strategies across the country, acquiring many firms in an effort to build a national platform.

These private equity investments largely depend on two sources of funding: equity capital from investors in private equity funds and debt capital used to leverage the investments. When private equity firms acquire, they typically prefer to do so with limited equity and with plenty of debt. This structure enables the private equity investors to get amplified returns on their equity investment. As the value of the acquisition increases, the debt portion stays the same, and all increases in value go to the equity holders. In 2007 and in the early part of 2008, this strategy worked well for the private equity industry, as it acquired all or part of several leading players in the insurance distribution space, including Hub, USI, Alliant Insurance Services, Inc., Bollinger, Inc., Higginbotham Insurance Agency, Inc. and others.

Private Equity: An Illustration

Total Value Growth = 10% / year
Equity Value Growth = 20% / year

$200
$150
$100
$50
$0

Investment Year: $100 million total value; $40 million in equity; $60 million in debt
Interim: $120 million total value; Equity grows as firm value rises; Debt balance level
Exit Year (Year 5): $160 million total value; $100 million in equity value after five years; Same $60 million in debt

Debt Equity

However, during 2008 the price of debt began to rise and the availability of debt began to fall. When the credit crisis hit in the fall of 2008, these problems were exacerbated. Private equity investors used to be able to count on obtaining total debt in the amount of 6 times the EBITDA of the companies they were looking to acquire, or more. This debt allowed private equity investors to make investments with smaller amounts of equity, supercharging equity returns. In today's market, however, it is difficult to find leverage of much more than 3 times EBITDA. Lenders (banks) are much more particular about what they are willing to lend and the leverage they control has also

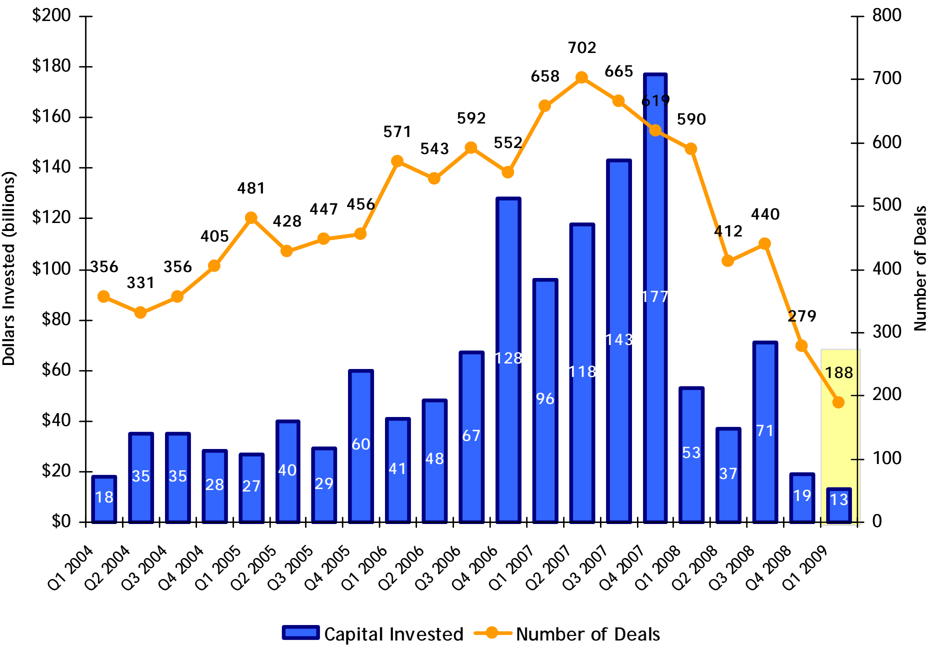
become more expensive. Currently, if private equity firms can find debt to leverage their investments, the interest rates on the debt are generally 200 to 400 basis points higher than in previous years.

"Make no mistake, volumes in the private equity industry have declined dramatically for new deals. First quarter volumes in fact are down roughly 80% industrywide from what they were before."

Steve Schwarzman, The Blackstone Group

All of this has taken its toll on private equity activity. In 2009, both private equity transactions and private equity fundraising are down significantly (see chart below). In Q1 2009, private equity investment dollars and transaction totals hit their lowest points of the last five years. If 2009 continues at the current pace, total deal flow this year will be less than 30% of the activity in 2008.

The Private Equity Industry has Suffered in Early 2009



Source: PitchBook

"Our acquisition appetite in 2009 will be more modest than it has been in the past."

Marty Hughes, Hub International

From the perspective of the insurance distribution industry, a buying group that had started to become a prominent buyer and important industry player has reduced its activity in the marketplace. However, this relative inactivity is likely temporary. Private equity investors are attracted to the insurance distribution space by the recurring revenue stream, high margins and minimal capital requirements. The combination of these attributes generally means high returns and insurance brokerage is no exception. The viability of private equity investments in insurance distribution is currently limited only by the viability of private equity itself. When conditions in the debt markets improve and when equity capital becomes more available, private equity will once again be a key acquirer in the insurance distribution industry. In the meantime, look for fewer deals and lower valuations as private equity firms try to maintain returns while handling more expensive capital and less leverage.

New Opportunities for Regional Buyers

Today, the insurance agency acquisition marketplace has changed, creating new opportunity for regional buyers. Public brokers are consolidating or nursing damaged valuations, banks are on hold (at best) or divesting (at worst) and private equity activity is restricted by a lack of capital. The three primary buying groups of the last several years are unable to replicate their past activity, which has

both decreased the number of buyers vying for a particular deal and lowered competition-driven market valuations.

This opens up a new world for large regional buyers, who were effectively squeezed out of the buy-side acquisition marketplace by the competitive frenzy of the last few years. Regional brokers couldn't match the premium prices being paid for agencies by public brokers, banks and private equity investors. Further, the sheer number of competitors for deals and the cost of playing the game prompted most regional independent agents and brokers to focus their growth strategies elsewhere. In fact, many of these regional brokers became sellers instead of buyers, capitalizing on the market opportunity.

With the playing field now more level than it has been in years, regional independent firms can leverage their most attractive selling point in competition for deals: culture. Culture isn't an insignificant variable for agency owners when they are contemplating the future home of their firms, and an attractive, compatible culture is often touted by regional independent agencies as an important consideration in selecting an acquirer. However, the attractiveness of culture can carry less influence in the face of a wide pricing disparity, which has been the case for much of the last three years.

It is still unlikely that regional brokers will consistently be able to price acquisitions as aggressively as a well-capitalized national competitor, such as Brown & Brown or BB&T. At the end of the day, price still drives many deals and regional brokers would be wise to avoid a price competition with the industry's most formidable buyers. But in cases where competition is more modest, and where a regional broker has significant synergy opportunities, regional brokers will have the chance to get good deals done. A recent study of large independent agencies indicated that the acquisitions that had been completed in the past three years were meeting expectations. Further, the agencies remained hungry for deal activity in the future.

Valuations are Down, But By How Much?

In early 2009, several industry observers began screaming from the mountaintops that valuations had plummeted from the levels of 2007 and 2008. While there is some truth to the declining-value story, there has also been some exaggeration of the magnitude of the pricing drop.

Looking at what has happened in the marketplace, it is clear that valuations had to fall. How can the public brokers continue to do deals even as their market valuations decline? How can private equity investors continue to generate acceptable returns as the amount of available leverage shrinks and the cost of leverages rises? The pressure on valuations is simply too intense to maintain the high pricing of 2007 and 2008.

But the change has not been as dramatic as some have been led to believe. What is really going on? To properly address this, it must first be established that the vast majority of deals in the marketplace contain two components.

- *Guaranteed price*: The price that a seller will receive regardless of future performance.

- *Earn-out consideration:* The additional proceeds, in excess of the guaranteed price, that a seller is eligible to receive based on future performance. Most earn-outs range between one and three years in length and are tied to future targets for revenue, EBITDA or some combination of the two.

"Up front guarantees will certainly be minimized."

Marty Hughes,
Hub International

First, guaranteed prices are down by approximately 10%. In 2007, the typical guarantee was 6.5 times EBITDA and it was not uncommon for top agencies to fetch guaranteed multiples of up to 8.0 times and sometimes higher. Today, with buyers worrying about their own declining valuations, searching for capital and anxious about the future performance of acquisitions, guaranteed multiples have fallen by approximately 10%. The typical guarantee is now 5.75 times EBITDA, and if an agency's profit margin has fallen from the levels of 2007 - 2008, then its value today would be reduced further.

Second, the perceived value of earn-outs has fallen in the eyes of potential sellers. Current market conditions have reduced expectations and driven up uncertainty regarding near-term performance. As a result, potential sellers now expect to receive less of their available earn-outs than in past years. While agency owners remain optimistic about the future of their firms since the P&C market and the economy will eventually recover, there is uncertainty about when the recovery will occur. It is this uncertainty that creates significant short-term doubt about the viability of hitting earn-out performance targets. Why, sellers ask, should they sell their agency during this period when earn-out money is least likely to be earned? Isn't waiting for signs of a recovery a better option?

What is the bottom line? The bottom line is that both components of agency valuations have decreased, largely based on market uncertainty and the resulting questions surrounding agency performance. However, we have not charted new territory on the low-end of agency valuations. We have simply returned to valuation levels that were common in the marketplace prior to the run up in 2006, 2007 and 2008.

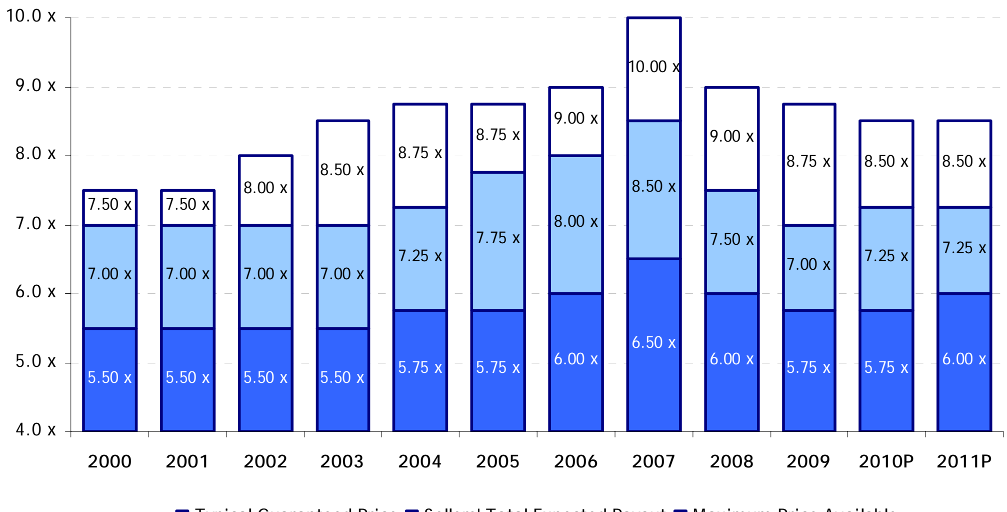
The table below shows graphically the recent history of valuation ranges for M&A transactions. The values shown are broken down into three parts: the guaranteed portion of the deal, the expected deal price (which includes the portion of the earn-out expected to be received) and the total available price. The figures below represent typical transactions in the marketplace and there were certainly deals that occurred that fell outside of these ranges. However, we would estimate that 80% of transactions that occurred during the time period shown fell within these ranges.

It is also important to note that the expected pricing is based on the sellers' expectations at the time of the transaction, not the current realities about what sellers are earning or have earned during earn-out periods. Interestingly, though the expected pricing in transactions occurring during 2007 was approximately 8.5 times EBITDA, it is likely that a typical seller that sold during 2007 is now receiving less earn-out money than expected due to the economic slowdown.

During 2006, 2007 and 2008, both the expected price and the maximum price available jumped as guarantees increased and as buyers used large earn-outs as a pressure release valve on valuations. The typical guarantee increased to 6.5 times EBITDA in 2007, up 18% from the 5.5 times EBITDA guarantees that were common in the early part of the decade. But a larger jump occurred in earn-out pricing. Because deal competition was so intense, buyers ratcheted up the total purchase price they were offering, but put more of the total price in the earn-out to share the risk. The total *potential* price available in 2007 was often 10.0 times EBITDA, up 33% from the total price available in 2000 and 2001.

The typical guaranteed price in the marketplace today, 5.75 times EBITDA, is down just over 10% from the typical guarantees delivered during the market's peak in 2007 and is consistent with guaranteed pricing prior to 2006 - 2008. Expected pricing has also declined as sellers back down their estimated earn-out performance and proceeds. Going forward, pricing will be influenced by an economic recovery and by any future P&C market tightening. If these two dynamics come to pass, guaranteed prices will likely rise, but buyers will keep a check on deal valuations by increasing the performance thresholds necessary for sellers to fully maximize their earn-outs.

M&A Valuations in the Insurance Agency and Brokerage Marketplace



Note: The Sellers' Total Expected Payout represents the total price that the seller expected to receive at the time the deal was closed and includes the portion of the earn-out that the seller expected to achieve.

A Buyers' Market?

With valuations down in today's marketplace, it is tempting to say that the industry is experiencing a "buyers' market." However, that is not necessarily the case. A "buyers' market" implies that the buying group has an outsized influence on deal flow and transaction terms, which isn't the case in the current market. Sellers that are choosing not to enter the market are currently exercising just as much control over M&A activity as the buying group. The buying group, despite being under

valuation and capital pressure, is still pursuing acquisitions as a viable way to grow and to obtain market share.

"There is some downward pressure on pricing, but we tend to look at the premier agencies, which will always command a relatively higher price for that level of quality."

Wade Reece,
BB&T Insurance Services

The market from 2006 through 2008, however, was a "sellers' market." The competition for deals on the buyer side was so rabid that it gave selling agencies the upper hand in transactions. The events of the past six to nine months have evened the scales, but haven't tipped them to the buyer side.

One of the reasons that the term "buyers' market" is not accurate is that top-performing agencies are still receiving premium valuations in the marketplace. Agencies that are able to remove some uncertainty from the equation by demonstrating strong organic growth and profitability are being rewarded if they decide to enter the M&A marketplace as sellers. Buyers recognize that the opportunity to acquire an industry or market leader does not come cheaply, and are still willing to pay for superior growth potential, effective management teams, operational excellence and industry or product specialization. There is no doubt that buyers are increasingly particular about the strategic fit of acquisitions. However, when there is a case of strong strategic fit with a leading target, the resulting valuations continue to be strong.

The Seller's Dilemma

For many agency owners, the value of their agency stock dwarfs the value of their other investments. With their agency stock such a crucial component of their overall wealth, it is no surprise that agency owners spend a great deal of time and energy wrestling with questions of how and when their agency investment will be monetized.

From this pool of agency owners comes the supply of sellers in the insurance agency and brokerage M&A marketplace. As agency owners move toward retirement and as agency WASAs climb, the decision regarding how to monetize agency equity looms.

There are many options available to agency owners when it comes to selling their shares, but there are only two basic strategies: internal perpetuation and a third-party sale. Many firms, regardless of the premium available in the third party market, have very vocally expressed a desire to remain independent indefinitely, believing that a third-party sale should be avoided at all times. In their opinion, the ability to maintain quality of life, advantages in the battle for talent and superior shareholder returns are the primary rationale for remaining independent.

For many agencies, however, the question isn't whether the firm will be sold in a third-party transaction, but when. Many agencies, even if they would like to perpetuate internally, don't have adequate internal perpetuation options. Many others actively seek a third-party sale, either for the premium pricing offered over an internal sale or for the ability to better strategically position their firm and gain greater access to value-added resources.

For the firms that will ultimately pursue a third-party sale, the question of when to sell has been an extremely difficult one lately. In 2008 and early in 2009, many firms have delayed their plans to enter the market as sellers, hesitant to sell the firm when there is so much uncertainty in the marketplace. However, others have decided that now is the right time, either because a particular strategic opportunity emerged or because the uncertainty about their projected internal valuation outweighs the uncertainty of the M&A marketplace. The chart below details the strategic rationale that sellers are evaluating in today's market.

The Seller's Dilemma

Why Firms are Selling Now

- Agency demographics (age and ownership percentages) mandate timing
- Great agencies are still in high demand and can still command premium prices
- A particular buyer can offer resources / opportunities not provided internally
- With the buyer list evolving, there is a greater variety of buyers with unique business models than in the past
- Concern that future changes in the economy, the healthcare industry or tax law will negatively impact future value
- Concern that changes in capital gains rates will adversely impact the net proceeds of a future transaction

Why Firms are Waiting

- The soft P&C pricing environment and weak economy create uncertainty around the agency's future performance and ability to maximize an earn-out
- Guaranteed pricing has fallen
- Agency demographics don't necessitate any near-term action
- Strong agency balance sheet allows owners to be opportunistic regarding sale timing
- More time will allow the agency's leadership team to make changes that will increase the firm's value
- Recent investments in growth will require more time to bear fruit

For many agencies today, the reasons to wait are winning the battle over the reasons to sell and M&A activity has suffered as a result. Potential sellers are heavily influenced by the uncertainty in the marketplace that has lowered valuations and reduced confidence in future performance.

Much of the climate of uncertainty is driven by factors outside of an agency's control: P&C pricing, general economic performance, potential healthcare policy changes, etc. However, agencies do have some control over one element of uncertainty: their performance. While growth and profitability are a challenge in today's environment, agencies that are able to generate results and remove some uncertainty around future performance will have the most options in the M&A marketplace. Significant organic growth and superior profitability are still valuable, and an agency certain that it can deliver in these areas can afford to wait to do a deal or it can confidently enter the marketplace today to command a strong valuation (see chart below).

Making Decisions

For agencies with solid performance and strong balance sheets, the range of possibilities today is as varied as at any time in recent memory. Should they sell their agency now or should they wait? Or, on the other hand, are changes in the landscape leading them to become an acquirer or perhaps to merge with a friendly competitor? Regardless of the direction chosen, top performers frequently distinguish themselves from their peers based on their ability to excel in strategic decision-making, which includes seven basic steps:

1. Gaining a clear understanding of the current situation – strengths, weaknesses and unique competitive positioning
2. Developing a clear set of organizational priorities and long-range objectives
3. Thoroughly reviewing and understanding available strategic options and alternatives
4. Identifying the course of action that allows the firm to best accomplish the desired objectives
5. Building a clear action plan and creating a timeline and accountability structure that ensures execution of the plan
6. Regularly monitoring progress and keeping options open if circumstances dictate plan modification
7. Staying informed and periodically going back through the strategic decision-making process

Agencies that are not confident in future performance or that are struggling with financial obligations are likely to be more heavily influenced by the current forces in the marketplace. These agencies may be forced into a decision one way or the other. Without a clearly visible runway of future growth, profitability and value creation (or at least value maintenance), agencies may be pushed into the marketplace by demographics or may be kept out of the marketplace by pricing and interest.

What's Next?

The M&A market for agents and brokers is down, but not out. In the first quarter of 2009, there were over 45 deals announced, a pace very reminiscent of the years immediately prior to the urgent market of 2006 – 2008 (*SNL Financial*). Certainly some of these deals were holdovers from 2008 and the market may continue to slow. However, deals are getting done. Buyers are interested, sellers are testing the waters.

Where will the market go from here? It is unlikely that deal activity or deal valuations will quickly return to the levels of the recent past. The forces in the marketplace are conspiring against that type of recovery. However, whether the market will continue to move slowly or whether it will gather speed remains to be seen. The answers to several key questions will influence the direction of the market.

- *How will coming changes in healthcare policy affect the insurance distribution business?* This is potentially the biggest wildcard in the industry right now. If legislation emerges that minimally impacts employee benefits business, some uncertainty could be removed from the marketplace, encouraging deal activity. However, if there are broad-based changes to the distribution of healthcare insurance, this line of business could lose value, becoming less attractive to buyers and discouraging deal activity.

- *When will a hard market return and will it hurt M&A activity?* There has been a lot of talk about a hard market, but any enthusiasm is currently dampened by economic conditions. But what if agents and brokers are able to generate strong organic growth on the backs of a hard market? Will the acquisition imperative fade? Will more sellers opportunistically put themselves in play?

- *How big a force will The Marsh & McLennan Agency be in deal activity?* The stated goals of The Marsh & McLennan Agency are very aggressive. If this new player can successfully complete significant numbers of transactions, it will likely put pressure on other traditional acquirers, inciting more competition in the marketplace.

- *Will community banks embrace insurance distribution as a source of non-interest income?* The pressure to diversify interest income for banks is intense, but not currently as intense as the pressure to retain capital. When the liquidity crisis subsides, community banks could drive significant acquisition activity with widespread entry into the marketplace.

- *What happens when private equity investors need to sell?* An interesting aspect of a private equity acquisition is that it sets a fuse for another transaction to occur anywhere from three to seven years later. There could be significant deal volume, and some high profile deals, triggered when current private equity investors in the insurance distribution space seek to monetize returns. Whether or not private equity buyers resume aggressive deal activity, there are many private equity backed firms operating in the industry today that will need to change hands in the coming years.

Fundamentally, consolidation is a natural activity in this industry and a normalized level of consolidation in the marketplace will continue into the future. This is simply the product of a fragmented marketplace. However, this normalized level of consolidation will be either pushed upwards or downwards by the extraordinary forces in the marketplace – by the answers to the questions posed above.

In five years, the universe of independent agents will look different than it does now. As a result of continued M&A activity, and of organic growth, the top half of the table will grow and the bottom will shrink. The industry will move toward fewer agencies that control, on average, larger books of

business. More national / global brokers will be created through acquisitions and through the growth of the largest regional players. Similarly, smaller firms will grow, merge or be acquired, forming a significantly larger number of regional and local players and shrinking the number of small firms.

The Future Population of Independent Agencies & Brokerages

Category	Revenue Size	Current Number of Firms	Number of Firms in Five Years	Change	Percent of the Population
National / Global Brokers	> $500 million	10	15	+5	0.04%
Regional and Local Players	$1.25 - $500 million	5,990	7,000	+1,010	20.58%
Small Firms	< $1.25 million	31,500	27,000	-4,500	79.38%
Total		37,500	34,015	-3,485	100.00%

Source: Reagan Consulting analysis

Within a short time span, we have seen highs and lows in the insurance brokerage M&A marketplace. The recent convergence of factors that fueled the most aggressive and dynamic deal environment in history has come and gone. It has been replaced by a season characterized by significant economic and market headwinds, resulting in a subdued and tentative M&A market. Neither of these two extremes is normal or permanent. Just as the heady days of the recent consolidation frenzy passed, so too will the deal malaise we find ourselves in today.

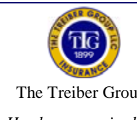
The basic fundamentals of the insurance distribution system remain strong and the core drivers of consolidation remain unchanged. As the economy and marketplace improve, the industry will likely see improvement in both agency valuation and deal flow. Contrary to some gloom-and-doom prognosticators, the M&A marketplace is not spiraling unstoppably downward.

Challenges abound in the current M&A marketplace for insurance agencies and brokerages. They always have and they always will. But well-positioned, top-performing agencies, whether buyers or sellers, always have good options, and that continues to be the case today.

The insurance distribution M&A marketplace is down, but not out.

About Reagan Consulting

Reagan Consulting provides valuation, strategic consulting and mergers & acquisitions services to the insurance distribution industry. In the past two years, we've advised on 33 M&A transactions with an average size of close to $20 million per deal. Selected transactions from 2008 are shown below. For more information, please visit www.reaganconsulting.com or call us at 404.233.5545.



The Treiber Group

Has been acquired by

Arthur J. Gallagher & Co.

Reagan Consulting advised The Treiber Group

2008

Saylor & Hill Co.

Has merged with

Barney & Barney, LLC

Reagan Consulting advised both sides on the merger

2008

Mang Insurance Agency

Has been acquired by

NBT Bancorp, Inc.

Reagan Consulting advised NBT Bancorp, Inc.

2008

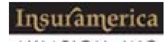
Puckett, Scheetz & Hogan

Has been acquired by

BB&T Insurance Services

Reagan Consulting advised Puckett, Scheetz & Hogan

2008



Insuramerica Aviation, Inc.

Has been acquired by

J. Smith Lanier & Co.

Reagan Consulting advised J. Smith Lanier & Co.

2008

Pacific Wholesale Insurance Brokers (Texas)

Has been acquired by

IMA Financial Group

Reagan Consulting advised IMA Financial group

2008

Preston Agency, Inc.

Has been acquired by

Starkweather & Shepley

Reagan Consulting advised Starkweather & Shepley

2008

Southern Risk Operations

Has been acquired by

BB&T Insurance Services

Reagan Consulting advised Southern Risk

2008

M. E. Wilson Company, Inc.

Has been acquired by

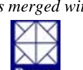
Brown & Brown, Inc.

Reagan Consulting advised M.E. Wilson Company, Inc.

2008

Consolidated Insurance Agency

Has merged with



Brower Insurance Agency

Reagan Consulting advised both sides on the merger

2008

Burkey Risk Services

Has been acquired by

BB&T Insurance Services

Reagan Consulting advised Burkey Risk Services

2008

Hutton Vincent Williamson McLean Insurance Group

Has been acquired by

Bankers Insurance

Reagan Consulting advised HVWM

2008

Premier Benefits Group

Has been acquired by

BB&T Insurance Services

Reagan Consulting advised Premier Benefits Group

2008

Roberts & Roberts Insurance Service, Inc.

Has been acquired by

Arthur J. Gallagher & Co.

Reagan Consulting advised Roberts & Roberts

2008

Beach & Gentry Insurance

Has been acquired by

Pinnacle Financial Partners

Reagan Consulting advised Beach & Gentry Insurance

2008

Farrell Backlund Insurance Agency

Has received capital from

Bristol County Savings Bank

Reagan Consulting advised Bristol County Savings

2008