

## Is there an M&A recovery on the horizon?

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What a difference a year makes. A year ago the industry was celebrating the record year of 2008, which concluded with 307 total transactions. Valuations were still high, but the red flags were flying high and mighty, pointing to a much different year for 2009.

Those warning flags were accurate. During 2009, the total number of announced transactions decreased to 185, or 40 percent from the prior year. More importantly, how did pricing hold up compared with the historic highs we saw from 2006 through 2008? To listen to some industry pundits, it would seem that valuations dropped as quickly as the stock market in early 2009. While pricing did decrease, it was not nearly as severe as some had predicted. Although the days of 7 to 8 times EBITDA (income before interest and taxes and depreciation and amortization) upfront are over for most firms, a closer look at 2009 will show that not only was the year not as bad as it could have been, but there are signs of positive trends as we enter the new decade.

From a pricing standpoint, due to multiple factors—including the worst economy since the Great Depression, a soft market, frozen credit markets, and concerns about the impact of healthcare reform—transaction multiples did decrease for the average agency, but primarily in the amount of guaranteed money paid at closing. The overall deal multiple, which includes the earn out, did not change as significantly.

For many agencies, economic and soft market conditions resulted in deteriorating financial performance, which resulted in lower revenues and reduced profitability. Therefore, the combination of reduced profitability and lower multiples meant that many agencies saw the value of their business decrease 20 to 30 percent from just 12 months earlier.



### Components of transaction pricing

To fully understand transaction pricing, it is important to break down the transaction structure into three key components.

1. **Guaranteed purchase price:** The dollar amount the seller will receive at closing or at a future date, regardless of future performance.
2. **Total potential purchase price:** The total dollar amount the seller could receive based on future performance.
3. **Expected purchase price:** The dollar amount the seller can expect to receive after the applicable earn-out period. For example, while the maximum purchase price may be 9 times EBITDA, it consists of a guaranteed purchase price of 5.5 times EBITDA and an earn out based on a compound annual growth rate of 20 percent during the earn-out period. Therefore, based on historical growth rates of 8 percent, the expected purchase price may only be 7 times EBITDA.

### Key drivers of multiples

Before reviewing transaction pricing, let's discuss several of the main industry and economic factors that resulted in the decrease in agency multiples during 2009.

- **Economy and soft market:** The impact of the worst economic environment since the Great Depression, coupled with the impact of another year of soft product rates, left many buyers concerned about current and future performance. Top-line revenue and bottom-line profitability decreased significantly during 2009 for many agencies.

- **Supply and demand:** Due to the economy and ongoing soft market, demand among all buyer groups (national brokers, banks and private equity groups) decreased significantly. In addition, with many sellers taking a wait-and-see attitude, unless an agency principal felt he or she had to sell or was presented with an opportunity that was too good to pass up, many decided to just sit on the sidelines.

- **Expectation gap:** Sellers who considered a sale ended up having to deal with a large expectation gap in pricing between seller and buyer. Sellers continued to focus on the glory years of 2006 to 2008 and could not accept the pricing changes that were taking place in the market. Buyers, on the other hand, probably overreacted to economic, market and political headwinds and changed their pricing models to the point where pricing was just not realistic for a seller to accept. During this time period, we had what we would call the "lost months," when very few deals could be consummated.

- **Threat of healthcare reform:** The threat of healthcare reform throughout 2009 and the potential impact on employee benefit brokers created confusion and uncertainty for both buyers and sellers, which resulted in reduced demand and lower pricing for many benefit brokers.

- **Public broker multiples:** Trading multiples for public insurance brokers remained low compared with historical levels. The average public broker multiple during 2009 was between 7 to 9 times EBITDA, compared with a historical average of 11 to 13 times EBITDA. This resulted in most buyers reducing the amount of guaranteed purchase price they were willing to pay a seller.

## Transaction pricing

# Table 1: Agency Value as a Multiple of EBITDA

## GUARANTEED PURCHASE PRICE

	2008	2009	Predicted 2010
Platform to national broker/bank	6.50 - 7.50	6.00 - 7.00	6.25 - 7.25
Revenue/fold in agency to national broker/bank	5.75 - 6.50	4.75 - 5.75	5.00 - 6.00
Privately held agency to local or regional agency	4.50 - 5.00	4.00 - 5.00	4.00 - 5.00

## TOTAL POTENTIAL PURCHASE PRICE AFTER EARN OUT (1)

Transaction type	2008	2009	Predicted 2010
Platform to national broker/bank	9.00 - 10.00	8.50 - 10.00	8.50 - 10.00
Revenue/fold in agency to national broker/bank	8.50 - 9.50	7.50 - 9.00	7.50 - 9.00
Privately held agency to local or regional agency	6.00 - 8.00	6.00 - 7.50	6.00 - 7.50

(1) Assumes 20% to 30% compound annual growth rate over a 2 to 3 year earn out period

## EXPECTED PURCHASE PRICE AFTER EARN OUT

Transaction type	2008	2009	Predicted 2010
Platform to national broker/bank	7.25 - 8.25	7.00 - 8.00	7.50 - 8.25
Revenue/fold in agency to national broker/bank	6.50 - 7.50	6.00 - 7.00	6.25 - 7.50
Privately held agency to local or regional agency	5.25 - 6.25	5.00 - 6.00	5.25 - 6.25

Source: Mergerstat, Pratt's Stats, Public Filings and Hales & Co. proprietary databases

Table 1 presents 2009 transaction multiples compared with 2008, as well as projected multiples for 2010. Overall, the average transaction price multiple decreased during 2009 compared with 2008. From a macro basis, the decline in agency multiples was primarily due to buyers' uncertainty related to economic and market challenges, threat of healthcare reform, reduced public broker multiples and stock price declines by bank acquirers, all of which resulted in significant less demand during 2009.

To fully understand the decline in market multiples, we need to review the changes in multiples by the various common components:

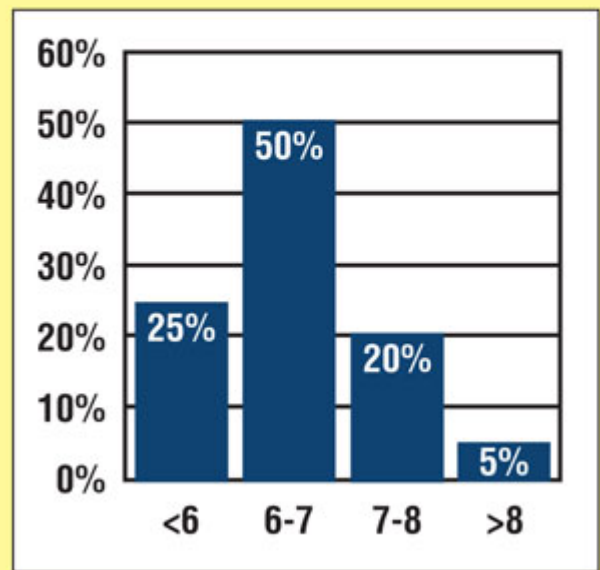
- **Cash/stock at closing:** The guaranteed amount of the purchase price when looking at EBITDA multiples decreased by less than 10 percent for platform agencies. The decrease for revenue or fold-in acquisitions was greater and much more volatile based on the specific characteristics of the agency, but overall, the guaranteed multiple dropped between 10 percent and 20 percent from 2008 multiples. Once again, with buyers concerned about not only their own financial performance but the future performance of sellers, more dollars were shifted to the earn out component.

- **Total potential purchase price:** The total potential purchase price has also decreased, particularly related to second-tier acquisitions. The average decrease was approximately 10 percent but, as with the guaranteed purchase price, platform agencies did not see as much of a drop and, overall, held their own compared to prior years.

- **Expected purchase price:** This is where sellers have been affected the most. Given economic and industry conditions, many sellers now place little value in the earn-out component as they continue to struggle with declining revenue and profitability and realize that growth, particularly in the short term, will be extremely difficult.

While the overall "average" purchase price has decreased from last year, acquirers will continue to pay a premium above the average purchase prices noted herein for the high-quality, high-performing independent agency. Our definition of such firms would be agencies that, despite difficult economic and market conditions, continue to generate above-average organic growth rates, revenue and profitability compared with their peer group. In addition, the larger the agency from a revenue standpoint, the more likely it is that the valuation will be higher than that of a smaller agency. Our benchmark for a "larger" agency is generally defined as an agency with revenues, excluding contingents, greater than \$10 million for property-casualty firms and \$5 million for employee benefit firms.

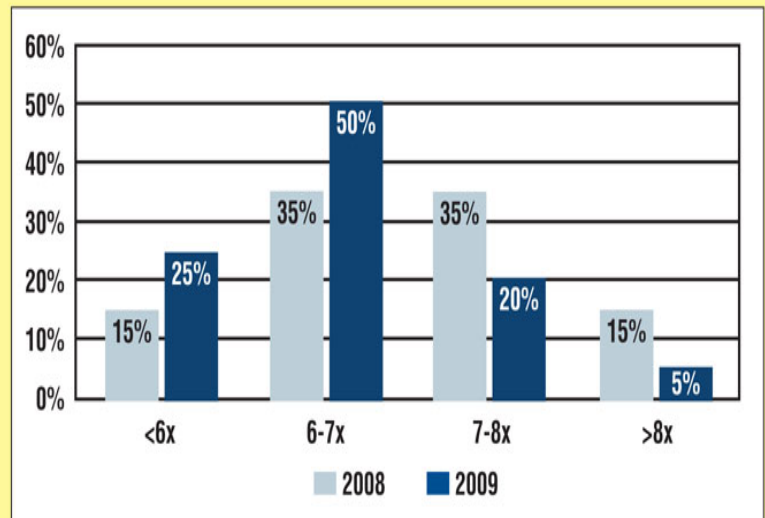
**Table 2: 2009 transactions as a multiple of EBITDA**



It is also critical to understand the percentage of deals within certain multiple ranges. Tables 2 and 3 provide an analysis of deal prices within various multiple ranges, along with a comparison with 2008. The percentages in these charts are based on the "expected" total purchase price, not the guaranteed price or the total maximum purchase price.

Transaction statistics for 2009 revealed that the percentage of transactions in excess of 7 times EBITDA decreased to 25 percentage points. This is expected, given the overall reduction in pricing, both in the upfront payment and the expected amount during the earn-out period. You would have to go back to 2002 and 2003 to find similar percentages. Likewise, when looking at the percentage of transactions in the range of 6 to 7 times EBITDA, the amount has increased from 35 percent to 50 percent during 2009. Finally, the percentage of transactions less than 6 times EBITDA increased from 15 percent to 25 percent during 2009.

**Table 3: Pricing changes - EBITDA multiple**



### Looking forward

The future for pricing fundamentals is still bright. While current multiples are below the historical highs of the past few years, they still are significantly higher than the 20-year historical average from 1980 through 2000. We believe the expectation gap between sellers and buyers will begin to narrow. Sellers are beginning to understand the current pricing cycle we are now in and will realize that valuation multiples are fair and reasonable and the peak pricing years of 2006 through 2008 are over, and will accept this “new reality.” Buyers, on the other hand, will face tremendous pressure to increase revenue and profits, which will lead to a slight increase in multiples from the lows we experienced for most of 2009. Overall, we would not expect the multiple to increase by more than .25 to .50 times EBITDA in total on an average transaction.

Finally, once economic and market conditions improve and overall buyer and seller confidence improve, we will once again see a flurry of acquisition activity in an industry that is still too highly fragmented and where size, scale, depth, and breadth create competitive advantages at all levels in the industry.

Robert Lieblein is managing partner at Hales & Company and has more than 25 years of experience. He has been involved in more than 150 mergers and acquisitions and is known as one of the industry’s leading financial advisors. He has written numerous articles for industry publications and is a frequent speaker for industry trade groups and associations. Lieblein can be reached at 717-541-9300 x 101 or [rlieblein@halesgroup.com](mailto:rlieblein@halesgroup.com).