



Deals in the balance

It may not be 2008, but experts agree that the agent M&A market is slowly improving

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Buy and sell or wait and see? When it comes to agent/broker mergers and acquisitions, it all depends on who you're talking to. On one hand, the bad economy and soft insurance market have negatively affected agency valuations, resulting in a sluggish market. On the other hand, the threat of expiring Bush-era tax breaks—and the presence of tempting acquisitions for buyers who have access to financing—could spur more potential dealmakers to get off the fence and do a deal before the tax breaks are history.

To get a 360-degree view of the current M&A landscape, AA&B spoke with five different experts on the market.

Although each had his own opinion on where the market was heading and when—and there was even some divergence on the current state of the market—everyone agreed that the recession and the soft insurance market have put a damper on M&As. And although activity is up this year compared with 2009, the boom days of high-priced deals and an avalanche of activity are gone, possibly forever. Moreover, future activity largely hinges on whether the economy rebounds enough to give both buyers and sellers the impetus to get back in the game.

Everyone seems to have a different opinion on if or when the agency M&A market will become more robust. When do you expect things to turn around, and what will be the impetus?

John M. Wepler: Given the time it takes for a typical deal to close, the year-to-date increase in deal closings is a far cry from what the industry will experience for calendar 2010 and beyond. Although deals were up 11 percent on a year-to-date basis through July, this is just the start of the wave. Deal activity is so significant today that discussions in process are outpacing buyer capacity to close. The bottleneck is so significant that by September 1, a number of buyers made the decision to defer all new deal discussions until 2011.

The impetus to the turnaround of the deal market at the beginning of 2010 was a surge in number of buyers and sellers. Many buyers that were historically active were in hiding during the early part of the recession, given their own public valuations, limited access to capital, weak board support or an attempt to try to buy at a discount. Some interested buyers attempted to remain active but became opportunistic and tried to reduce pricing to their advantage. The pendulum swung too far and pricing fell to such a point that sellers would not come to the party and the deal market dried up. Buyers could not grow organically and, for the first time in more than a decade, did not have deal activity to make up the shortfall. As a result, early 2010 marked an inflection point in buyer aggressiveness in both pricing and prospecting. Today, there is a broad, aggressive buyer market and pricing is back to a reasonable level.

Seller supply is up. Many agency owners have reduced or ceased reinvestment in the next generation given the prolonged soft market and the recession. The weighted average owner age in the industry has increased from 51 years to 57 years since 1998. The pool of candidates available to make an internal market for the stock is smaller than it was and a far cry from what it should be to perpetuate. Many potential candidates do not have the confidence in the business given the market, and even more don't have the personal income or risk tolerance to buy enough stock to move the needle. A lack of internal buyers, a lack of buyer capacity and concern over future growth generally translate to an owner who is not comfortable holding the note on his own buyout and in turn drives an eventual sale.

David M. Simmons: Agency/brokerage M&A has actually been the strongest segment of the insurance M&A market in 2010. Our statistics indicate that the number of agency and brokerage deals in 2010 year to date already surpasses the number of deals for all of 2009. In addition, the average deal size is up from 2009. The agency M&A market is clearly not

as robust as in 2008, which was a peak year, but it's still pretty strong. We're also seeing more interest by consolidators—larger firms and private equity investors buying agencies and brokerage firms as part of a roll-up strategy.

Tim Cunningham: It will minimally take 2 to 3 years for deal flow to recover and it may be longer, if at all, to reach the go-go activity of 4 to 5 years ago—all due to the "perfect storm" of the recession and impact on insurable exposures (payroll and sales), coupled with the soft property-casualty market. Further, lower head count has impacted employee benefits revenue. The impetus for a recovery will be continued economic improvement and the likely market shift on the property-casualty side, but that may be 2 to 3 years off. It's unknown whether the impact of healthcare reform on employee benefits revenue could also have an impact. The quality of the inventory is also in question. Discriminating buyers may simply sit on the sidelines due to the mediocre to poor quality of some sellers.

Robert J. Lieblein: The fourth quarter of 2010 is going to show significant activity compared with the past 24 months. The primary reason is the pending change in capital gains rate. As a firm, we have not seen this much activity since 2007. I expect that will slow in the first quarter of 2011, but will pick up as the economy picks up. I do not foresee activity going back to 2007 and 2008 levels for quite a while. Profits are down at many agencies and the resulting valuations of many firms are not compelling for many business owners to sell.

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Robert W. Reagan: The main reason there has been less activity is because of poor agency operating results driven by a soft P&C market and a poor economy. Many agencies are not driven to sell because their numbers would not drive a good price, even when the buyer is paying an attractive multiple of EBITA. Also, most buyers will be paid a portion of the total consideration as an earn-out based on future results. With the market and the economy as it is, many agents aren't optimistic about their ability to grow earnings or achieve an earn-out.

From the buyer's perspective, it may seem as if they could buy cheap, but sellers, unless backed into a corner or unless they have unusually good operating results, are not selling because they're not motivated to do so.

Even in those situations where owners may be thinking of retirement, they don't want to sell at a low point. There may be some people who have to do something in spite of the market, but others are going to wait a year or two until they think they can get a better price or better terms.

Things will change when we see an improving economy where businesses are starting to hire and insurance premiums (and agency revenues) go up. When that happens, operating results will improve and the level of M&A activity will increase.



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More small business sales are fueled by seller financing. Is this something you're seeing in agency M&A, and what effect, if any, is it having on the marketplace?

Lieblein: We are seeing more seller financing because of a lack of credit in traditional bank financing, particularly SBA financing. On smaller deals, the only true source of financing is InsurBanc and Oak Street Funding, but often that is not enough, so seller financing is required. It clearly complicates deals because of the "credit risk" that exists for the seller compared with selling to an entity like Brown & Brown, Arthur J. Gallagher or Hub International. Pricing becomes

somewhat difficult because the seller often wants a premium if seller financing is involved. But in today's market, sellers need to understand that seller financing is the norm and it is not realistic to expect a higher purchase price.

Wepler: Seller financing has increased significantly over the past 2 years and is the byproduct of a shift in the composition of the typical buyer. Privately held buyers have been and always will be the most active segment using seller financing. Privately held buyers became the most active segment during 2009 for the first time in a decade, given a willingness to pay fair pricing when many others were attempting to be opportunistic. Today, pricing has firmed to the point where public brokers, banks and private equity funded brokers are reclaiming lost ground and dominating the playing field. This has shifted the market back to the normal realm where buyers use cash or their stock as currency versus relying heavily on seller financed notes.

Reagan: If someone is going to sell their business to a third party, they don't have to provide seller financing; most active acquirers have capital, so it's not an issue. Where it does come into play is if an agency wants to sell internally. A lot of agencies still want to be privately held and that will most frequently require seller financing unless they can find a third party (like a bank or insurance company) to provide the financing.

Cunningham: Seller financing has and continues to be prevalent on smaller deals—the smaller buyers have not had the same capital base and/or access to capital as the "larger" conventional buyers such as Brown & Brown, Hub and Gallagher. The current environment has not impacted the structure of deals both large and small. But there really has been no change in how deals are done.

[Read Tim Cunningham's "Deals or no deals."](#) Published 9/3/2010

Is the threat of an expiration of the Bush-era tax cuts having an impact on M&As?

Lieblein: Absolutely. There are more sellers actively trying to close deals by Dec. 31, 2010 than since the heyday of 2007 and early 2008. The difficulty is many of these sellers waited too long to start the process and many of the top buyers are overwhelmed with firms looking to have their deals close by 12/31. Not all these deals will close by then and the sellers must realize their proceeds will be reduced by 5 percent.

Wepler: The increase in the long-term capital gains rate from 15 percent to 20 percent on Jan 1, 2011, has not created a groundswell of activity in and of itself. However, it has prompted many to conclude that if selling in the short run is the plan, it makes more sense to sell now to capture strong valuations and higher after-tax proceeds.

Cunningham: I see no impact. Look at the numbers: 2009 had the least number of deals in the last 10 years; 2010 will be the same based on activity to date, and it might be worse. Notwithstanding the 5 point shrinkage due to the scheduled increase in the capital gains tax rate, the smart sellers believe they will recover 5 points and more over the next 2, 3 or more years. We rarely find one singular issue, such as the impending increase in capital gains tax rates that influences sellers to go to market. Rather, it is a combination of issues. Yet there may be a rush at the end of the year if it becomes clear from Washington that rates will jump on January 1 and the procrastinators finally reconcile the impact of the tax change. However, if the deal is not in process now, it may be too late, as buyers need a minimum of 60 to 90 days to do the analytics and close the deal with due diligence and legal documents. Only the very small, super-clean deals can be concluded in less than 60 days.

Simmons: It's adding to the uncertainty of an already uncertain M&A market. However, I do not believe this is driving or accelerating M&A activity because this issue has become so political that no one can predict the outcome. If it becomes more certain that the cuts will expire, we could see a rush of deals trying to close before year end.

As in the real estate market, I would think that today's economy would make it a great buyers' market for agency purchases. Why aren't we seeing more activity?

Wepler: Buying a house takes a weekend. Buying an insurance agency takes from 2 to 12 months. The deal market has gone from famine to feast. We are in the midst of the build-up and the number of deals in the pipeline is now starting to show in the number of closings. It is a buyer's market for agencies that are inferior and a seller's market for agencies of quality.

Reagan: The real estate market is depressed because a lot of people who were in it were heavily leveraged. In that kind of environment, a lot of buyers are coming in to buy cheap and get good deals; if you have money in that business, it's a great time to buy. As far as insurance agents and brokers, there aren't many situations where firms are so highly leveraged that they're in default. Most privately owned firms may not be growing, but they're not broke.

Simmons: Tight credit conditions, economic uncertainty and the continued soft pricing market on the personal and commercial lines businesses is making it harder to do deals because profit projections and expectations are so much lower. In addition, there remains a significant gap in valuation expectations of sellers and buyers, which is making it harder to close deals. Until the uncertainty decreases and the valuation gap narrows, it will be difficult to get deals done. I think the catalyst will be the turn from a soft to hard market.

Lieblein: Unlike real estate, when the owner is forced to sell, many agency owners, while they probably should be selling, are taking a wait-and-see approach. The sellers are also not willing to take big discounts like you see in the real estate market. On the flip side, buyers overall are being more conservative and cautious in their acquisition approach, so you don't see as many deals as one would expect.

On the seller side, how has the soft market and recession affected agency valuations? Should the seller wait for pricing to improve to sell, or is current pricing at a "new normal" level, unlikely to rise to previous high valuations?

Cunningham: If a firm's EBITDA margin is down 25 percent due to the "perfect storm," then its value is down 25 percent. EBITDA multiples (+/- 6) have not changed significantly, although the deals have slightly more stringent earn-out terms. In addition, while a seller's pre-tax and/or EBITDA margin as a percentage may have stabilized, they have likely experienced a relatively material decline in the actual dollar amount due to the "perfect storm" conditions. If you don't need to sell in 2010, wait. The prudent future sellers have embraced that strategy.

Reagan: There are some sellers who, in spite of the market, are doing pretty well. Buyers aren't having as much activity as in the past and may be more aggressive at this point. For some firms whose numbers aren't off as much—in healthier parts of the country or with strong niches and aggressive sales forces—it might not be a bad time to sell. Others, whose numbers are way off and don't have to sell, should sit back, continue to grow and look at doing something a year or 2 from now (if they are inclined to sell to a third party). They'll probably get a better price and better terms.

Simmons: The insurance industry and insurance M&A is inherently cyclical. Historically, we have seen M&A activity increase at the turn of the pricing cycle. Buyers typically want to enter when the market is soft but beginning to turn because valuations are low. Owners want to sell when pricing is hard but beginning to soften because valuations are higher. I think this cycle will repeat itself.

Wepler: Agency valuation collapsed during 2009, rebounded during 2010 and is now very strong. Value is not where it was in the mid 2000s, when valuations hit an all-time high given the glut of capital in the world, buyer demand and a sense that the world economy was unstoppable. Banks were looking for foundation agencies, brokers had board support to expand and private equity firms had unlimited access to capital at low interest rates with little to no collateral requirements. The world got to a place where private equity firms felt like "a bad deal was better than no deal," to demonstrate the ability to deploy capital to start another fund. Valuations in many areas of the world economy peaked at a level that was not sustainable and will not return for quite some time. It is our opinion that pricing today is the new normal.

Lieblein: Although pricing is not going back to where it was in 2007 and early 2008, pricing related to the upfront payment has not dropped as much as many potential sellers think. For a high-performing agency, we see a drop of maybe a 100 basis points, so from 7 times upfront to 6 times upfront. For average agencies, the drop is similar, 6 to 5 times upfront. This could be a great time to sell for an agency—once the economy and soft market improve, the ability to earn more money in the earn-out improves. Compare this with a firm that sold in 2008, and ended up getting only what they received upfront. Potential sellers will need to wait for the hard market to impact their financial results, which will take a year, and then another year to close—and then, like most hard markets, it will start turning soft within 24 to 36 months. I tell agency owners who are trying to "time the market" that it is just not possible. Most advisors who are active in the M&A market would say the same thing: the market is not bad now, pricing is fair and the odds of moving to pricing we saw in 2007 is slim to none.

At one time, banks were the big institutional buyers of independent insurance agencies. Do you see banks getting back into this in any meaningful way?

Simmons: That was a strategy driven primarily by the need for banks to expand product distribution and increase fee-based revenue. I don't see banks being big buyers of agencies in the near term. Although there will likely be some exceptions, I believe that most banks will stick close to their core banking activities in the short term and deal with investment, capital and operational issues.

Wepler: Many banks will not be back in the near future given their own challenges. During 2008 and 2009, an increase in loan loss reserves, capital requirements and the reduction in earnings from the writeoff of non-performing assets significantly impacted many banks. As a result, many sat on the acquisition sidelines during 2008 and 2009 and will continue to focus on their core banking business during 2010 and 2011.

However, a handful of banks that have weathered the economy and have a strong insurance platform will be very active. The top 25 percent of bank-owned agencies achieved growth of 5.6 percent during 2009 and posted a return to owners of 16.1 percent. On a risk-adjusted cost of capital basis, a higher-performing insurance operation is often one of the highest-performing areas within a bank. The interest in and support of insurance as a core service has also been enhanced by the legislative attack on overdraft and ATM fees, leaving insurance as the line of business with the brightest future within the fee income (or non-interest income) side of the banking business. Above all, the leading banks in insurance acquisition are committed to continue on the journey of becoming a comprehensive solution provider of financial services within their geographic market.

Lieblein: I believe BB&T and Wells Fargo will continue to be significant players in the M&A space. However, they are impacted by the low stock price of the bank, which makes it difficult for them to be price competitive in the market. I think as the stock market improves and additional stability returns to the economy and credit markets, other larger banks such as Regions and Bancorp South will reenter the M&A market. But overall, I do not see banks making the impact that they did 4 or 5 years ago.

Reagan: Many large to mid-sized banks, all the way down to community banks, are interested in insurance acquisitions to diversify their income stream and get earnings growth. Banks are not going to dominate the business, but they will be a long-term piece of the distribution system.

For public brokers, acquisitions are an important part of their strategy, and private equity owned firms like Hub, USI and Alliant are interested in acquisitions as well. There are also new private equity players. We get a call a week from someone who has raised capital looking at a consolidation play. The challenge is not from the buyer side. The challenge is finding enough sellers in a position to consider a sale of their firm.

Cunningham: Many banks that did deals in 2001 and 2002 got an unnatural lift due to the post-9-11 hard market. They now see margin compression due to the "perfect storm." Many could possibly consider disposing of their agency assets when the market improves in 2, 3 or more years.

What, if any, impact exists on agency M&A activity if accounting standards switch from GAAP to IFRS?

Cunningham: IFRS's impact is likely to be felt only by the largest firms when the transition begins, which may still be several years in the future. The primary impact will be in the disclosure of contingent purchase price components and decisions about whether to consolidate less than wholly owned subsidiaries. For the vast majority of domestic property-casualty and employee benefits brokers, IFRS will have a negligible impact on their M&A activity.

Lieblein: To the extent that a switch to IFRS would impact how you treat the accounting for acquisitions could impact M&A activity. Anytime an accounting rule has the ability to negatively impact earnings per share, it could impact M&A activity.

Reagan: Accounting has some impact on certain buyers, whether they're private or private equity or publicly traded, but I would not anticipate and haven't seen any changes that would have any material impact on the level of activity based on this.

Simmons: This is more likely to have an impact on international and cross-border M&A activity. I believe this is a positive development and will lead to greater conformity in accounting and financial statement analysis, which will have a positive impact on M&A activity and deal success in the future.

Wepler: The switch is largely inevitable, given the adoption of IFRS by many countries and the challenge in comparing the financial statements of companies across the world. Whether or not the switch occurs in the U.S., it will have no impact on the M&A market. Agencies are acquired using pro forma cash flow earnings, not GAAP earnings. Agencies with strong leadership that reinvest in the future, embrace an organic growth culture and require superior service will always have value and be in demand. The success or failure of a transaction in this industry is dependent on people, not accounting standards.

“Doing the deal” is only a preliminary step in a successful merger or acquisition. What are the biggest challenges involved in successfully integrating an acquired business, and how can they be overcome?

Simmons: Deloitte has researched this extensively and two of the primary reasons deals fail relate to errors in approach and execution. Common errors in approach include acquiring businesses that are poor strategic fits or businesses that are too far removed from the acquiring company’s core competencies. One of the primary execution errors is a failure to recognize and appreciate the differences in company culture. Sometimes the cultures are just too different to merge successfully. I believe that both types of errors can be reduced by more thorough and comprehensive due diligence before the deal is done.

Wepler: The two areas that make or break a deal are culture and managing expectations. If the cultural fit is so divergent that it’s obvious the fit is not there, run as fast as you can. Differences in personality, strategy, priorities and perspectives on service will be tamped down by the desire to close. These challenges, however, will become magnified 100 times after the check clears. Lack of fit is the poison in any deal in the long run. Managing expectations is also critical. Both buyer and seller should embrace a detailed due diligence process that maps to a post-closing operational business plan so all involved know what changes will occur. Too many buyers tell sellers that nothing will change, which makes sellers very disenchanted when changes are implemented. To survive in this economy and rate environment, both parties must agree that change is the only constant and that collaboration as partners after closing will ensure success.

Reagan: Part of a successful integration is good communication up front, where you lay out expectations on both sides and both sides are going in with eyes wide open. Differences in cultures can be a challenge – different ways of handling compensation, benefits programs and technology platforms. It’s important to develop relationships and rapport between the employees of both organizations and try to create a combination where “one plus one equals more than two”. Good preparation, training and being wise about how the organizations will be brought together and operate with employees feeling excited about their new work associates and employer are all important.

Lieblein: The problem often starts when the seller does not understand that for most buyers, growth is critical post transaction, and if they have not developed a true sales culture, they struggle with this and people get frustrated. Most major buyers understand what is necessary for successful integration and explain it pretty well to sellers during the “doing the deal” phase. The reality is you have many entrepreneurs who think they can work for someone else, but cannot in the end, and then culture begins to break down. The other problem is where sellers do not properly reward key producers and employees, who end up feeling like they have been “sold out.” They ultimately leave the organization and in the end, what the buyer thought he was buying does not work out. Sellers who have developed a great culture are generally more successful in integrating.

Cunningham: The biggest challenge is underestimating the complexity and difficulty of the integration process. It can be overcome by:

- Focusing on the quality of the deal and the target
- Understanding and getting to know the seller
- Conducting a solid operational due diligence
- Planning, planning, planning—the devil is in the details
- Resolving the hard issues early in the process
- Anticipating the worst.