Making a successful play for another insurance agency

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AT SOME point, undertaking an acquisition becomes a crucial strategic move for many large, growing agencies. But making a successful play for another agency is a complicated matter. The quality of the seller's management and employees, the characteristics of its clients and its financial condition are only some of the issues that must be looked at. Since acquisitions aren't made in a vacuum, agents also should be aware of what other players in the game are doing.

A good purchase may not only give the agency more business but also provide it with new markets, new producers or other competitive assets. Sellers, whether they stay on after the sale or immediately take the proceeds with them into retirement, also have a stake in seeing that acquisitions are successful.

What can buyers and sellers expect in today's market? How can both parties ensure a transaction will be a good one? In this article, we'll attempt to provide some answers.

Who are the buyers?

Agencies in the market to buy other agencies should know who their competitors are. In acquisitions between 1998 and 2003 that were publicly announced (most sales between independent agencies are not), 39% of the buyers were publicly or privately owned brokers, and 35% were banks or thrifts. In the past year, publicly traded brokers, under pressure from Wall Street to continue growing earnings despite the softening market, have stepped up their buying even more.

> **The quality of a seller's staff, finances and management are only some of the factors that will determine the outcome of the game.**

Historically they have focused on larger insurance agencies, those with $3 million or more in annual revenue. Lately, however, they've also been buying smaller agencies and rolling their books into the brokers' local or regional offices.

Banks have not picked up their pace of acquisitions, as publicly traded brokers have. Typically they look for a large, well-run, well-equipped agency in a community and make it their "foundation" agency. Subsequently, they may acquire other agencies to roll into these foundation agencies.

Insurance agency valuation

An agency's value is determined by its earnings—more specifically by its earnings before interest, taxes, depreciation and amortization, or EBITDA. Then EBITDA is multiplied by an appropriate risk factor, or capitalization rate, to produce a book-of-business valuation. That value can be divided by revenue to create a multiple of revenue, which is how agents often express the value of their agencies. A particularly fortunate agent might tell another that he sold his agency for 2.0 times revenue. While he may have done so, the buyer in all likelihood didn't come up with that offer simply by doubling the agency's commissions. The buyer's reasons for paying what

he did were much more complicated—and financially sound.

In addition to book-of-business value, agencies have a balance-sheet-liquidation value, usually referred to as tangible net worth. The sum of the book-of-business value and tangible net worth is an agency's fair market value.

To determine an agency's book-of-business value, a buyer should create a pro-forma profit-and-loss statement—i.e., a projection of how the buyer believes the seller's agency will perform after the acquisition. Here, in broad strokes, are the sources of pro-forma revenue to consider.

• *Commissions:* One thing to check is new and lost business. If the agency recently lost a large account, make sure the commissions from it are not reflected going forward. On the other hand, if the agency just landed a large piece of business, it should be given credit for that in the pro forma.

• *Investment income:* One source of investment income is interest earned on premium float. An agency that is good at collecting premiums will earn more off the float than one that is not and should be given credit accordingly.

• *Contingencies:* To a large degree, an agency's contingency revenue is beyond management's control. Therefore, the pro forma should simply reflect the historical average. If an agency's contingencies have been relatively stable, an average of the last two or three years should suffice. If they have fluctuated significantly, an average over a longer time span should be considered.

• *Miscellaneous income:* This could include, for example, rental income if the agency leases part of its building. Be careful not to include any gain on an asset, as opposed to the revenue it generates, on the pro forma.

Pro-forma expenses must be calculated, too. One line item that often needs to be adjusted is owner compensation. In this category, a prospective buyer may find payments for vacation homes, autos, cell phones for kids and other property that the owner decides for tax purposes to buy through the agency. We encountered one agency that even listed compensation for a gardener on its income statement. When we asked about the matter, the owner said he used the expense item to provide income out of the agency for his spouse. All such excess owner compensation should be deleted from the pro forma, since the buyer obviously will not continue it. The buyer also should look for nonrecurring expenses, such as legal fees for a settled claim, which should be left off the pro forma.

Risk factors

Subtracting pro-forma expenses from pro forma revenue gives you pro-forma earnings. Adding interest, taxes, depreciation and amortization yields pro-forma EBITDA, to which an appropriate multiple will be applied. The multiple will be based on the buyer's assessment of the risks to maintaining and growing earnings. The higher the risk, the lower the multiple. Some of the risk factors to consider are the following:

• *Age of key employees:* How much turnover might a buyer expect, and how difficult will it be to maintain or grow the business if, for example, most of the producers are in their 60s?

• *Dependency on large accounts:* In a recent valuation in which we took part, one account represented 87% of the agency's book of business. The loss of that account obviously would have a profound effect on earnings, increasing the risk of the acquisition.

• *Quality of companies:* What are the agency's top 10 insurers? How stable and financially sound are the agency's carriers? What are their Best's ratings? Does one insurer have more than 25% of the agency's business? If so, there may be a significant risk to earnings, if the agency loses that market.

• *Non-compete and non-solicitation agreements:* Has the agency contractually protected itself from the risk of losing business to departing producers?

• *Business diversification:* The importance of this factor will vary with the buyer's characteristics and goals. Many agencies these days want to become more involved in life and health insurance, making an agency with a large book of such business an attractive acquisition. A buyer whose business mainly consists of commercial lines might be particularly interested in an agency that derives 75% to 80% of its business from personal lines.

• *Sales management:* Has agency management been good at growing the business? Are producers held accountable? Such an agency may justify a higher-than-average multiple.

• *Historical growth rate:* An agency might be profitable, but if it grew only 5% during the hard market while other agencies grew 20% or 30%, there could be a problem.

Market conditions also affect multiples, which rose between 2000 and 2002, reflecting the hard market and the premium growth it produced. Now, as the market softens, we're starting to see multiples drop.

Due diligence

In the due diligence process, prospective buyers get the opportunity to see all the seller's records and verify the accuracy of previously provided information used to prepare the pro-forma statements. A detailed checklist (we use one 15 pages long) should be used to ensure the review is thorough. Among issues to review are the following:

• *Employees:* How productive are they (in terms of the agency's revenue per employee and other criteria)? How does their performance stack up against industry averages? How long have they been working for the agency? (Frequent employee turnover is not a good sign.) Are they being compensated appropriately? If the buyer's employee compensation package is significantly different from that of the acquired agency, how difficult will it be to reconcile them?

• *Finances:* Do the details in the general ledger corroborate the information previously given to the buyer in the agency's financial reports?

• *Customers:* The buyer should check the customer records against previously provided reports to ensure that the type, number and size of clients are as represented.

• *Carriers:* Buyers should verify the accuracy of previously provided information about insurance company representation. Insurer contracts should be examined to determine whether they are assignable to the buyer. If one of the buyer's reasons to acquire an agency is to obtain a key market, and the carrier has the right to walk after the sale, it's best to find that out before consummating the deal.

• *Balance sheet:* The condition of the seller's balance sheet constitutes one of the greatest risks to the buyer. Accounts receivable and insurance company payables should be examined in particular. Check the aging of accounts receivable. Look beyond the typical summary (accounts past due 0-30 days, 30-60 days, 60-90 days and

more than 90 days). Make sure any aging credits are removed so you can see what the true receivables are. Also examine the seller's collection procedures and their history with bad debt. Are they writing off a lot of it?

It's also vital for buyers to ensure the insurance company payables report agrees with the general ledger, because 85% to 90% of agencies we see don't reconcile company payables. You want to discover any discrepancies now, not weeks or months after the sale.

• *Unusual P&L items:* Also look for any unusual income or expense items. For instance, as you go through the seller's detailed P&L statements, you may see car payments for a vehicle used by the owner or a family member. If you didn't catch this when you built your pro forma P&L, you should be able to discover it during due diligence.

• *Insurance company records:* Compare the monthly production reports from the agency's carriers to previously provided reports generated off the agency's computer system. (It's not unusual to find discrepancies.) As previously mentioned regarding the pro forma, the buyer also should examine information about contingency commissions in the records. If they have fluctuated greatly, try to find out why.

• *Producers:* How are producers compensated? If the buyer's producer compensation system is significantly different from the seller's, what issues are likely to arise when the producers are "transitioned" to the new system?

Does the agency have contracts with its producers? If so, do they grant producers vesting rights in their business, perhaps in connection with a deferred compensation plan? When producers have vesting rights, we often find that unless agencies obtain outside audits of their financial statements, they do not report the vesting rights as liabilities. But a buyer will want to deduct any producer's ownership in the business from the agency's value. If the buyer wishes to have complete ownership of the business after the sale, it may be necessary to negotiate with the producer. A better approach is to have the owner negotiate with the producer and absorb any cost of buying out the producer's interest. One common solution is for the owner to give the producer part of the agency-sale proceeds as consideration both for the producer's business and for signing a non-compete or anti-piracy agreement.

• *Customers:* The buyer should determine its vulnerability to loss of major accounts after the sale. If a bank is a buyer, for instance, might a major account move after the sale because of a business relationship it has with another bank? Also, the buyer should determine how many large accounts have been gained and lost in the last three years to gauge the vola-tility of the business being purchased.

• *Customer files:* A buyer should audit the seller's electronic customer files, comparing them with the declarations sheets and other paper records from the companies to ensure the business has been represented accurately. The buyer also should examine the seller's filing procedures. Ensure there is consistency in how transactional filing and related processes like document imaging are carried out.

• *Regulatory matters:* The buyer should ensure that insurance licenses of all employees holding them are current. Make sure that continuing education requirements are being met, too. Determine whether any regulatory complaints have been lodged against the agency and whether they have been satisfied.

• *Tax returns and financial reports:* Verify that all returns have been filed and taxes have been paid. If the agency uses an outside source to prepare its financials, compare the outside reports to any internal reports.

• *Insurance:* Examine the agency's E&O policies and applications to determine if there have been any claims. When we ask agencies whether they've had any significant E&O claims in the past three years, typically we are told they haven't. Then when we look at the previous applications, we see that a claim or incident has been reported. If so, we determine whether the claim is still pending and poses any risk to the buyer. E&O claims are not the only ones that should be investigated. An employment practices or other type of claim also could be pending.

Forms and documents

Let's consider some forms and documents used in acquisitions. One is the due diligence checklist. It should be thorough and should be used consistently. We have encountered agencies that have bought numerous small books of business, ranging in size from $100,000 to $200,000 in revenue, using a different approach each time. That's asking for trouble. Buyers must have a detailed due diligence checklist and then have the discipline to use it consistently, or it will be all too easy for something to fall through the cracks.

Another document is the letter of intent. Buyers usually give these documents to sellers after they've completed their pro formas. It sets forth what a buyer is willing to pay the seller and specifies exactly what is being bought. If the seller is to stay on after the sale, the owner's compensation will be spelled out, too. Representations and warranties will be provided as well. The buyer's attorney will draft this document. We've seen some that are two or three pages long, and others that are as thick as a small phone book. Much depends on how much protection the attorney thinks is necessary and the size and complexity of the acquisition.

The letter of intent is contingent on due diligence turning out satisfactorily. Suppose a buyer comes up with $200,000 in pro-forma EBITDA for an agency and agrees to buy it for five times that amount. If due diligence reveals the agency's EBITDA is really only $150,000, the buyer obviously is not obligated to pay the seller $1 million and may offer only $750,000—or less. The seller may walk away, but so what? We stress to buyers and sellers that the pro forma is a promise: a promise to the buyer about what will be delivered, and a promise to the seller to pay a certain amount for it. If the first promise is not kept, the second is not binding. If everything turns out fine in due diligence, however, the parties sign a purchase and sale agreement and have a closing, followed by disbursements of the funds to the seller.

What are agencies worth?

What have sellers been getting for their agencies? Drawing from information derived from our own valuations and from publicly announced mergers and acquisitions, we calculated that in 2004, the average pro-forma EBITDA for agencies bought by other independent agencies was 21.1% of revenue. Multiplying that figure by an average EBITDA multiple of 5.32 produced a book-of-business valuation of 1.12 times revenue. In these transactions the sellers' average tangible net worth

was .09% of revenue. Adding that to the book-of-business valuation, we get an average fair market valuation of 1.2 times revenue. That, on average, was how much these agencies sold for.

How does that compare with transactions involving other kinds of buyers? In general, the banks paid most—but they also bought better agencies. Those acquired to become "foundation" agencies had pro-forma EBITDA equal to 28.1% of revenue. Banks rewarded them with a 7.99 EBDITA multiple. In terms of revenue, the book-of-business valuation worked out to 2.25 times revenue. These agencies also had healthier tangible net worth, equal to .16 of revenue. Together, these figures produced a fair-market value (selling price) of 2.41 times revenue. Subsequent agencies banks bought to roll into the foundations agencies had proforma EBITDA equal to 24% of revenue and sold for 1.61 times revenue. Agencies bought by brokers had an average EBITDA equal to 26.3% of revenue and were bought for 1.9 times revenue.

Most agencies are bought on an "earn-out" basis. In other words, the seller receives the agency's tangible net worth and a certain portion of the book-of-business value upfront. The rest is paid in annual installments, the size of which typically varies with the purchased book's performance.

In 2004, agencies bought by other agencies on average were paid 65.5% of the book-of-business valuation upfront. (Brokers and banks typically paid anywhere from 79.9% to 89% upfront.) The balance of the purchase price was paid out in installments, usually over three to five years.

Improving the offer

You may ask yourself why the average independent agency paid sellers only 1.2 times revenue in 2004. One reason, as we have seen, is that the agencies they bought were not as profitable as those purchased by banks and brokers. But another big reason agencies pay less is because many are unable to pay more—particularly upfront. Consequently, they pay a higher portion of the purchase price in installments, which are paid out of the earnings generated by the acquired agencies themselves.

Suppose a $3 million agency (revenue) plans to make an acquisition. From all the statistics we've seen, the average agency has a tangible net worth equal to just 10% of revenue. That amounts to $300,000 for our $3 million agency. This figure mainly is made up of three components: fixed assets, which have no liquidity; loans owed by shareholders; and whatever the agency has in working capital. Typically, working capital will be about a third of tangible net worth, meaning the agency really has only $100,000 available for a down payment on an acquisition. The rest of the down payment usually takes the form of a bank loan—often backed by the agency owner's personal guarantee.

This scenario demonstrates why agencies should build their tangible net worth. If they don't, they won't have the liquidity to seize acquisition opportunities when they come along—or upgrade their technology, move from outgrown facilities, bring in new producers, etc. Agencies should have tangible net worth equal to 20% of revenue. If an agency plans to perpetuate itself internally, the figure ought to be 25%. Otherwise the selling owner could find himself (or herself) having to return from retirement to retake the reins of a cash-strapped agency.

While agencies often are limited in what they can afford to pay upfront for acquisitions, there are ways they can structure win-win deals with potential sellers. Assume an agency offered for sale has $1 million in annual revenue and pro-forma EBITDA equal to 20% of revenue. A potential buyer concludes that a 5.0 multiple is justified, producing a book-of-business value of 1.0 times revenue ($1 million.) Given the agency's historical performance, the buyer reasonably could expect a 20% return on his investment (the proforma EBITDA), although it is not guaranteed. To minimize the risk that the buyer won't get a 20% return, he can offer a conservative base consideration of .8 times revenue, or $800,000.

To make the deal more attractive to the seller, the buyer could then offer 20% of the agency's revenue in each of the next three years. Assume the agency then grows by 10% in the year after the acquisition, to $1,100,000. The buyer would pay the seller 20% of that figure ($220,000), which is .22 of the original revenue.

In the second year, the agency grows by another 10%, to $1,210,000. The seller receives 20% of that amount ($242,000), which is .24 of the original revenue. The 10% growth streak continues into the third year, generating $1,330,000 in revenue for the agency. The seller's share is 20%, ($266,000), or .27 of the original revenue.

Thus, after three years, the seller has been paid the down payment of .8 times revenue, plus three installments of .22, .24 and .27, for a total purchase price of 1.53 times revenue. That deal might satisfy the seller. (In a moment, we'll consider whether this is a good deal for the buyer, as well.) Of course, the seller takes some risk that he can help the buyer grow the business after the sale or, if he plans to retire, that his staff can.

If the acquired agency had experienced no growth for the three-year period following the sale, the seller still would have received .2 times revenue in each of the three years, for a total of 1.4 times revenue. That probably would have been overpaying for the agency. Therefore, in these sorts of deals, the buyer should require a minimal amount of growth. Perhaps the buyer would pay 20% of revenue if growth exceeds 5%. If growth is flat, the buyer pays perhaps 10% of revenue. Such an arrangement aligns the interests of both the buyer and seller in seeing that the agency continues to grow after the sale.

In the example above, for sake of simplicity we based the earn-out on a percentage of agency revenue. In practice, most knowledgeable buyers actually base the earn-out on a multiple of EBITDA to ensure profitability. When revenue grows, profitability doesn't necessarily grow by the same amount.

We've looked at how the seller would fare under our hypothetical earn-out; now let's consider the buyer. Assume again that profitability grows at the same rate as revenue. The first year, revenue (and earnings) grew 10%, to 1.1 times the original revenue. Thus the buyer's pretax return on investment would have been 21.6%. (Divide the .22 of revenue first-year earnings by the the sum of the .22 of revenue installment and the original .8 of revenue down payment. In subsequent years, the buyer's pretax return on investment dips slightly to 19.0%, then 17.6%. If earnings continue to increase by 10% a year, the pretax return on investment improves to 19.8% in the fourth year because the buyer no longer is making payments to the seller. From there on, the return contin-

ues to increase every year if earnings growth is maintained. So the buyer has locked in close to a 20% return using a structure that has an upfront payment and an earn-out component. The arrangement is fair to both the buyer and the seller.

Types of transactions

A buyer can purchase a seller's stock, in which case the buyer becomes the owner of every asset—and liability—the agency has. For the seller, the proceeds of the sale are taxed at the 15% federal capital gains rate, not as ordinary income, typically more than twice that amount. The buyer, however, enjoys no tax advantages, since he cannot depreciate any part of the payment for the agency.

In an asset sale, the buyer's transaction is with the selling agency corporation, rather than directly with the owner. The buyer doesn't receive any assets not specified in the asset purchase agreement. If the selling agency owned the building in which it operated, the buyer doesn't have to purchase it, unless he wants to. (When buying stock, on the other hand, the buyers own everything, including any building.) The buyer also can decline to buy such assets as the cash surrender value of life insurance policies insuring the selling owner(s). Nor does the buyer take on any unwanted liabilities, like a bank loan against the agency's building. Typically, the only liability the buyer assumes is for the agency's insurance company payables.

Buyers like asset sales because they can amortize the main assets (expirations and goodwill) over 15 years. If the seller's agency is a C corporation, however, the payment will be taxed twice. First, it is taxed as capital gains to the corporation, which usually has little or no basis in the sold assets. So on a $1 million sale, it may pay $300,000 in capital gains tax. When the net proceeds are disbursed to the shareholding owner(s), they are taxed again as capital gains, usually at a combined federal and state rate of about 20%, so the seller loses another $140,000 and is left with about $550,000 of the $1 million sales price.

If the agency is an S corporation, however, the capital gains tax to the entity is avoided. Rather, the entire sales price flows directly through to the seller, to whom it is taxed as ordinary income. If the seller is in the 34% federal tax bracket, the total rate would be 37% to 40% or so, depending on the state tax rate.

If an agency is not structured as an S corporation, it should talk to its CPA about converting to one. In transactions in which we've been involved, S corporations have received about 20% more from buyers than comparable C corporations, since the buyer can amortize and depreciate assets. To benefit the seller, however, any such conversion must take place at least 10 years before the agency's sale.

CPAs sometimes advise against use of S corporations because their owners cannot deduct some of their benefits for tax purposes and are taxed directly on corporate earnings. But while owners may have to pay a little more in taxes today, they'll wind up with much more when they sell their agencies.

Tax-deferred transactions

When a buyer wants to make the owner of the selling agency a shareholder in the buyer's agency, or if the seller is against an asset sale because of its tax consequences, a stock swap can be the answer. These transactions technically are mergers, rather than acquisitions. The seller pays no taxes on the transaction until he ultimately sells the stock the buyer exchanges for his.

While the buyer is unable to depreciate or amortize any assets, he usually has to pay less for the agency, since he's helping the owner postpone any tax liabilities over the next 10 years or longer, depending on when the seller leaves the buyer's agency. We've often seen this arrangement used in bank acquisitions. One nice aspect of this deal, if the bank is publicly traded, is that the seller receives an asset he can sell over time. He avoids that big tax hit he otherwise would incur immediately after the transaction. (Publicly traded brokers, of course, also frequently make use of stock swaps when purchasing agencies.)

In a tax-deferred transaction, the seller doesn't have to receive the entire selling price in stock, but it has to amount to at least 50% of the consideration. As long as that condition is met, the seller can defer paying taxes on the stock until he sells it. At that time, he will pay capital gains on the difference between the seller's original basis (if any) in his former stock and the selling price of the new stock.

Buyers should bear in mind that in stock swaps, they assume all of the selling agency's liabilities, both real and contingent. Therefore an extended reporting period (tail coverage) should be purchased on the selling agency's E&O and EPLI policies, or prior-acts coverage for these exposures should be arranged under the buyer's policies.

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The best insurance

An acquisition is a major strategic initiative. While this article has provided an overview of the process, and considered a few of the forms an agency sale can take, many other factors can come into play. An agency's best insurance for successfully negotiating the myriad issues and options that characterize any acquisition is to have a rigorous, methodical system for evaluating the opportunity—and the discipline to follow it. Legal counsel with experience in acquisitions should be retained, of course, and the advice of valuation experts also is well worth considering. A&B