Insurance MGA's and Wholesalers – Agency Values and M&A Update

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In the insurance distribution environment, wholesale brokers and MGA's make up a relatively small number of entities. But they tend to be larger in size and geographic scope, and are often uniquely positioned regarding their value-added proposition, industry and coverage expertise, market authority, and in other respects as compared with retail agencies, and therefore warrant special consideration in a valuation process and evaluating merger and acquisition options, including internal succession planning.

Basis of Valuation Overview

a. Agency value is the sum of two parts.

- The 'earnings value', also called the book of business, goodwill, intangible assets, customer list, blue sky, etc., all of which refer to the value of the earnings of the Agency, which are then discounted by, or capitalized at a rate of return which rewards the owner for the risks assumed in the business.

Historically, buyers of most wholesale agencies wanted a 15% to 20% pretax return when buying an agency (discount rate), so that $1 of pretax operating earnings or EBITDA (Earnings before Interest, Taxes, Depreciation and Amortization) was worth $5 – $7, calculated as follows:

  - $1 / 20% = $5
  - $1 / 15% = $6.67

- An Agency's book of business or earnings value is often expressed as a multiple of annual retained revenues (net retained commissions and fees). Since $1 of retained revenues can normally generate .20 - .25 of pretax operating earnings, and since earnings have been worth 5 – 7 times their amount (use 6 as a midpoint), then .20 - .25 of earnings would be worth $1.20 - $1.50, or 1.2 – 1.5x retained revenues, calculated as follows:

  - .20 x 6 = $1.20
  - .25 x 6 = $1.50

b. PLUS - The 'tangible net worth' of the balance sheet, which includes all assets (excluding intangible assets) less liabilities, accounted for on a fair value basis, to the extent that the amount of tangible net worth exceeds the property and equipment of the agency, and a base amount of working capital.

Using a price/retained revenue method to determine the value of the intangible assets can be reasonable, but ONLY IF the following assumptions are generally true.

- The agency generates industry average levels growth and profitability, and
- The quality and risk profile of the agency is similar to an average industry model

Especially with wholesalers, the quality of the operation and the risk profile of the agency is often unique, so a formula valuation often breaks down or is inadequate to properly price or value the agency.

Other material factors affect pricing include the following:

There are a number of other material factors and considerations that affect the overall pricing of an agency.

- Deal structure for tax purposes – For example, the seller's ability to qualify for lower capital gains rates, and the buyer's ability to qualify for a tax deduction of the purchase price.
- Terms of Payment – Whether, and to the extent, that the price paid if fixed or variable, and whether paid in cash at closing or paid over time.
- Balance Sheet Cut-Offs – At the transaction date, the split of allocation between the parties for operating expenses, payroll, direct bill commission, agency bill commission, and contingency income. While it may be most common that operating and payroll expenses and agency-bill commission are cut-off on an accrual basis, and direct bill and contingency commission are cut off on a cash basis, everything is negotiable.
- Related Entities – Sometimes, either as a division of the agency, or a separate legal entity, a wholesaler will have a premium finance operation or other related business that generates additional revenue and profit on or from the insurance business written by the wholesaler. How this revenue and profit impacts the value of the agency is a special consideration.
- Real Estate – Sometimes there are real estate considerations in the transaction in which the seller owns the office building occupied by the agency. Whether the seller's goal is to find an agency buyer who will also purchase the real estate or enter into a long-term lease agreement can be a material factor for the seller, and affect the pricing of the agency.
- Future Employment – Sometimes the seller, or other key employees, want to be employed by the buyer for certain periods of time. Their employment, compensation, benefits and perquisites, can be a material factor is estimating the future profitability of the agency, and can affect pricing.

We often advise clients, whether they are on the buy side or the sell side, not to set or finalize a price until these other considerations are generally agreed, since each of these considerations can be material, and they can and should affect the final pricing of the agency.

Private Agency Buyers (vs) Publicly Traded or Private Equity Buyers

The transaction process, including developing the price and terms and contract conditions, can be materially different when dealing with a private buyer, versus a public buyer or private equity buyer. The flexibility in terms and conditions, the requirement of an earn-out provision for a portion of the consideration, the length and severity of the representations and warranties of the seller, the complexity of the contract, the contract dispute resolution mechanisms, and the venue clause (the state court which will resolve disputes), can be materially different depending on the sophistication and size of the buyer. There are benefits and risks, pros and cons, with each type of buyer. It's helpful to know these as you enter into negotiations, so that the price and terms negotiated can reflect these unique benefits and risks.

Recent and Future Pricing Trends

We've been involved in insurance M&A transactions since 1983, and for most of that time, pricing has been fairly consistent within a range (i.e. generally 5 – 7x trailing twelve month EBITDA). However, in 2008 – 2010, the economic downturn significantly reduced pricing, especially regarding the percentage of consideration that was fixed, and the portion that was variable or adjusted based on performance following the transaction. Revenues and profits during this period were volatile, and buyers wanted some protection that, following the transaction, the level of revenues and profits they purchased would continue and grow. That fear gradually evaporated after 2010, so that by 2012 and forward, there has been increased optimism that revenues and profits were in a medium to long term growth trend. This, combined with historically cheap money, and the growth in private-equity funds and ownership of businesses in all industries, has been pushing values higher and higher. Now, quality agencies are generally selling for minimum guaranteed prices equal to 7 – 8 times trailing twelve month EBITDA, with another 2 – 3 times EBITDA possible in a realistic earn-out. If the competition is especially fierce, as can be generated in a controlled-auction situation, or the target is larger and/or uniquely positioned, guaranteed pricing of 10x+ EBITDA is possible. (At average levels of wholesaler profitability, for example 25% of retained revenues, this can push the price/retained revenue multiple up and over 2.0x.) However, reading about high-profile one-off transactions can, in our opinion, over-inflate the expectations of a typical wholesaler, and it can be disappointing to find that when the wholesaler tests the market and finds the group of buyers only willing to pay a more historically-average level of consideration. A seller should realistically evaluate themselves prior to entering the M&A marketplace.

Final Points and Summary

- Wholesale agencies and MGA's have always been, and in our opinion, will always be, attractive M&A targets.
- Sophisticated buyers, which increasingly make up the majority of buyers, will base pricing on sustainable earnings and future growth, not just price/revenue multiples, so it is in the agency's best interest to maintain their annual organic revenue growth and their profitability at or above industry averages (5% and 25% respectively). This requires effective, proactive strategic and operational management.
- Determining whether your preference is for internal succession, or sale to an outside party, will drive a number of key management decisions regarding operations, and if considering an outside sale, the performance in the 3+ years prior to the transaction is heavily weighted in the development of price and terms.
- Other considerations including related entities and real estate, transaction structure for tax purposes, ongoing employment arrangements for the seller and key employees, accounting cut-offs, and other factors, are material when developing the overall pricing and deal structure.

If you need assistance as either a seller, a buyer, or in structuring an internal succession plan, our advisors can assist, and have worked with wholesalers and MGA's for over 25 years.

Dirk S. Nohre is the senior partner at Nohre & Co., CPA's and has been active in the insurance industry since 1983. The firm is involved in 25+ insurance M&A transactions per year. Dirk can be reached at dirk@nohre.com, or his direct line (715) 833-6740.