Key Considerations of Agency Acquisition & Perpetuation

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Today’s Discussion

- Roadmap for Today
- Where are we in today’s M&A market?
- Buyers and Sellers
- Succession Planning
- Assessing Agency Value
- Accessing Capital
- Ten Things You Need to Think About
Current Market Observations
Today’s M&A Market

- Record setting activity in FY2018 & FY2019
- Buyers continue to be aggressive
  - What are they buying?
  - The importance of sustainable & predictable cash flow
- Private Equity represents 60% of activity
  - Selective criteria & fit
- Rate environment & market liquidity drivers
- “There is a buyer for every agency, but it’s all about the price & structure…”
M&A Activity 2016–Present

- 2016 similar to prior year with 443 deals announced.
- 2017 accelerated to 546 announced deals.
- 2018 had over 600 announced transaction with very active PEG activity continuing.
- 2019 reached a new high of 625 deals announced with demand remaining strong and no sign of slowdown.
- Buyers continue to be hungry, aggressive and enabled. Buying earnings potential.
- Money has been historically “cheap” for years now.
Interest Rate Environment and its Impact

- Persistent low rate environment was driving equity markets – public broker stock value relatively high – this currency helps drive premium prices

- Low rates for debt capital when available – increases buying power

- Stress test for rising rates – reverses trend for capital and equity valuation. Yield curve is back to normal and Fed inclination is to maintain rates in near term

- Changes in rate environment can materially affect the marketplace depending on where you sit
Availability of Capital & Liquidity

- Low rate environment— has driven activity

- PEG Buyers continue to be flush with liquidity and are utilizing pre-existing platforms

- Banks are aggressive but not necessarily in this space. SBA options mainly (can be expensive).

- Agencies still viewed as a Specialty borrower

- Seller financing still very popular, although this too has cycles.
Agency Succession Planning
Agency Succession Planning

Succession Planning Alternatives:

- **Sell to an Unrelated Third Party**
  - Competitor/Strategic buyer
  - PEG/Roll-up/Financial buyer

- **Merge with another Agency**

- **Sell to a Related Third Party – Internal Perpetuation**
  - Colleagues/Partners/Family
  - Producers/Management – Staged or Total?
  - ESOP – works very well in select situations
Buyers vs. Sellers

Perspectives Differ –

If you are a Seller
- Everyone with equity is a seller, it’s just a question of when.

Focus on personal goals, tax considerations, maximizing agency value, timing, intangibles, quality of buyer, sustainability, impact on employees...

If you are a Buyer
- Are you ready to acquire?
  - Are you ready to be an owner?

Focus on due diligence items, technology platform, staff, company relationships, access to capital, risks, lifestyle changes...
Agency Transition Planning
Initial Considerations

- Start before you think you have to: 3–5 years

- Self-assessment
  - Honest with Yourself
  - Your Role & Identity in a transition
  - Emotions and Decision-making
  - Staged Exit or Full Leap??

- Finding a Qualified Buyer/Target
  - Bringing someone in-house
  - Logical competitors – geographic and product
  - Advisors
  - What does a buyer/seller want? Identifying strengths and weaknesses.

- Consequences of Inadequate Planning – Control the Process!
Internal Perpetuation Considerations

- Willingness /ability of Buyer to assume risk and debt
- Viability of perpetuation plan or buy–sell
- Size of debt structure required
- Sustainability of post–transaction agency
  - Retention of staff/clients/appointments
- Goals of Seller re: intangibles v. price
- Where is this buyer? Can this be staged over time?
Financial vs. Strategic Buyer

- Valuation Metrics may differ for external third-party buyers
- Guarantees v. Earn-Outs
- Intangible considerations – legacy, employees, community
- Deal terms and structures may differ
  - Cash buyer v. leveraged buyer
- Flexibility re: earn-outs, timing, decisions
- Market attractiveness and optionality
- What’s the ultimate “Price”?"
Perpetuation Case Study
Internal Staged Perpetuation Plan

Agency Snapshot

- Founded in 1988, first generation owner seeking to capitalize on agency’s value
- $5.0MM commission revenue with modest growth
- $1.125MM EBITDA cash flow
- 45% personal, 55% commercial
- 15+ employees
Perpetuation Case Study
Internal Staged Perpetuation Plan

Seller/100% Owner

- Started as a scratch agency
- Owner still has runway left
- Considered the reality of selling when approached by external third party buyers including large aggregators in 2018.
- No serious discussions with internal candidates prior to outside offers.
Potential Buyers

- External third party PEG
  - Ample liquidity
  - Financial Buyer
  - Seeking operational leverage & cash flow

- External Competitors
  - Leveraged buyer – needs seller to take back note
  - Aggregator looking for operational efficiency
  - Offer include significant earn-out potential

- Internal perpetuation buyers
  - Seller has two sons that want to take the reigns
  - Also internal producer that wants to acquire ownership
Perpetuation Case Study
Internal Staged Perpetuation Plan

The Challenge

- Seller had received external third party offers. $9.0MM offer (8.0x CF) with limited upside potential based on revenue and margin growth

  - Owner motivated by liquidity $, but didn’t consider maintaining legacy
  - Continued agency success not for benefit of seller, his family or employees
  - Cash flow no longer accrues for benefit of the seller
  - Seller still somewhat motivated to manage and grow the business, but attractiveness of cash upfront was compelling.
Perpetuation Case Study
Internal Staged Perpetuation Plan

The Solution

- Internal staged perpetuation – sell 30% of the business to receive upfront liquidity while maintaining ownership upside and directing perpetual cash flows to recipient(s) of choosing.
- Staged sensibly, can generate greater cash flow/value than outright sale.

The Deal Structure

- 30% sold to two sons and producer for $1.7MM. Discount at 5X CF given for selling minority interest to internal parties.
  - Used the agency value to get bank loan to allow buyers to fund deal.
- Agency growth averaged 5% with management and employee legacy maintained. New owner motivated to build on success.
- After 5 years, revenue totals $6.4MM. At 22.5% EBITDA margin and internal value of 5X CF, original owner’s 70% interest now worth $5.0MM; agency principal received $4.5MM in agency cash flow during this time.
- Total cash flow/value with initial sale of $11.2M > $9.0MM outright offer with limited upside.
Perpetuation Case Study
Internal Staged Perpetuation Plan

Points of Emphasis

› Agency principal shouldn’t underestimate length of runway.
› Perceived difference in value between outright sale and staged internal sale – start with simple math.
› Great importance on building agency value over time. Quick sale gives up perpetual cash flow.
› Legacy, quality of life, employee well being – all factors to consider.
› Continuing to serve clients and grow relationships.
ESOP: An overlooked but very attractive alternative

What is it?

- A flexible, discrete, tax efficient and controlled buyer of company stock
  - A qualified retirement plan under IRS
  - The only plan that can borrow money
  - Employees do not own stock – have a “financial interest”
  - No financial disclosure to employees required
  - Great alternative to a 3rd party buyer
  - Perfect perpetuation vehicle
Perpetuation Continued
ESOP: An overlooked but very attractive alternative

Works best for:

- “E” Employ more than 20 people
- “S” Seller not looking to get the last $$$ but after tax proceeds can approx. 3rd party buyer & exceed pure internal buyers
- “O” Open to 40% gov’t subsidy – tax efficient
- “P” Produce an equivalent a/t sales price
Perpetuation Continued
ESOP: An overlooked but very attractive alternative

Advantages:

◦ Sole shareholder may defer/eliminate capital gains taxes
◦ Can eliminate most state & all federal taxes
◦ Can retain/attract talent
◦ Can buy 0% – 100% of shares: can be staged
◦ Seller can still participate in upside should the company value grow after sale to ESOP
◦ Seller note is much safer in ESOP structure: debt repaid with a/t dollars
◦ Works when there are no clear successors: still maintain control
Perpetuation Continued
ESOP: An overlooked but very attractive alternative

Disadvantages:

- Costs upfront & ongoing
- Need to be a C corp at time of transaction
- Sellers must have owned stock at least 3 years
- Need about 6 – 9 months to complete
Tax Considerations

- Legal & Business Structure
- Asset Sale
- Stock Sale
- Personal Goodwill
- Capital Gains Taxes
Asset Sale Considerations

- Purchase & Sale Agreement
  - Transferred asset description
    - FF&E
    - Expirations
    - Files & Records
    - Intangibles
    - Assignments of contracts, non-competes
  - Previous transactions?
  - EE Agreements
  - Leases
  - Date of transaction
  - Price
  - Seller’s post-sale services
Agency Valuation
Valuation has two components:

- **Value of Earnings** (Intangible) (Book of Business.)
- **Value of Balance Sheet** (Tangible) (Investment in Business.)

\[ \text{Value} = \text{Earnings Value} \text{ plus Balance Sheet value} \]
Valuing the Agency – Balance Sheet

- Cash
- Accounts Receivable
- Fixed Assets
- Debt
- Accrued Expenses
- Company Payables
- Equity Arrangements
Valuing the Agency – Balance Sheet

Most buyers prefer an asset purchase.

- Need a nominal level of working capital
- Seller keeps the cash
- Seller settles the liabilities
- Limits liability for the buyer
Valuing the Agency – Earnings

› Determine Pro Forma Profitability.

› Determine an Appropriate Capitalization Rate (notice that I did not say “Multiple”).

› Determine an Appropriate Deal Structure.
Valuing the Agency – Earnings

- EBITDA aka Cash Flow
- Adjustments for:
  - Executive compensation to market levels.
  - Producer’s comp to the Buyer’s level or market level.
  - Normalize contingents.
  - Eliminate owner’s perks and other expenses.
  - Consolidation savings. Sometimes up-front. Who gets this value?
Valuing the Agency – Earnings

- How does Pro Forma Earnings compare to traditional expectations?
  - Expectation is a 25% to 30% Profit Margin.
  - Expectation is a 10% EBITDA growth rate.

This will give the appraiser an idea of the Potential of Earnings.
Myths of Multiples

- Integrity of available transaction data
  - Timing and context
- EBITDA v. Revenue model
- Public buyer v. Private buyer
- Banks have always caused a problem, now PEGs
- Transaction size and structure
- “CCM” aka Country Club Multiple
- Believe nothing you hear
- Market still paying premiums for high quality agencies
  - 2018 multiples approximately 15%+ higher for the top 25 deals
  - Where do you fit?
Valuing an Agency – Drivers of Value

- Brand/Reputation
- Quality of Leadership
- Quality of Staff
- Continual Investments in Producers
- Current from a technology perspective
- Specializations
- Restrictive Covenants

This will give the appraiser an idea of the Quality of Earnings.

“All Earnings/Revenue are not created equal”
Valuing the Agency – Bottom Line

- Market will pay for sustainable and growing profit.
- About a 13% RP on 2.5% RF Rate.
- Earn-out component tied to revenue or profit growth. Need 15% growth.
- Supply and demand factor for platforms.
Strategies for Enhancing Value

- Bringing in talent/talent development
- Keeping talent and future owners
- PD Finance Programs
- Using leverage to grow revenue
- Operational efficiency improvements
- Financing technology and work-flow upgrades
- Leasing vs. Loans vs. Cash
- Is leverage bad?
Options:

- Adding Value through Inorganic Growth
- Adding Value through Organic Growth
- Adding Value through Efficiency Improvements
- Let’s define value as “improved cash flow over time.”
Case Study
Inorganic Growth

Is growing via acquisition right for my agency?

Understand how growing inorganically can create value...

- Buyer identified a seasoned agency and two books of businesses that would enhance its existing book of business

- Synergies existed between the buyer’s agency and the business being acquired

- Cross-selling opportunities, enhancement of existing carrier relationships and the addition of experienced staff added value to the agency
Case Study
Inorganic Growth

Points of Emphasis

- Buyer has owned and operated a successful property and casualty agency for the past 30 years

- He identified a valuable agency with a book of business that demonstrated stability, growth and high retention

- Retained staff, including the two owners, from the acquired agency, which aided in retention and made the transition seamless to clients

- Buyer has shown consistent growth through multiple strategic acquisitions
Agency Snapshot

- Founded in 1987
- $4 million in commission revenues
- 60% small commercial, 35% personal, 5% benefits
- 12+ employees
Case Study
Inorganic Growth

The Challenge

- Finding a financial institution that understood an agency that has grown inorganically through many acquisitions.

- Securing a financial structure that would allow the agency to keep growing using modest leverage.
Case Study
Inorganic Growth

The Solution

- Contacted InsurBanc who was able to quantify the value of the agency and understood the growth opportunities the acquired agency would provide

- InsurBanc was able to provide the funds to complete the acquisition without seller notes which was important to owner.

The Deal Structure

- $4.2MM 7 year term loan
- Refinance of $500k of existing bank debt
- $1.6MM agency price – 2x revenues
- $2.3MM price for lift-out of 2 books of business
  - 1.6x commission revenue
Strategies for Enhancing Value

Uses for leverage to support inorganic growth:

- Purchase smaller agencies
- Purchase books of business
- “Lift-out” of staff or a department
Focus on Cash Management Effectiveness:

- Convenient Access v. Technology
- Margin Improvement
- Efficiency
- Lower costs through remote capture
- Lower bank costs drop to bottom line
- Value of Deposits in a return environment
- Use deposits to improve loan terms
Accessing Capital in the Market
Sources of Financing

- Sellers
- Banks
- Personal Resources of Buyers
- Other Institutional Sources/Some Combination of the Above
Structuring a Deal

- 100% Seller Note
- 100% Bank Financing
- Structured Transaction Bank/Seller
Deal Terms and Conditions

- Loan Duration
- Cost of capital and interest rate risk
- Security and Collateral
- Personal Guarantees
Financial Preparation

- Considerations on the Buy – Side
  - Personal financial situation
  - FICO Scores
  - Personal liquidity
  - Personal leverage
  - Risk appetite of your spouse/partner
  - Short term sacrifices for long term success
  - Tax Returns – PFS – Clarity and organization
Financial Preparation

- Considerations on the Sell – Side
  - Quality of financial reporting
  - Cocktail napkin statements
  - Quality of agency management reporting
  - Operating profitability v. contingency profitability
  - Being in Trust
  - Operating trends over multiple years/cycles
  - Agency Real Estate if applicable
    - Market leases
    - Ownership structure
    - Appraisals
  - Agency Valuation Reports
The Banker’s Perspective

- Pro Forma Financials with Assumptions
- Management Resumes
- Basis of Valuation
- Sustainable deal structure
The Banker’s Perspective

Why do Banks undervalue agencies?

- Lack of Tangible Assets on Balance Sheets
- Managed Bottom Line
- “Thin” Net Worth
- Assets walk out the door every night
- Lack of industry knowledge
- Fear of the unknown
The Banker’s Perspective

- EBITDA & Debt Service Coverage
- Adequacy of Working Capital
- Adherence to Fiduciary Responsibilities
- Skin in the Game – Equity
- Realistic Assumptions?
The Banker’s Perspective

Financial Information

- 3 Years FYE Statements
  - Management System Reports
- 3 Years Tax Returns
- Interim Financial Statement
- Personal Financial Statement/Principals
- 2 Year Tax Returns/Principals
- Projections with Detailed Assumptions
- Operating Account Statement/Analysis
The Banker’s Perspective

Key Financial Indicators

- Trust Ratio
- Current Ratio
- Cash Flow/CMLTD (Debt Service Coverage)
- Cash Flow/ LTD (Leverage)
- Expense Management
The Banker’s Perspective

Business Analysis

- Breakdown of Business Lines
- Markets and Carriers
- Retention Experience
- Loss Ratios
- Contingency History
Building value is a continual process. Seek to improve the Drivers of Value. Time can be your friend.

Agencies are all unique and each succession planning situation requires an independent approach and qualified advisors. Be careful about multiples…

Arrange financing before you need it. A current best practice is to get a line of credit to add producers, improve tech platform and acquire small books of business.
Next Steps

- Understanding Options
- Understanding Value
- Harvesting Value
- Accessing Capital
- How does this really work?
Thank you!

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