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AGENCY FINANCIAL MANAGEMENT

EXPLORING THE SALE OF YOUR WHOLESALER

The acquisitions market is not robust, but it's improving

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If you are an MGA, MGU, or program administrator owner, the thought might have run across your mind as to what options would be out there if you were to sell your firm. We are constantly being asked about the current merger and acquisition (M&A) environment. Whether you are interested in exploring a sale now or 10 years down the road, it helps to understand who the acquirers are and what their appetites are for MGAs, MGUs, and program administrators. We will take you behind the scenes as we discuss what acquirers are looking for in an ideal acquisition.

M&A environment

The past year has been a tumultuous one, to say the least, for the United States economy. Faced with the prospect of a complete collapse of the financial system about a year ago, the economy has come off of life support and is making its way towards recovery. The turmoil of late 2008 caused both acquirers and sellers to head for the sidelines and take a wait-and-see attitude. Although the current environment can still be characterized as sluggish at best, acquirers are becoming more confident as the stock market continues its ascent from the March 2009 lows.

M&A activity has been down markedly compared to prior years. The difference in the bid-ask spread (i.e., seller expectations vs. the bids that buyers were comfortable putting in) has put a damper on deals being completed. The tightening availability of credit also has hamstrung certain acquirers—such as private equity firms—in their quest to make acquisitions. That stated, more deals are entering the pipeline as acquirers and sellers resume talks that were put on the back burner last year.

Acquirers

Turning our focus to who is buying, we segment acquirers into the following groups:

• **Publicly traded brokers:** Firms such as Arthur J. Gallagher and Brown & Brown, which have significant wholesale and MGA operations, continue to be acquisitive. As they are publicly traded on the stock market, they have easier access to capital and, in turn, to fund future acquisitions.

• **Private equity backed entities:** Firms such as AmWINS Group (backed by Parthenon Capital), Fortegra Financial (backed by Summit Partners), Swett & Crawford (backed by HM

Capital Partners), Strongwood Insurance Holdings (backed by CCMP Capital) and Arrowhead General Insurance Agency (backed by Spectrum Equity Investors) have expressed interest in making acquisitions within the MGA and program administrator space. Having the support of a private equity firm provides the financial backstop needed to grow these firms.

• **Insurance companies:** Certain carriers are also interested in acquiring MGUs and program administrators in order to bring these capabilities in-house and achieve cost synergies. An example is Ironshore, which teamed up with Rockwood Programs, to acquire Wright & Co., a program administrator focused on the professional liability market.*

• **Privately held MGAs and wholesalers:** These companies also present an alternative avenue when you are exploring a sale of your firm. An acquirer fitting this bill is Southwest Insurance Partners which purchased Southwest Risk, a property-focused insurance wholesaler.*

Sell now or wait?

A simple question; however, there are many variables to consider. The following questions can help you evaluate whether or not now is the right time to sell:

• Where do I think the capital gains tax rate is going to be in a few years?

The capital gains tax rate, currently 15%, is in effect through 2010; thereafter, it is likely to increase to an amount in excess of 20%. For every $10 million in taxable proceeds, this increase would amount to an extra $500,000 in taxes if a sale were delayed to after 2010. If an owner is already planning to sell, it would be advisable to begin preparing now in order to allow for six months to a year to go through the sale process and maximize the proceeds subject to the current capital gains rates.

• What stage in my work/life cycle am I currently in?

All things being equal, an acquirer will place a higher value on a firm whose owners/producers are relatively young. Rightly or wrongly, acquirers tend to assume that owners who are in their late 50s or older will retire or reduce their involvement with the business.

If you are looking to maximize the value of your business, sell before the owner(s) hit this age period. The acquirer will be more confident that the ownership group will stick around and help retain and grow the business post-acquisition.

• Do I have a strong management bench? Are all the owners on the same page with regard to an exit strategy?

When evaluating an acquisition, an acquirer would ideally like to see that there are multiple “go-to” people within that firm, rather than just one person. If you do not have a management team or second-in-command person who could take over seamlessly for you if you were to discontinue involvement in the business, then it would be wise to develop or hire people who can fill those roles.

Continuing on the same path, if there are multiple owners within your firm, you will want to make sure that everyone is in agreement as to the eventual exit strategy. You do not want to “head to the altar” with an acquirer only to find out that a shareholder or group of colleagues will be blocking a sale.

• Is the firm’s corporate structure tax-efficient for a sale?

If your firm is an S corporation or limited liability company (LLC), then you are already well positioned for a sale. If your firm is a C corporation, however, you may want to think about converting to an S corporation due to the tax ramifications of a sale. All things being equal, acquirers place a lower value on the stock of a C corporation because they are not able to derive the tax benefits they could get with amortizing an asset purchase.

In most cases, a converted entity must be an S corporation for 10 years in order to receive the full tax benefit of the corporate structure. As a seller, if you sell the assets of a C corporation, you will be hit with double taxation on the proceeds. There are a few instances where a transaction can be structured as a personal goodwill acquisition in order to minimize the tax hit. Consulting now with your accountant will help you prepare for when the time is right to sell.

As mentioned earlier, the decision to sell is dependent on the owner(s)’ personal situation and goals. If you plan to sell in the next few years, it may be advisable to begin the process now so that you can take advantage of the low capital gains tax rate. The sale process can take anywhere from six months to a year when taking into account the various steps involved (i.e., gathering financials and book of business information, preparing a firm overview, contacting and meeting with potential acquirers, negotiating an offer, due diligence, and finalizing legal documentation). Even if you are not currently interested in exploring a sale, it does not hurt to ponder the previous questions so that you can put yourself in a favorable position when the time is right.

* *Disclosure: Mystic Capital Advisors Group, LLC, was an advisor in this transaction.*

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