Making mergers and acquisitions win-win deals

FEW transactions are more important to agents and brokers than selling their business—or buying that of another party. For sellers, the transaction can represent an opportunity to remain in business in an improved position or the cashing in of a life's work in preparation for retirement. For buyers, acquisitions represent the fastest route to growth and the furtherance of strategic plans.

At last fall's Third Annual Target Markets Program Administrators Summit, mergers and acquisitions were explored during a workshop presented by Kevin P. Donoghue, managing partner of Mystic Capital Advisors Group, a consulting firm; and Scott Reynolds, chief actuary and operations manager for American Wholesale Insurance Group, which has made several acquisitions in the past couple of years. Their presentation examined the process primarily from the standpoint of buying or selling program administrators, but much of what they said was germane to any agent or broker involved in such transactions. Following is an edited transcript of their comments.

Kevin: The first step in selling your business is to determine what it's worth. Before you solicit bids you should get an independent appraisal from someone who knows the insurance marketplace. What is the after-tax value that you need to realize from this business to make it worth selling? If, following an appraisal, you don't think you can get it, why go through the process of selling your business? Often people discover that their agency is not worth what they think it is and decide they'd rather keep it. Sometimes an owner, acting without the guidance of an appraisal, asks for an outrageous price. Such owners do themselves an injustice. Down the road, when they decide they're really ready to sell, potential buyers may assume the sellers still have unrealistic expectations. Valuations also are vital to buyers. The time for a buyer to get a fix on the value of an acquisition is before making an offer. That's because offers, once made, are almost impossible to renegotiate.

Generally, the value of a firm is expressed as a multiple of a particular statistic. More often than not, that statistic is EBITDA (earnings before interest, taxes, depreciation and amortization). For agencies and brokerages, however, I generally favor a multiple of EBITA. I drop the "D" (depreciation) because I find it's offset by a buyer's ongoing need for capital expenditures following an acquisition. Buyers usually pay a multiple of EBITA (or EBITDA) ranging from 4.0 to 6.5. Profitable, growing agencies will go for something close to 6.5. Smaller businesses whose growth has been going downhill might go for less than 4.0. Retail agencies generally trade for higher multiples than wholesale businesses do.

There are any number of factors that can affect the multiple, including whether the seller is a C corporation or an S corporation, and the condition of its balance sheet. How the seller will be paid for the agency—whether in cash up front or in retention-based installments—also affects the multiple.

Scott: What I hope to bring you is a buyer's perspective. In the past two years, we've entertained about 30 possible acquisitions of program administrators, MGAs or wholesalers, and we've closed five of them. We aren't interested in all-cash deals. Rather, we offer sellers three payment components, and usually they are roughly equal. First, there will be a cash component maybe equal to a third of the selling price. Then there will an equity component—stock in our combined, post-merger organization. Last, there will be a series of installment pay-

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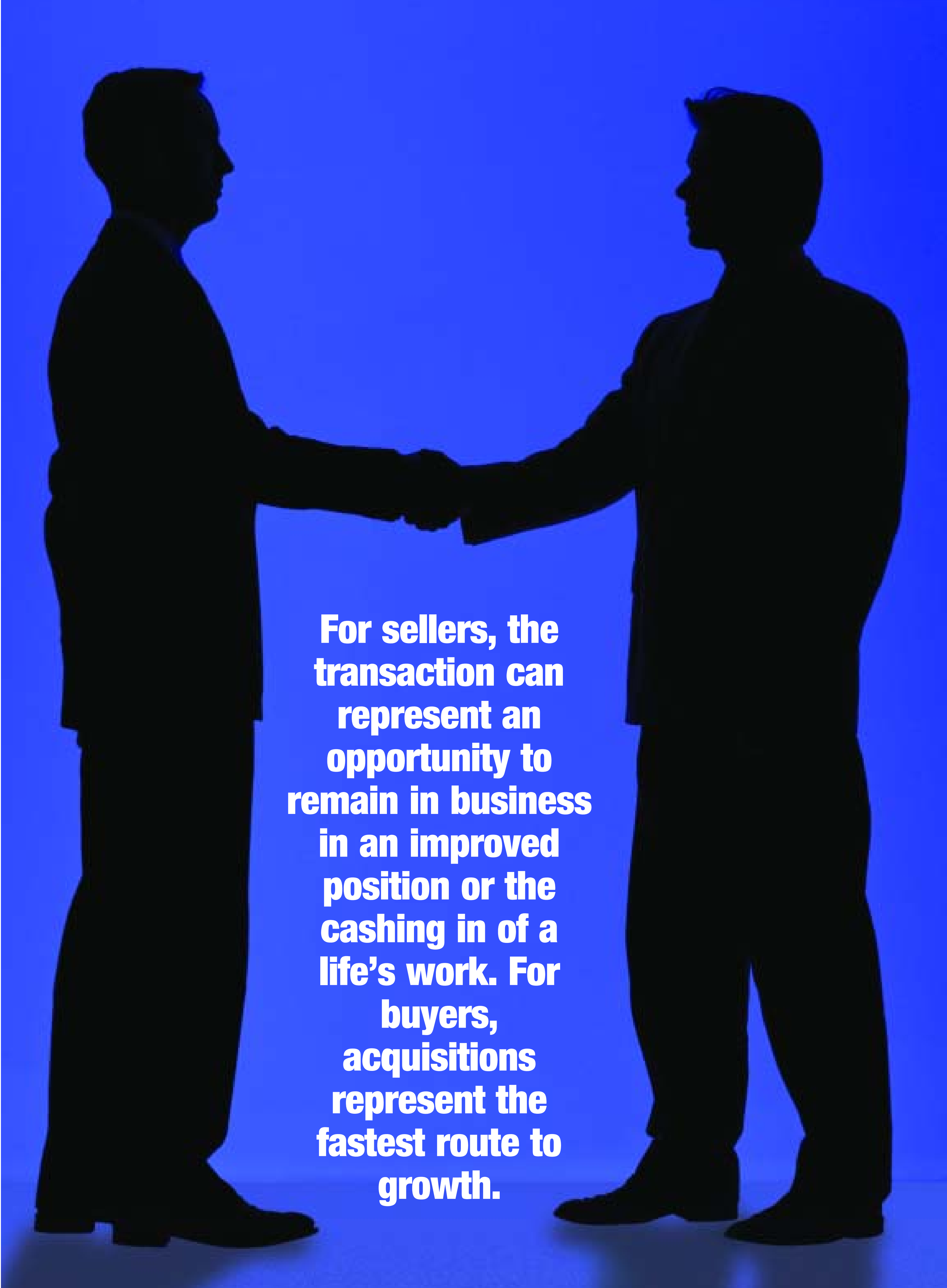
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ments, usually retention- or performance-based, over a period of three to five years or whatever span is negotiated.

We structure payments in this way because we generally are not interested in acquiring a business whose owner simply wants to cash out and retire. If we were to offer an all-cash deal to a seller, he or she then might not have the incentive to continue to lead a growing business that can leverage the resources that our combined organization creates. The equity component of the payment gives the seller a vested interest in the growth and performance of the post-merger company.

Kevin: When an agency is bought with cash up front, the seller will get a lower multiple. If it's a pure "earn-out" deal (a series of performance-based installment payments), with no cash up front, the seller will receive a higher multiple. Deals generally are struck somewhere in the middle, where you have a fixed component (cash) and a variable component (the earn-out).

Sellers should assess the structure of the earn-out. Is it achievable, or is it unrealistic? Occasionally, a buyer will offer what looks like a breathtaking multiple for an agency. But then the small print compels the seller to do the impossible, like double their growth rate within a year, to fulfill the earn-out. Before you sign a letter of intent, know how you are to earn the variable component of a deal. Does it require you to grow 20% for each of the next two years? Does it require you to just maintain the current volume? Know where the risk is.

Also, keep in mind the time value of money. A buyer might say you're going to get $1 million a year for the next five years, if you reach a set of goals. Well, the value of that offer isn't $5 million. Its present value is probably closer to $4 million. And on a risk-adjusted present-value basis, it's likely considerably less than that.

The other issue is equity. Scott's crew is building a larger organization. Maybe they one day hope to do an initial public offering of stock. National brokerage houses, which also are active in mergers and acquisitions, already are publicly owned and generally pay for an acquired agency at least partly with their stock. Publicly traded stock is easily sold, but when sellers exchange part of the value of their agencies for a minority equity position in a privately held company, their stock will be highly illiquid. So understand what you are getting into. Ascertain under what circumstances you can get out, and how your stock will be valued when you do.

In summary, cash is great. Equity is fine if you can get yourself out of it or it has a minimum guaranteed value. Then in regard to the earn-out, you really have to assess whether or not it is achievable.

The confidentiality agreement

Scott: In the course of a merger or acquisition, three major events take place. The first is the signing of a confidentiality agreement. Based on initial conversations we've had with the seller, we decide we want to talk further and share information with each other. So we each sign confidentiality agreements and then start sharing summary information. Among questions we ask are: Who owns the business? What is its corporate structure? What is its nature? Why are you considering a sale? The seller would ask us similar questions.

At this stage of the process, we are looking at the big picture rather than all the details. We ask ourselves how the agency would fit into our organization. We're not doing "roll-ups," in which a buyer simply assimilates acquired books of business. Rather we're looking for strategic fits, agencies that can continue to operate more or less independently within our organization. So if we already have one MGA that writes ocean marine insurance, we wouldn't be looking to acquire another. Although we might increase our market share by doing so, we'd be creating internal competition and failing to enhance our product portfolio. In short, we're interested in acquisitions that give us a presence in some part of the country where we currently don't have one, or that provide a product or program that blends well with our portfolio.

Another business that would interest us would be one whose value we could somehow leverage. We may have resources that the seller lacks: financial resources, financial oversight capability, actuarial resources, marketing or technology resources, human resource management, etc. None of that has to do with brokering insurance, but it's everything behind the scenes. Sometimes a firm will have a weakness in one or more of those areas. If we can eliminate that weakness and thereby increase that firm's EBITDA multiple, it could make an attractive merger candidate.

At this stage, we also examine all of the seller's relevant financial statements and, assuming the seller would make an attractive strategic fit, make an offer that will be subject to confirmation of the seller's representations via the due diligence process.

The letter of intent

Scott: The next phase of the transaction starts with the signing of the letter of intent. At this point, we have dealt with the big-picture issues and are now ready to get into the details to see if they confirm what we've seen so far.

Kevin: When the parties sign that letter of intent, the deal is not over. The LOI typically is nonbinding. After it is signed, the buyer does due diligence on the seller—and often the seller does some due diligence on the buyer. A lot of things can go wrong between the time the LOI is signed and the closing. The buyer will go though the seller's data with a fine-tooth comb. In doing so, it may find that some of the seller's previous representations do not pan out. If so, the buyer in all likelihood will lower the previous offer. So sellers need to be certain—well in advance of putting themselves onto the market—that their house is in order and that their records reflect that.

Scott: After the letter of intent is signed, we basically have access to all of the seller's data. Likewise, the seller has access to our information, so the LOI is not a one-way street. And given that both parties have signed confidentiality agreements, they should be comfortable with sharing information.

At this point, we are ready to get into the heart of the due-diligence process. Among the matters we look into are the following:

• *Underwriting results:* The first

thing we're going to look at is the underwriting. (This discussion assumes the acquisition of an MGA or program administrator. Obviously, underwriting wouldn't be a consideration if we were acquiring a pure wholesaler, which has no underwriting authority.) We look at the carrier underwriting audits. If we ask for the latest audit and the seller says he can't find it, that's a red flag. Usually the reason a seller "can't find" an underwriting audit is because it was a bad one. We like to see two underwriting audits. One bad audit may be understandable. But two in a row calls into question the soundness of a program and the long-term relationship with the carrier.

We look at premium and claim details and from them derive program loss ratios. If the numbers jibe with the loss ratios the seller previously gave us, that's a strong green light to proceed with the deal. Often, however, the premium and claim detail is not available, and that's troubling. Sometimes when it is available, it's 18 months old. As with "missing" underwriting audits, current data might not be available because the seller fears it will appear unflattering. But having as much up-to-date information as possible makes the merger or acquisition move along more quickly than it will otherwise.

The exact form the information takes (spreadsheet, database, text file) doesn't matter, so long as it's detailed. As long as it includes data for individual policies and associated premiums, we can sort it as we wish. We also need claims details, with claim numbers and associated policy numbers. Summaries really are not sufficient, because they allow us to look at the information only as it's presented in the summary. With the detailed information, we can build the summary any way we wish.

I'm an actuary, so naturally we pay attention to the actuarial analysis of a program. We love to see a carrier's actuarial analysis, and we also appreciate any third-party analysis that a seller may have obtained. Then we'll take the seller's premium and claim data, update it and analyze it ourselves. Usually our analysis comes in pretty close to a carrier's or a third party's; major discrepancies are usually not an issue.

We look at how closely the seller has adhered to his underwriting authority. We determine whether the proper accounts are being written for a program and whether they've appropriately priced. If this information is available, that's a good indication that the program is sound and that the carrier will remain on board.

• *Carrier relationships:* Good carrier relationships are important to the successful conclusion of a deal. We want to make sure the seller has sound, carrier-supported programs. Copies of the seller's correspondence (letters or e-mail) with his carriers are helpful, as well as letters of authority that may have been granted.

Of course, we contact the seller's carriers at an early stage of the due diligence process to inquire about their relationships with the seller and whether they will stay on after the sale. Generally, they give their blessing. That's a plus; it is indicative of a strong book of business that won't have to be remarketed. That said, if a carrier is looking to get out, a change of ownership in the agency provides a good pretext for the insurer to end the relationship.

We look at the commission rate the carrier has been paying the seller. Maybe it has been knocked down a couple of points or has been made dependent on underwriting results. Maybe we see evidence that the seller's underwriting authority has been reduced over time. Such things raise concerns about the status of the carrier relationship. It's nice to see multiple carriers for a given program. That means we still would have options if one carrier decided to depart.

We look at cancellation clauses. Once, carriers commonly granted six-month—or even nine-month—program cancellation clauses. Now, it seems you can't get anything more than 90 days. We consider anything longer than that a real plus. Anything less than 90 days concerns us, because trying to move a program in a shorter time frame can be difficult.

• *Claims:* If the seller is using a third-party administrator to handle a program's claims, we will examine the claims audit to see if the carrier's figures match the TPA's. If they don't, we may need to rework our actuarial analysis of the seller's underwriting performance. If the carrier is adjusting the claims, the claims audit usually is not a critical concern to us.

If the seller can readily get loss runs from the carrier, that's a plus. I'm not sure why, but sometimes it seems difficult for a seller to get loss runs during the due diligence process. Perhaps insurers are afraid the information is going to get shared with outside parties (other than us).

• *Financial controls:* We require an aged account receivables report. Without one, it will be difficult to produce an accurate balance statement. We also need information about any current litigation, as well as an E&O claims history. We want to see records for the premium trust account. Going out of trust, unfortunately, has been the downfall of more than one program. We also want to examine all leases—on real estate, software, office equipment, etc.—to see what kind of ongoing commitment we would be assuming if the deal goes through.

• *Distribution:* We carefully examine the seller's distribution system. We examine the contracts and incentive arrangements a program administrator has with retail agents. We like to see exclusivity agreements signed by qualified retailers.

• *Technology:* We examine the seller's software systems and procedures. A major point is how submissions are processed and how the data on submissions is captured. Depending on the seller's current platform, this may be an area where we can bring value to the deal through our own technology resources.

• *Human resources:* We ask for a detailed organization chart, as well as information about employee salaries and benefits, bonus plans, etc. Sometimes we've discovered that key employees have been promised future equity in the firm. We want to make sure that all arrangements are disclosed during due diligence.

Kevin: Deferred compensation is another issue that sometimes is not reflected in the information initially provided to a buyer. Sellers should make sure that all such liabilities are clearly disclosed in advance. Don't hide anything, because it's going to come up in due diligence. It's much better to get all the issues on the table up front and let buyers determine whether they want to proceed.

But don't withhold important facts before signing the nonbinding letter of intent and hope buyers either won't discover them or will accept them without lowering their price if they do. That just doesn't happen.

Wrapping it up

Kevin: The final event that takes place in the merger and acquisition process is the signing of the purchase and sale agreement. Unlike the letter of intent, this document, of course, is binding. All the hard work of a sale should come after the signing of the confidentiality agreement and the letter of intent. If that work has been done well, the only remaining chore after this final document is signed will be the popping of champagne corks.

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