

Cookson Walker Consulting

Timing is Everything

Understanding Multiples and Negotiating the Valuation Landscape

By Paul Greenhow and David Townley

Significant property and casualty insurance broker transactions have recently occurred, with considerable activity amongst small to mid-sized, privately owned operations. While the pricing of these deals is not a matter of public record, details have trickles through the broker network of consistently high values reflected as a multiple of commission income.

Adding fuel to the speculative fire was the recent blockbuster sale of HUB International Ltd. for more than three times commission income, a deal that is proposed to close in the coming months. Furthermore, transaction terms seem to be favouring the seller with client retention clauses no longer as prevalent and an increased amount of the purchase price consideration being paid up front in cash.

Watching the changing landscape, Cookson Walker Group and *Canadian Insurance Magazine* recently conducted a groundbreaking "MAPS" (merger, acquisition, perpetuation, and succession) Survey on these critical broker issues. The major findings include (see expanded results at end of article):

- 40 per cent of brokers are planning to sell within five years.
- 66 per cent of brokers have no potential purchaser in mind, or they plan to sell to an unrelated third party.
- 50 per cent of brokers are actively seeking acquisition opportunities.
- 70 per cent of brokers intend to make an acquisition within five years.
- Brokers think that 2.0 to 2.5 times commission income is the average value their firms are worth.
- 6.0 times EBITDA is the average value brokers think their brokerages are worth.
- Twice as many brokers think valuations will rise rather than decline in the near future.

FURTHER EVIDENCE

The results are consistent with studies conducted by both the Canadian Federation for Independent Business and CIBC World Markets. These reports indicate that only one-third of small to medium-sized enterprise (SME) owners are planning for their succession; the majority of those, however, have plans that are informal or undocumented. The

number of SME owners nearing retirement (55 to 64) is growing at more than 7 per cent a year and 41 per cent of SME owners intend to exit their businesses within five years.

A more recent study conducted by PricewaterhouseCoopers concludes that of a sample of Canadian Businesses, 45 per cent did not have succession plans and of these, 90 per cent were family owned business.

Considering this data and, more particularly, the intention of 40 per cent of insurance brokers to sell within the next five years, we can expect an increased supply of p&c brokerages for sale and a significant volume of broker transactions in the coming years.

Notwithstanding the current and anticipated swelling of the ranks of insurance brokerages for sale, according to our survey results, over the next five years buyers will outnumber sellers by a ratio of 7 to 4! This inequity, along with other environmental factors, is contributing to the price escalation that broker transactions are experiencing.

Based on some very ballpark numbers, we estimate that there is roughly \$6.5 billion in value in the Canadian privately owned p&c insurance broker sector. Accordingly, approximately \$2.5 billion in insurance broker goodwill and customer lists is expected to change hands over the next five years (based on our survey responses that nearly 40 per cent of brokers are looking to divest within the next five years).

When this is considered in conjunction with the absence of succession planning (only 9 per cent of survey respondents have a documented succession plan), considerable deal flow awaits those brokers who are financially stable and in a position to quickly react to potential opportunities. Whether you are considering buying or selling, if you have taken notice of the opportunities that lie ahead, this should be your wake up call!

PUBLIC MARKET VALUATIONS

The publicly available data presents a fairly consistent valuation outlook in Canada based on a review of metrics for Canada based on a review of metrics for both Western Financial Group Inc. and HUB from 2000 to 2006. The valuation metrics include both revenue and profitability (or earnings) multiples.

The revenue multiple is calculated by dividing the enterprise value (representing the equity value plus debt) of the company by its annualized revenue. The profitability multiple is calculated by dividing the enterprise value by EBITDA (earnings before interest, taxes, depreciation and amortization). Both revenue multiples and earnings multiples are common methods of valuing service businesses and, in particular, insurance brokerages.

The revenue and EBITDA multiples averaged 2.0 times and 10.0 times respectively and both traded in a tight range, levels over the period 2002 to 2006. For an industry known for its troubling market cycles, valuation stability prevailed over a period of changing premium levels and capacity of the markets.

PENDING HUB SALE

In late February, HUB was offered \$1.7 billion (US) plus the assumption of \$145 million in debt by a group of private equity firms. When valuation is calculated (based on Dec. 31 2006 financial statements; we have conservatively excluded debt as the net tangible assets – which are total tangible assets less total tangible liabilities, including debt – are

approximately nil), this translates in revenue and EBITDA multiple in excess of 3.0 times and 13 times respectively!

If one were to reflect the purchase price in terms of a multiple of commission revenue, this multiple increases to more than 3.5 times commission revenue. Talk about knocking the cover off the ball – and this is a real purchase transaction offer, not just hearsay or rumours.

One should be aware of several reasons why public company multiples may be different than private company multiples, including;

- Public companies typically trade at higher multiples than their private counterparts because they have more capital and a liquid market for their shares.
- Offsetting this somewhat is the fact that the valuations of public companies represent minority interests and, as such, trade at discounts because of the inability of any one individual to control the affairs of the business.
- Acquisitions representing the value of a controlling interest in a company often exceed the stock trading value of a given company. The purchase offer for HUB represents nearly a 30 per cent premium when compared to the 90 trading day average closing stock price prior to the announcement of the transaction. In addition, potential synergies resulting from a transaction can increase transaction values even further from the current stock trading value.
- The EBITDA multiples are based on actual, historical EBITDA results and, as such, the valuation multiples represent current value relative to past performance rather than to future or anticipated performance. This tends to suppress the multiples of growing businesses and does not mirror the definition of value being based on the future cash flows that are generated by a business.

HUB has efficiently executed a classic business model in purchasing privately owned insurance brokers at multiples of EBITDA in the range of 5 to 7 times EBITDA or at or below 2 times commission income, and has turned around to realize an EBITDA multiple of approximately double both valuation metrics. While only a double (in terms of valuation metrics), senior management have certainly hit a home run through generating \$1.7 billion in sale proceeds for their astute business planning and execution since getting established in Canada less than 10 years ago.

The acquirers, Apax partners and Morgan Stanley Principal Investments, commenting on the acquisition, have attributed substantial value to “HUB’s high quality team and franchise,” and consider the company to have “one of the best management teams in the industry.” They further state that the company has established “a leading position in the North American insurance brokerage market as a result of the dedication of its respected management team and effort of its employees.”

Despite these other positive attributes to the business, the valuation is also indicative of the market forces and general increase in broker valuations over the past six months, reaching what industry veterans are considering historical high points for the period 2002 to 2006.

It should be noted that while trading within a relatively tight range over the period 2000 to 2006, public market valuations of both WFG and HUB increased to more than 2 times revenue and nearly 11 times EBITDA as of Dec 31, 2006. For the two months leading up to the announcement of the HUB deal, the stock prices of WFG and HUB both increased by about 10 per cent.

Just prior to the announcement of the HUB sale, an article appeared in *National Underwriter, Property & Casualty*, a U.S. p&c publication, entitled "Have Agency Buyers Lost Their Minds?" This apparently a question frequently being asked by agency principals south of the border, who are shocked to hear how high a price a buyer has paid for a peer agency. How in the world, they wonder, could their mediocre competitor possibly be worth 2.0 times revenue? We wonder what they think about the more than 3.0 times revenue sale of HUB?

AS THE CYCLE TURNS

Several driving forces are helping to push up valuations, amongst which is the emergence of a soft market. Contrary to good intentions to maintain an even course, the industry continues to be cyclical and we have been in this position before. The recent market correction led to improved insurer profitability through a combination of increased premium levels, consolidation and improved stock market performance. Consequently, surplus capital was generated.

That, in turn, has helped whet the appetite of insurance companies to provide acquisition financing. Many insurers have publicly announced and offered support to their insurance broker networks in the form of financing, succession planning support and transitional solutions.

As well, markets have been spurred to take a defensive position to protect their volume. As premiums decline as the market softens and insureds shop for better deals, carriers look to safeguard their volume levels, again via creative financing solutions to their broker network and by offering value-added services so as to further cultivate and assist their loyal broker networks.

LOANS AND CAPITAL

The low interest rate environment has also contributed significantly to the appreciation of broker transaction values. Consider the following impact of interest rates on an acquisition. The increase in monthly payment based on a typical seven-year loan amortization period or payback period increases by approximately 17 per cent when interest rates double from current levels of about 5 per cent to common levels seen historically of closer to 10 per cent.

Multiple sources of capital are similarly playing a role. As we could not say it better, we will quote the title and excerpts of a *Wall Street Journal* article that appeared in the *Globe & Mail* in January. The story, entitled "river of Cash in Markets Generates Ripple Effects," suggests that "a liquidity boom has pushed financial assets to heights worldwide and driven investors into riskier corners of the market in search of better returns" and "even the most pessimistic economists and central bankers see little sign that the liquidity boom, and the benign financial environment it has fostered, will disappear soon, barring some major shock to the system."

This so-called river of cash from various sources is and will likely continue to be felt in the insurance industry from private equity funds and from U.S. markets searching for strong and stable returns, which can be earned through the p&c industry in Canada. Remember that the HUB deal is being arranged by private equity funds.

Private equity is new funding in the sector. It is not money being reinvested by the same participants, such as the banks, insurers or brokers. While only a small portion of the market (tier 3, or larger brokers) appeal to these new players, this could result in the traditional lenders stretching their lending parameters to compete for investments and secure profitable financing deals on transactions.

While there is no direct impact on the private independent Canadian p&c broker as a result of the pending HUB transaction, there could be a ripple effect resulting from the hype generated by such news.

Broker confidence is stocked by the knowledge of these high valuation transactions, and this confidence leads to higher multiples being both demanded by sellers and paid for by acquirers. If they can sell for such a good price, why can't I? If they paid top dollar, it must be worth it! Look no further than the survey results cited earlier where twice as many respondents indicated that the price of brokerages will rise rather than decline in the near future.

While the increased transaction values are a current reality, the economics of such values is an entirely different subject matter. Insurance brokers making acquisitions and paying current market multiples must be confident in their acquisition strategy and in their ability to maintain customer lists and generate sufficient profitability to service debt requirements, or generate an adequate rate of return if financed internally.

Valuations are nearing record highs. While we do not know whether they will continue to climb, level off or decline, be cognizant of the cyclical nature of the insurance industry and the possible impact that the forces of supply and demand will have on the insurance broker marketplace.

If you are considering retirement and/or looking to sell, the industry is currently experiencing high transaction values that will generate substantial financial returns for the hard work invested in building and managing your insurance brokerage.

SURVEY RESULTS ARE IN!

The Mergers, Acquisitions, Perpetuations, and Succession Survey was conducted by Cookson Walker Group and *Canadian Insurance Magazine* to put the spotlight on important trends in the industry and ultimately educate brokers about their implications. These trends include the aging demographic of brokerage owners, the apparent lack of succession planning by brokerage owners, the recent flurry of brokerage transactions and the elevated valuation multiples of these deals over historical levels.

The survey was advertised in the September 2006 issue of *CI* and was completed on a voluntary basis. Approximately 100 owners responded, with strong representation from every major region across the country. Based on the foregoing, the survey has an 8 per cent margin of error at a 90 per cent level of confidence.

The responses highlight two dominating trends: The demographic forces that will contribute to high levels of broker transaction levels over the next five years, and the increased valuation expectations relative to historical levels and the optimistic outlook for rising valuations.

Succession

- 55 per cent of broker owners are over the age of 50.
- 40 per cent of brokers are planning to sell within five years.
- 45 per cent of brokers do not have an exit strategy to how, when and to whom they plan on selling their brokerage.
- 9 per cent of brokers have no formal written succession plan/exit strategy.
- 66 percent of brokers have not potential purchaser in mind or they plan to sell to an unrelated third party.
- 50 per cent of brokers are currently seeking acquisition opportunities.
- 70 per cent of brokers intend to make an acquisition within five years.
- 40 per cent of owners came into the business through purchase or transfer of shares from family.
- 50 per cent of owners plan on selling or transferring their brokerage to family.
- 50 per cent of brokers have family members active in the business.

Valuation and Outlook

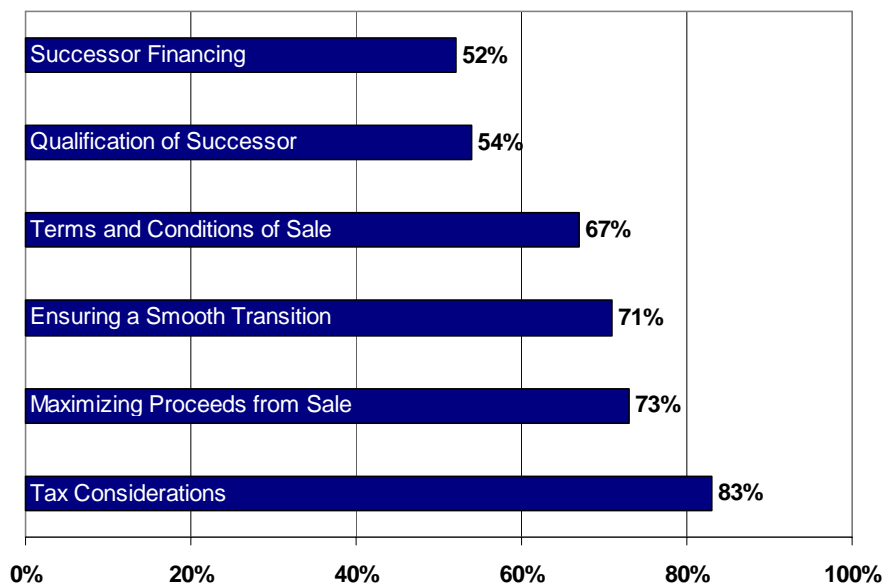
- Broker valuation expectations of their business: 2.0 – 2.5 times commission income; 6.0 time EBITDA.
- The maximum price that brokers would pay for a commercial property lines book of business (assets only, not shares) is 2.0 times commission income. Personal property followed closely at 1.9 times commission income.
- 40 per cent of brokers did not know the value they would pay for life, group health and disability insurance or financial products.
- Twice as many brokers think valuations will rise rather than decline in the near future.

Financing

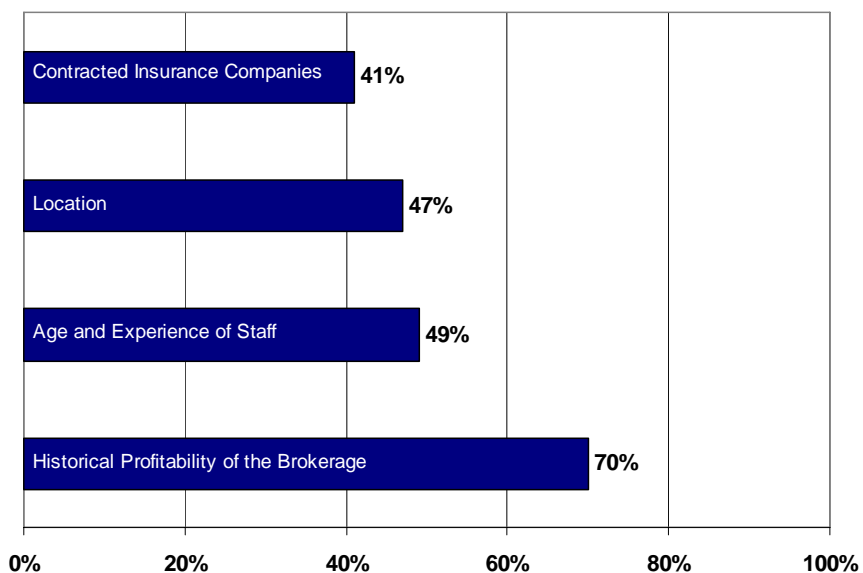
- 57 per cent of respondents cited banks.
- 55 per cent of respondents cited insurance companies.
- 50 per cent of respondents cited internal cash flow.

Succession priorities

Respondents generally concluded that ensuring a business legacy or that their name survives were not important factors in succession plans. Neither were they particularly concerned about monitoring successors. The priorities were:



Also considered “very important” factors were:



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