

LET'S MAKE A DEAL

SELLING A BROKERAGE IN THE CURRENT MARKETPLACE

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Significant changes in the p&c industry have affected the dynamics of mergers and acquisitions and the negotiation of agreements for such transactions has likewise been altered dramatically.

The public consolidators and insurance companies have either disappeared from the landscape, suspended their activities in Canada or significantly reduced their M&A activities. Insurers are now reluctant to provide financing to facilitate acquisitions. In a hard market with increased pressure to preserve capital for regulatory purposes, they simply do not have the discretion they had years ago to make loans for broker acquisitions. If they do provide financing at all, they are much more selective.

Doing business in the hard market has meant increased premiums and tighter underwriting. As a consequence, the number of markets represented by the average insurance broker has shrunk. Hypothetically, this situation should dictate a flood of M&A activity with small brokers eager to sell because of the retention risk associated with reduced market capacity and the potential threat of losing additional insurance markets. But there is a disconnect in the marketplace.

Brokers wanting to acquire are generally not eager to simply pick up volume because their insurance markets are not currently interested in picking up volume. As a result, without solid relationships with their insurance markets or with markets that will not cooperate with a sale, brokers are not desirable commodities in today's world.

THE PLAYERS

In terms of long-term business strategy, the acquisition of insurance brokerages is often rationalized by the opportunity to increase commission growth, strengthen existing or access new insurance markets, improve profitability absolutely or through synergies, favourably alter the existing mix of business, obtain staff and management skills, set up a branch office, solve a perpetuation problem and so on.

In today's marketplace, the primary motivation is perpetuation as older brokers exit or younger staff buy out retiring shareholders. Larger brokers are acquiring to obtain management skills and staff and to improve profitability through synergies. However, as noted earlier, growth in volume is not an important strategic issue because of premium increases and the focus by brokers on the retention of quality business.

Although an acquisition may strengthen a brokers position with an insurance market, it is more difficult to win access to a new market through acquisition in the current market. It is very unlikely a broker with an

existing book of business with unfavorable claims frequency or experience could buy another since it would be difficult to obtain the approval of the vendor's markets.

All of these factors, both the strategic reasons for acquisition or sale and the environment in which the transaction takes place, have implications for the terms of the related agreement of purchase and sale.

VALUATION

Many factors affect the valuation of an insurance brokerage including: The relationship of the owner and clients; the type and quality of business; probable return of clients on expiry; credit and collection policies; location; whether markets or clients are captive; growth prospects; employee retention; profitability; economic and political environment; and the quality and breadth of representation of insurance markets.

The most important valuation factors in the current marketplace are the type and quality of business, and the quality and breadth of representation of insurance markets. Put another way, the value of a brokerage is enhanced if it has a balanced book of business in terms of automobile, homeowners and commercial liability combined with strong standard market support – strong being defined as having at least three standard markets.

In a hard market, these factors more than the others threaten the sustainability of commission income and earnings, which a prudent purchaser should address in a purchase and sale agreement.

FINANCING

The availability of equity and debt financing has shrunk. Some of the public consolidators were privatized by insurers. These and other insurers are now focusing primarily on underwriting profits and preservation of capital as opposed to growth through acquisition and through financing their broker distribution network.

During the period of broker consolidations, transactions involved high levels of cash from public markets and insurers. By contrast, they now commonly involve bank financing and vendor take-backs.

The banks generally impose stand-alone business and financial rigour to acquisition transactions, which exclude, for example, synergies that might be achieved by an insurer lender. Consequently, fully-leveraged purchases may not be as easily accomplished and may require additional security, or a vendor take-back if the available security for the financing is not sufficient.

The availability and nature of funding can affect the terms of a transaction. This is magnified when a bank cannot fully fund the negotiated price, there is a lack of security available, and the vendor must provide a note payable.

LEGAL STRUCTURE

Until recently, a sellers' market and the sellers' interests prevailed in the p&c industry. Almost all of the transactions were structured as share sales to respond to the sellers' desire to maximize their after-tax yield on sale. Sellers were also able in most cases to pass most of the future risks to the purchasers.

Most transactions involved payment of the full purchase price in cash on closing. Purchase prices were usually also set and fixed on closing, based on earnings or a multiple of commission income during the 12-month period prior to closing, and the selling price was rarely subject to adjustment based on 'retention clauses'. In isolated cases, sellers would permit limited adjustments to the purchase price based upon the measurement of commission revenue earned upon renewal of identified 'key accounts' for a period following closing.

Many sellers find that they must be more flexible these days. For the most part, trans-

actions are still being structured as share sales because of the associated overwhelming beneficial tax treatment for sellers. However, the determination of the purchase price and the manner of payment of the purchase price are now open season for hot negotiation.

RETENTION

The concept of retention is again in vogue. Since purchasers are essentially buying an income stream, it is reasonable for a purchaser to demand that such income be demonstrated by its renewal through the course of a retention period.

On the other hand, this means that a seller must be willing to undertake the risk of non-retention. A seller who is willing to suffer the risk of retention must first be satisfied that the purchaser has the motivation, the ability and the markets to replicate the seller's level of customer service. In many cases, this risk can be partially offset by the seller's continuing presence with the purchaser's brokerage following closing.

The format of retention is also changing. Historically, purchasers were only interested in verifying sustainability of income during the retention period. In most agreements, the purchase price was initially calculated based on a multiple of the gross commission income during the 12-month period prior to closing. It was then subject to a reduction if the total gross commission income proved to be lower during a retention period following closing (usually a 12-month period) than was the case during the 12-month period prior to closing.

However, the growth in premiums over the past few years has spawned resistance to this approach by many purchasers, who now argue that they may experience significant attrition following closing that can be masked by the growth in premiums and commissions attached to the business that remains. In other words, the renewal income stream may suggest satisfactory results but the purchaser may have lost a chunk of business.

A vendor will argue that the purchaser is still getting what the purchaser wants — an income stream. However, this is an income stream from a book of business that reflects explosive growth in premiums and one which may not yield the same premiums and commissions when a softer market returns.

In response to this phenomenon, current retention clauses frequently avoid the measurement of the total renewal commission income. Instead, many agreements will allow the purchaser to deduct from the base purchase price for every policy that is in-force at the time of closing and is 'lost' during the retention period as a result of lapse or cancellation. The parties deduct an amount equal to the aggregate historical commission attached to the 'lost' policies multiplied by the purchase price multiple. Using this approach, it is possible for the purchase price to be reduced even if the historical gross commission is achieved or exceeded on renewal during the year of retention.

PAYMENT

It is becoming more common for the seller to 'hold paper' (i.e. vendor take-back) for part of the purchase price. For the purchaser, business and legal efficacy always dictates payment of a portion on closing and payment of the balance over time. If the agreement permits, dragging payment into the future will enable a purchaser to set off future payments against damages suffered or liabilities incurred as a result of a seller's violations of the agreement.

Since most of the brokerage transactions are structured as share purchases, the right of setoff against future payments is a terrific safeguard against hidden or contingent liabilities which arise following closing. If the purchase price is based on retention, it is natural for the purchaser to delay payment as much as possible. Remember that if retention is involved, the actual purchase price will only be determinable after the expiry of the retention period.

Conversely, holding paper is not in the sellers' interest. If a seller is prepared to accept partial payment of the purchase price on closing, the issue of security for such unpaid balance must be addressed. Sellers prefer but will rarely receive hard security in the form of letters of credit or solid collateral realty mortgages.

The security (if any) will generally consist of personal and corporate guarantees and/or 'corporate security' – pledge of the shares that have been sold and general security granted by the seller's former brokerage. While this security may strongly persuade the purchaser to comply with payment obligations, they may not create real solutions to a seller who wishes to recover the balance of the obligations following default.

Even if the seller is able to 'take back' the brokerage through the corporate security, it is uncertain whether the seller will be able to re-establish connection with markets and customers. A quick re-sale of the brokerage to recover the balance owing will be viewed suspiciously by all purchasers and value will be severely discounted in such a distress situation. In fact, the situation could be worse.

In order to raise the amount due on closing, the purchaser may have already granted security to a financial institution so the security held by a seller may have no real value at all. Therefore, sellers must examine the nature of the security carefully and the importance of this examination should climb in proportion to the amount that remains outstanding.

Although the activity level for mergers and acquisitions is stagnating for the reasons highlighted, it has not stopped altogether.

Those participating in selling or purchasing a brokerage have found that the dynamics in the current marketplace have changed to emphasize the significance of planning and due diligence. The nature and type of buyer and seller must be determined and assessed. A valuation or purchase price must be negotiated and funding obtained. The terms of

the negotiated transaction must be reflected in a purchase and sale agreement. Because of the changed environment for mergers and acquisitions these terms have changed.