A Primer on Private Equity's Impact on Insurance Brokerage M&A

The insurance brokerage sector has been radically transformed by private equity (PE); in fact, it is hard to overstate the impact. In less than a decade, many of the large players have changed, private equity sponsored agencies have seen explosive growth, and old, deeply-established firms have been acquired. Private equity sponsored agencies have increasingly dominated the insurance brokerage business, dramatically impacted transaction pricing and terms, and influenced the sheer number of deals.

In this white paper, we outline the history of private equity firms' involvement and impact in the insurance brokerage industry and explore why insurance brokers have such high appeal for these firms. As PE investments are critically relevant for owners of insurance brokerages - both large and small - we will also discuss how agencies of any size can jump on the private equity bandwagon.

Private Equity Increasingly Runs the Insurance Agency Business

A Brief History

Private equity investors only entered into the insurance industry space around 2007, with the historic leveraged buyout transactions of HUB International and USI Insurance Services by Goldman Sachs Capital and Apax Partners. Prior to this time, publicly-traded insurance brokers and large commercial banks were the buyer groups that dictated the market for agency valuations. Banks were hesitant to lend to insurance agencies as these agencies lack tangible assets to offer as collateral. Unsurprisingly, valuations were significantly lower than they are today and far fewer transactions were closed.

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HUB and USI changed the tides as they proved to be stable cash flow streams, vehicles for both inorganic and organic growth, and resilient investment platforms, even during the Great Recession of 2008. They validated the use of the leveraged private equity model in the insurance brokerage industry - demonstrating these deals could generate material returns for the private equity firms that sponsored the transactions.

The "modern" age of private equity involvement in the insurance brokerage industry really started in 2013 when Acrisure sold a majority equity interest to private equity capital. This transaction, accompanied by Acrisure's subsequent dramatic growth and recapitalizations to other private equity firms, paved the way for an explosion of private equity capital entering into the insurance brokerage space, which radically transformed the industry.

Let's demonstrate the impact by the numbers.

The Expansion of Insurance Brokerage M&A Transactions

There are currently at least 30 insurance brokerages that have received private equity money. The investments have ranged from Acrisure's $2.9 billion leveraged recapitalization to private equity investments under $10 million. The size of the brokerages that received these investments also range - some surpassed $1 billion in revenue while others amounted to as little as $5 million. Furthermore, over 70 capital providers are either invested in insurance distribution, have participated in a Sica | Fletcher process, or are interested in investing in the space.

As a result of the private equity money that has poured into the brokerage industry, the sheer number of insurance brokerage M&A transactions has exploded in the past decade.

The vast majority of these transactions have been consummated by private equity sponsored brokerages. As reported by S&P Global, 1,720 insurance brokerage M&A transactions took place between January 1, 2017 and December 31, 2019. During this period, the private equity sponsored agencies in Sica | Fletcher's Agency & Broker Buyer Index were responsible for 952 of the total number of transactions (55% of the total), with Acrisure alone responsible for 292 of these deals. While we do not maintain data on all private equity sponsored transactions, we estimate that at least 75% of all agency acquisitions during this time were closed by agencies affiliated with private equity firms. Furthermore, about 30% of the firms in Business Insurance's most recent ranking of the top 50 brokerages are affiliated with private equity firms and either did not exist or were dramatically smaller a decade ago. In accordance with this data, industry leaders generally consider private equity sponsored agencies the fastest growing firms in the industry.

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Acrisure is a great example of the explosive growth a private equity sponsored firm can generate. In 2013, the company first sold a majority interest in private equity capital - at the time it had under $40 million in revenue. Currently, Acrisure has surpassed $1.7 billion in revenue and continues to grow. Several other brokerages have followed a similar path - they raised capital when they were small or in start-up phases, and have grown exponentially over a few years' time. For example, one agency raised private equity money less than three years ago when it had under $6 million in revenue. At present, and after a series of acquisitions, the agency's revenue exceeds $60 million. As a result of stories like these, private equity firms continue to look for attractive investment opportunities in the insurance industry.

Should Agency Owners Jump on the Private Equity Bandwagon?

With the success of private equity in the industry over the past decade, it is no surprise agency owners wonder whether or not they should jump on the private equity bandwagon. To help answer some initial questions, we have put together a list of common factors that motivate investors, as well as the impact selling could have on an agency.

Why PE is so Interested in Insurance Brokerages

Private equity investors express interest in the insurance brokerage industry for some very simple reasons, including:

- The relatively straightforward nature of the business - an insurance brokerage offers predictable, renewable cash flows calculated on a simple-to-understand margin basis.
- The numerous opportunities for acquisition of healthy smaller businesses with no clear succession plans, often resulting from the industry's dramatic fragmentation.
- The predictability of the cash flows - this enables the acquiring entity to use debt in the capital structure and dramatically increases the returns.
- The reliability of market value - the market pays a huge premium for larger agencies; the larger the agency, the higher the multiple the market uses to value it.
- Added growth and operating efficiencies for all the agencies involved - a result of the acquiring agencies' consolidation under the rubric of one broker.
- The ownership interests of the private equity firm, management of the acquiring agency, and the acquisition targets can be aligned so everyone benefits as the business grows and prospers; in short, everyone is a partner and everyone wins!

Repositioning the Agency for Growth and Additional Value Creation

The main reason for an agency owner to jump on the private equity bandwagon is to reposition the agency for additional growth and value creation. It is not only to "sell." Simply stated, being part of a private equity vehicle can reposition the agency to grow far faster than would be possible staying independent. This is true whether your firm is the acquisition vehicle or part of a larger acquisition vehicle.

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In the previous section, we cited two examples of companies of various sizes that have raised private equity capital. These are just two examples of the more than 30 agencies that have attracted such capital. While the owners sold off a significant portion of their equity in obtaining the private equity investment, the value of the residual equity has grown to multiples of the valuation of the company prior to the investment. The owners ultimately increased the growth trajectory and dramatically increased the value of the firm by partnering with a private equity firm.

If you're the owner of an agency that is unable to attract private equity capital due to your agency's size or other attributes, pay special attention to the next section which will focus on how you can still take advantage of the private equity boom.

I Don't Own a Large Agency - How Do I Take Advantage of Private Equity?

The reality is that the vast preponderance of insurance brokerages (probably over 95%) have revenues under $5 million annually. While these are often thriving businesses, they are nearly always too small for direct investment by a private equity firm. If you are the owner of an insurance brokerage like this, you may be asking yourself why any of this is relevant to you. How can you take advantage of the dramatic upsurge of private equity investment in the insurance brokerage?

We said the following in a previous section, but it bears repeating:

"The main reason for an agency owner to jump on the private equity bandwagon is to reposition the agency for additional growth and value creation. It is not only to "sell." Simply stated, being part of a private equity vehicle, whether your firm is the acquisition vehicle or part of a larger acquisition vehicle, can reposition the agency to grow far faster than would be the case staying independent."

Realities and Misconceptions

Private equity sponsored brokerages are growth vehicles, and as a result, they are not simply looking for businesses to acquire and integrate. Often, they are looking for partners who want to reposition their businesses to grow faster. They understand that agency owners who are looking to sell want to be paid the full cash value upfront. They also want to create incentives to encourage the agency owner to stay and accelerate the growth trajectory of the business. They structure each transaction to accomplish this end.

> Unlike transactions of previous years, private equity sponsored brokerages now understand that successful transactions are all about the people.

Business owners considering the potential sale of their business operate under a number of misconceptions about the sale process and result. Here is the reality:

The transaction consideration is typically paid 100% upfront - unlike transactions of years gone by (excluding extenuating circumstances), private equity sponsored brokerages do not pay part of the transaction consideration as a typical earnout.

You become a partner in the new entity - unlike transactions of previous years, private equity sponsored brokerages now understand that successful transactions are all about the people. An insurance brokerage without its key people is like a melting ice cube - it slowly slips away. For that reason, the transactions are structured to keep the business owner "in the game." They make you a partner in the business by providing you with a part of the consideration in equity, typically the same equity that is owned by senior management and by the private equity firm. They also provide growth bonuses as part of the consideration for a number of years following the transaction.

The focus is growth and not integration. Your business can potentially grow by receiving higher commissions and contingencies, as well as by gaining access to additional markets. Concurrently, you are able to free up time to focus on growing the business rather than running the business. Also, because you and all of your new colleagues in the acquirer are partners, you have the same incentive to grow the business as a whole. Throughout the process, your business will typically keep its own name, at least for several years after the transaction, and depending on the acquisition partner and your situation, your business also typically operates fairly independently.

> You are not selling out, you are repositioning your business.

You are not selling out, you are repositioning your business. As a strategic advisor, we always encourage our clients to consider each option for repositioning their business to create additional value. For some agencies, the best option is raising private equity capital, for others a sale, and for still others internal perpetuation. In the most successful sales, you are not simply selling the business; you are repositioning it to create more value, to achieve your personal objectives, and create greater satisfaction. In fact, many of our clients learn that they did not sell out, they in fact traded up.

Anatomy of a Transaction

Now that we have covered how a smaller agency can take advantage of private equity investments, let's outline how acquisitions are typically structured in the current environment. The reality is that a lot has changed over the past several years, and there are many misconceptions about what these deals look like. While each of the acquirers has a slightly different way of structuring acquisitions, the common themes are as follows:

The Initial Purchase Price

In the old days, this used to be called the down payment; but the reality is that there is no such thing as the down payment anymore. As mentioned earlier, barring extenuating circumstances, 100% of the "value" of the equity is usually paid at the closing of the transaction. Let's break down how this is paid:

Valuation

- The valuation is invariably calculated as Pro Forma EBITDA multiplied by the EBITDA multiple. Note that there are two variables used, and each is as important as the other.
- Pro Forma EBITDA is your firm's most recent 12 month earnings before interest, taxes, depreciation, and amortization, adjusted by a number of factors which serve to normalize your earnings stream.

Due to the complexity, you should ALWAYS use an advisor to help you calculate it. The best advice here is "seller beware." Remember, a big fat juicy multiple times zero is still zero!

- The EBITDA multiple paid is a function of your agency's size, the current state of the market and the competitive situation in which your agency is being sold. There is no equity market fixing the multiple that your agency will sell at, and this is another reason you need to use an advisor when considering the sale of your agency.

Structure of the Consideration

- The vast majority of the consideration will be paid in cash at closing. Typically, a percentage of the consideration will be paid in stock of the acquirer. This is generally the same stock that is owned by senior management and the private equity investor.

- The reason stock is used is that acquirers understand they are investing in people, first and foremost. They are focused on growth, and they want the sellers of agencies to look at themselves as new partners in the acquirer whose interests are aligned with the other partners.

You can also focus more of your attention on growing the business rather than simply managing it.

Growth Bonuses

Following closing, you will be paid an incentive bonus or bonuses to grow the business. Different buyers use slightly different methods to calculate these growth bonuses. They typically are structured as a multiple of the growth of EBITDA or revenue above a threshold over a period following closing. These growth bonuses are very valuable for a number of reasons. Immediately following closing, you will be able to take advantage of the typically higher commissions and contingencies of the buyer due to its larger size. As mentioned earlier, you can also focus more of your attention on growing the business rather than simply managing it. Also, these growth bonuses often include incentives for you to complete acquisitions, leveraging the buyer's capital and attractive growth story.

Agency Management Post-Closing

Typically, the agency continues to be managed by the existing management team and, at least for a period of time, operates under its own name. Today's acquirers operate by emphasizing a growth strategy and not an expense reduction strategy, so you can continue to manage the business post-closing based on the pro forma EBITDA you presented. Depending on the acquirer and your agency's needs, some back office functions (accounting, IT, HR, etc.) may be integrated or simply may be left alone. Concurrently, you will be able to avail yourself of the markets know-how and distribution network of the acquirer to continue to grow your business.

In Closing

We hope you found this overview of private equity helpful. We understand that we just scratched the surface of why these transactions have become so popular in the insurance brokerage industry, even with smaller agencies, and how these deals are structured. We are here to answer any questions you have.

Our business is a people business, and our objective is to advise agency owners on how to reposition their business for continued growth and success, while achieving their personal objectives. Please visit our website, www.sicafletcher.com, for information about our services as well as recent deal updates, or call us directly at 516.967.1958 if you would like to schedule a consultation.

About Sica | Fletcher

Among the brokerage community, Sica | Fletcher is well known as the leading strategic advisory firm in the U.S. that specializes in the insurance brokerage space and related industries that compliment it. In 2019, we led the country with 92 transactions completed for the insurance agents and brokers, and in 2018, we led the country with 79 closed transactions. We are also the leading advisor to the private equity firms that are most interested in investing in insurance brokerages and in the private equity sponsored agencies that have been created in recent years.

The firm was founded in 2014 by Michael Fletcher and Al Sica, two of the industry's leading insurance M&A advisors who have closed over $6 billion in insurance agency and brokerage transactions since 2014.