

Valuing Insurance Agencies

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Contents

Background and Industry Landscape

Key Value Drivers

How are Insurance Agencies Actually Valued?

Case Studies

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Q&A

A Little Insurance Jargon

Agent/Broker

- Agent typically represents the insurer, rather than the insured.
- Broker typically represents the interests of the insured, rather than the insurer.

Commission

- Agency commission = agency share of insurance premium, typically recorded as revenue.
- Producer commission = producer's share of the agency commission

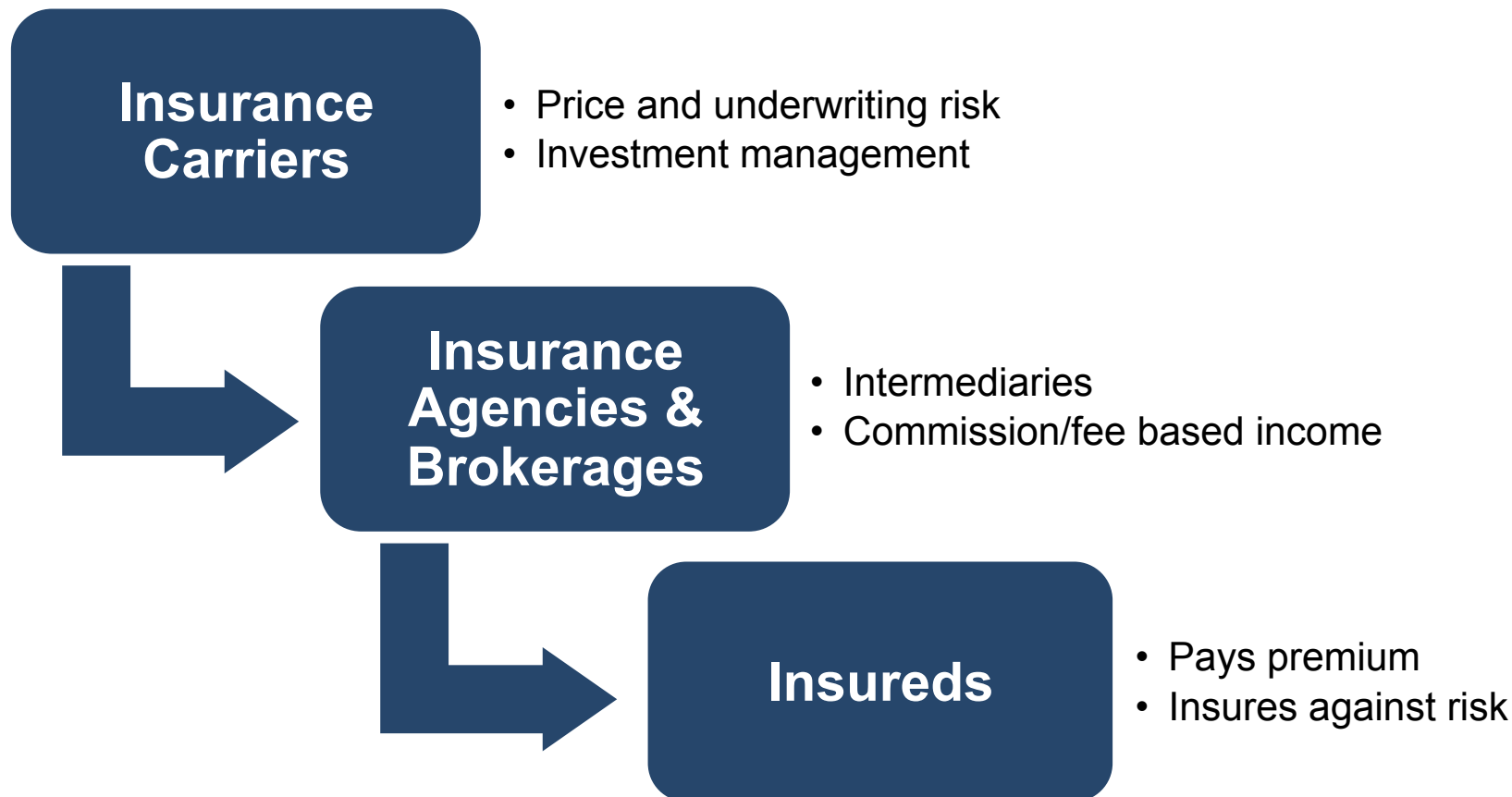
Premium

- Amount charged by an insurer to provide coverage. Typically recorded as revenue by the insurer.

Producer

- Common term for an agent, broker, or other insurance representative who sells insurance.

Where Do Agencies Fit?



Types of Insurance Agencies

Insurance Carrier

- Develop product, file rates with regulators
- Collect premiums, service policies, pay claims

Captive Agency

- Contracted through a single carrier
- Example: State Farm, Allstate

Independent Managing General Agency (MGA)

- Intermediary b/w Carrier and the Insured
- Binding, underwriting, pricing authority

Independent Wholesale Agency

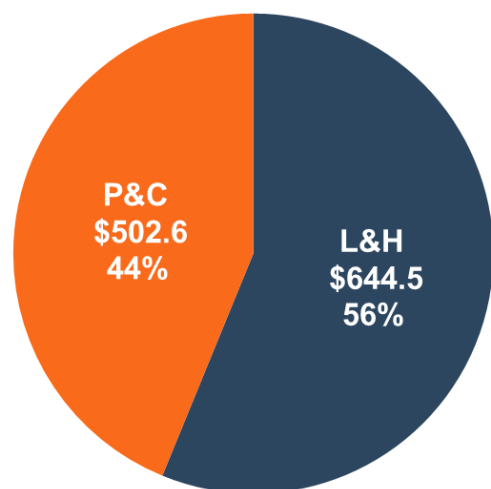
- Intermediary b/w retail agent and carrier
- Typically no contact with insured

Independent Retail Agency

- Intermediary b/w the insured and marketplace
- Relationships with one or more carriers

Overview of the Insurance Market

Net Premiums Written, 2014, U.S. entities, in billions



Property & Casualty

≈ 50/50 PL/CL

Auto

Home

Commercial lines

Workers' Comp.

Marine

Financial/Mortgage

Life & Health

Individual Annuities

Individual Life

Group Annuities

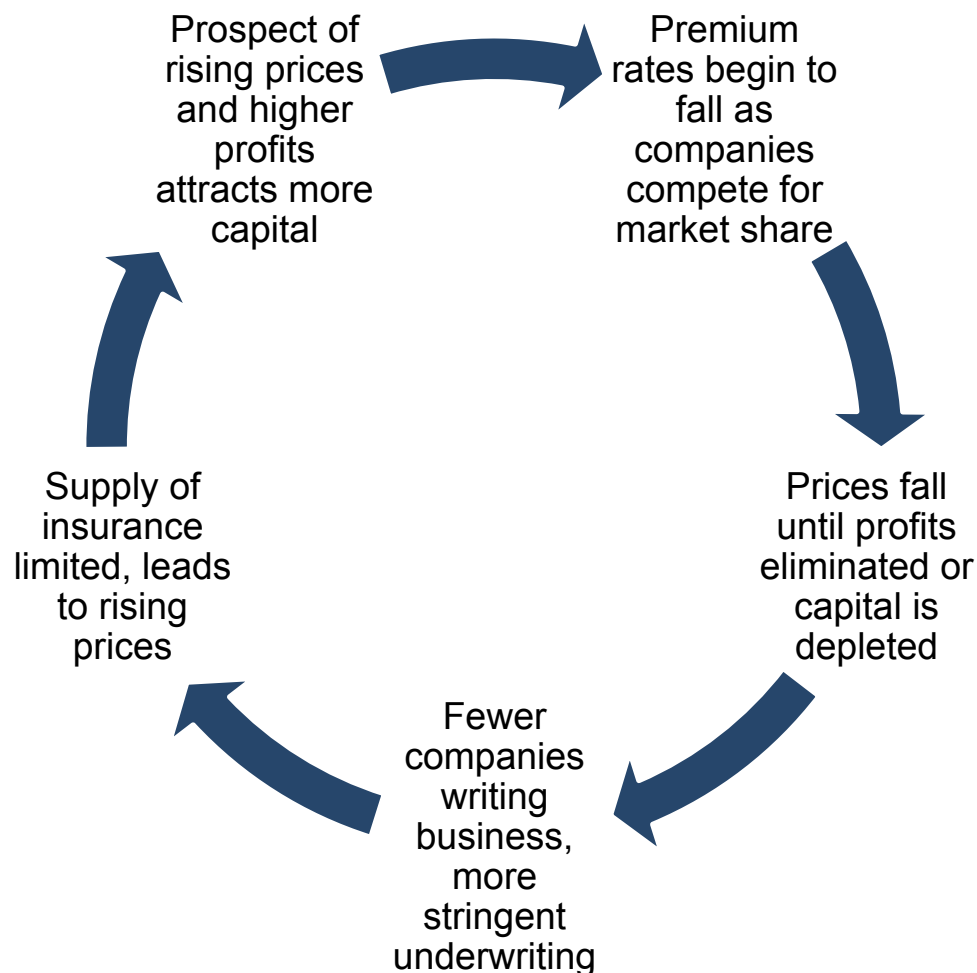
Group Life

Accident/Health

Other

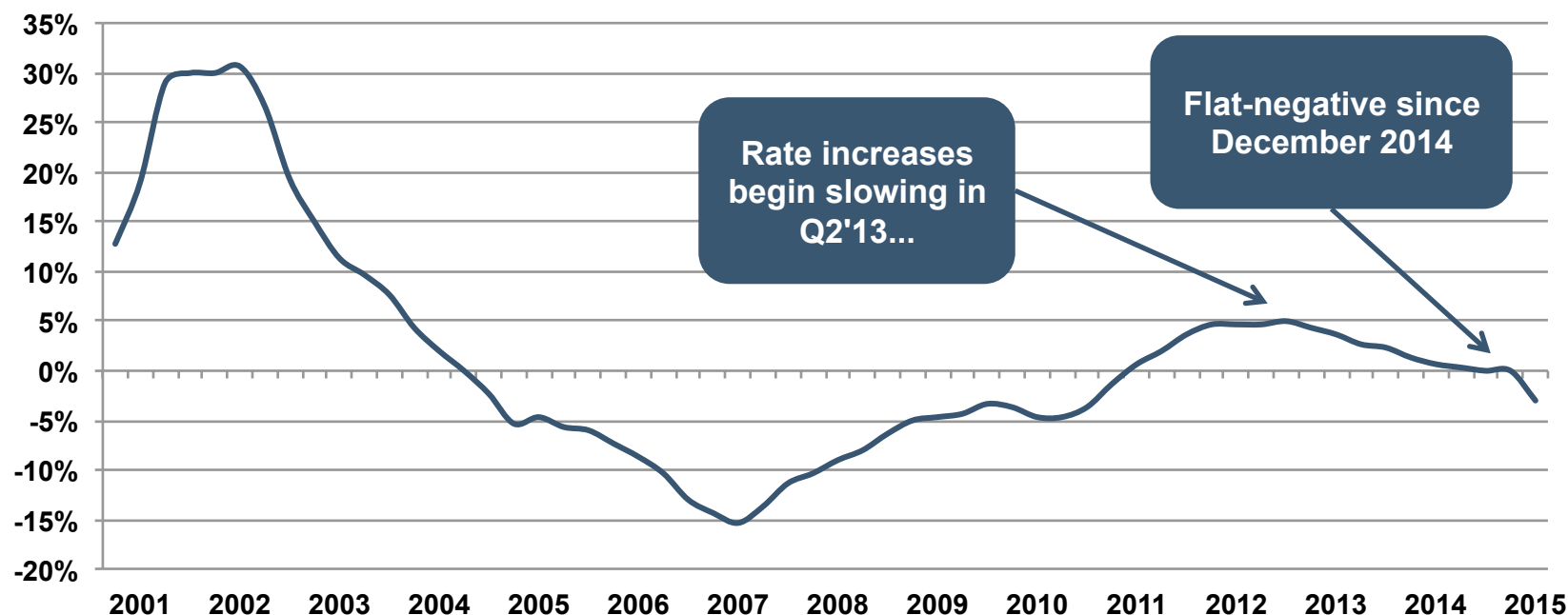
Source: SNL Financial and Insurance Information Institute

Property & Casualty Insurance Cycle



Insurance Cycle in Perspective

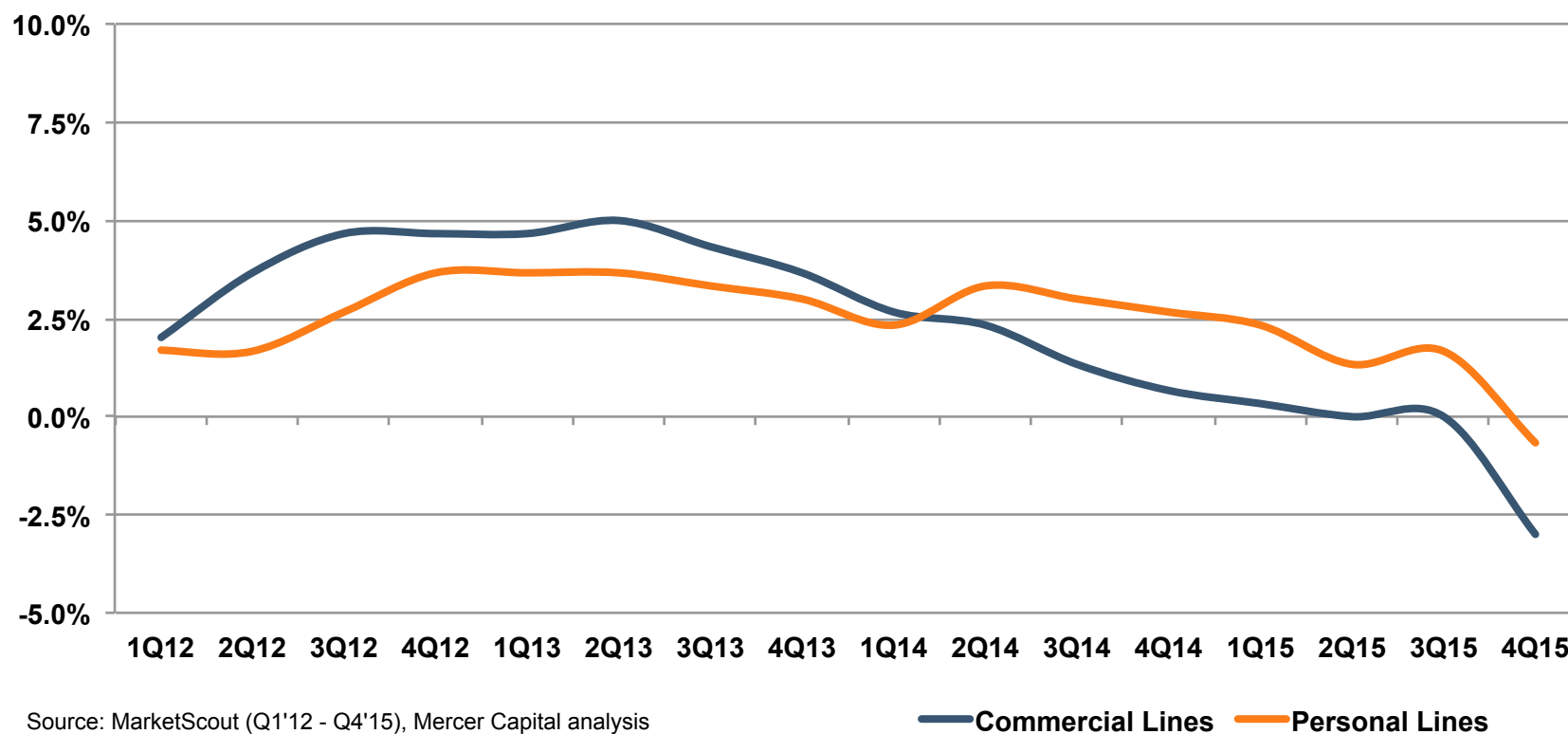
Quarterly Average Composite Rate Change for Commercial Insurance (Yr/Yr % Change)



Source: MarketScout (Q3'01 - Q4'15), Mercer Capital analysis

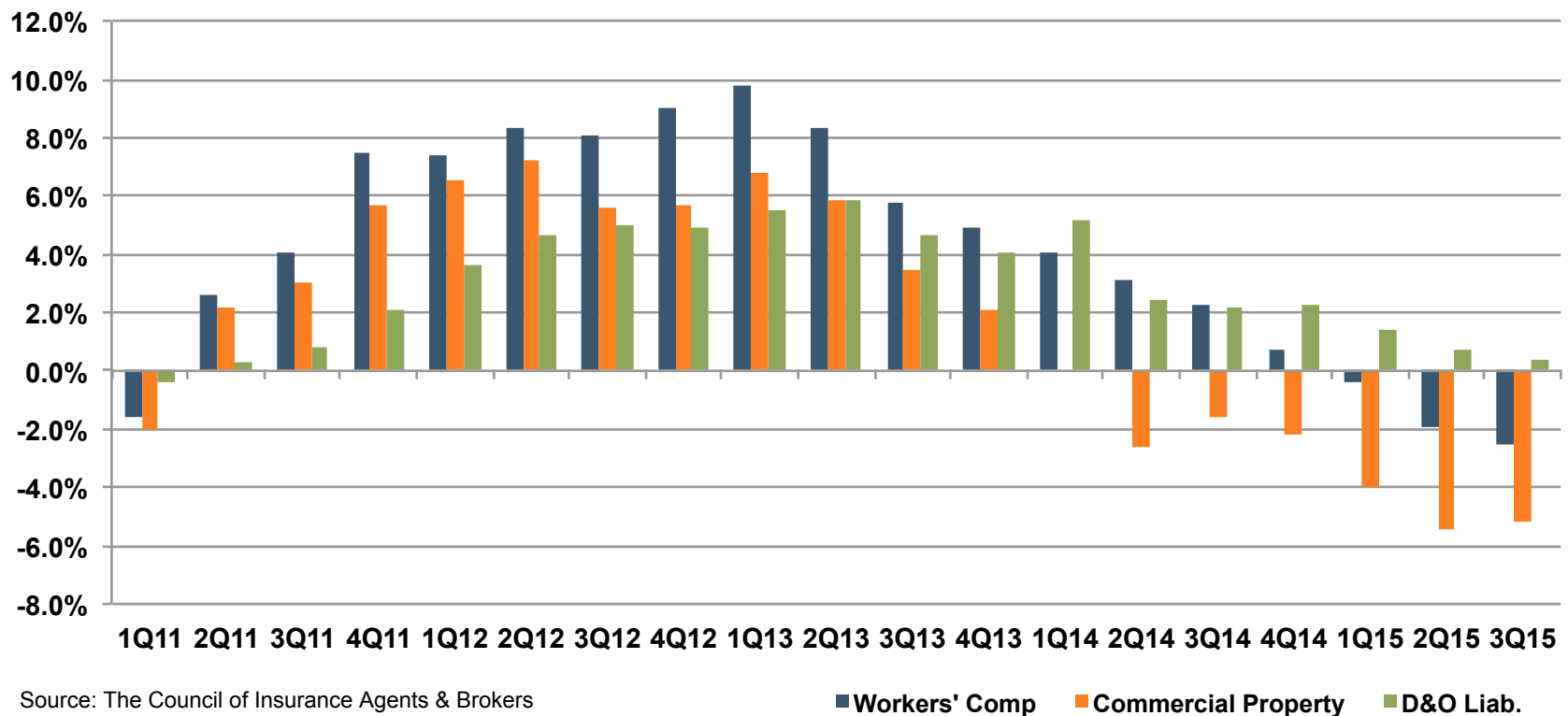
Commercial vs. Personal Lines

Quarterly Average Composite Rate Changes



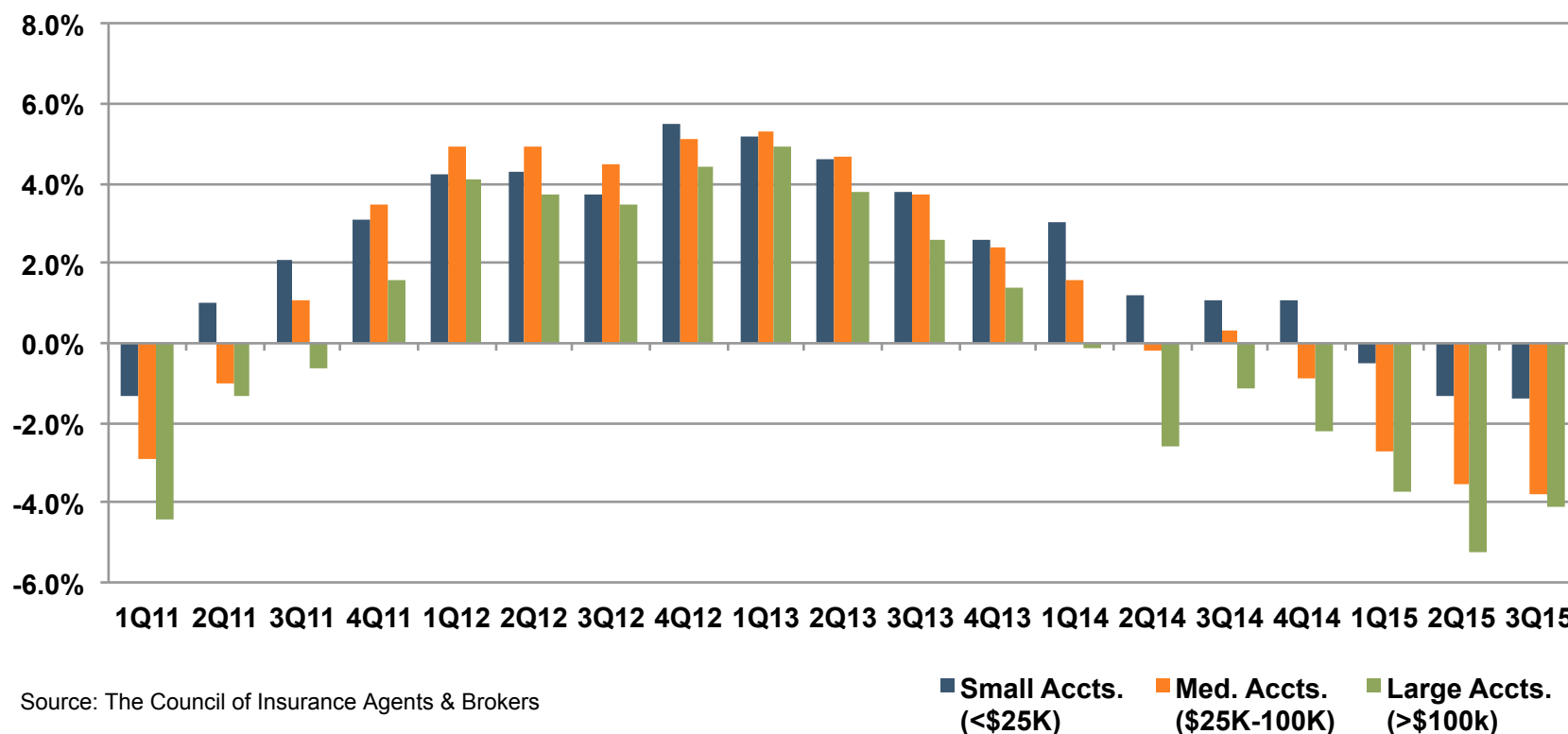
Some Lines Are More Volatile Than Others...

Commercial Insurance Rate Changes by Line of Business



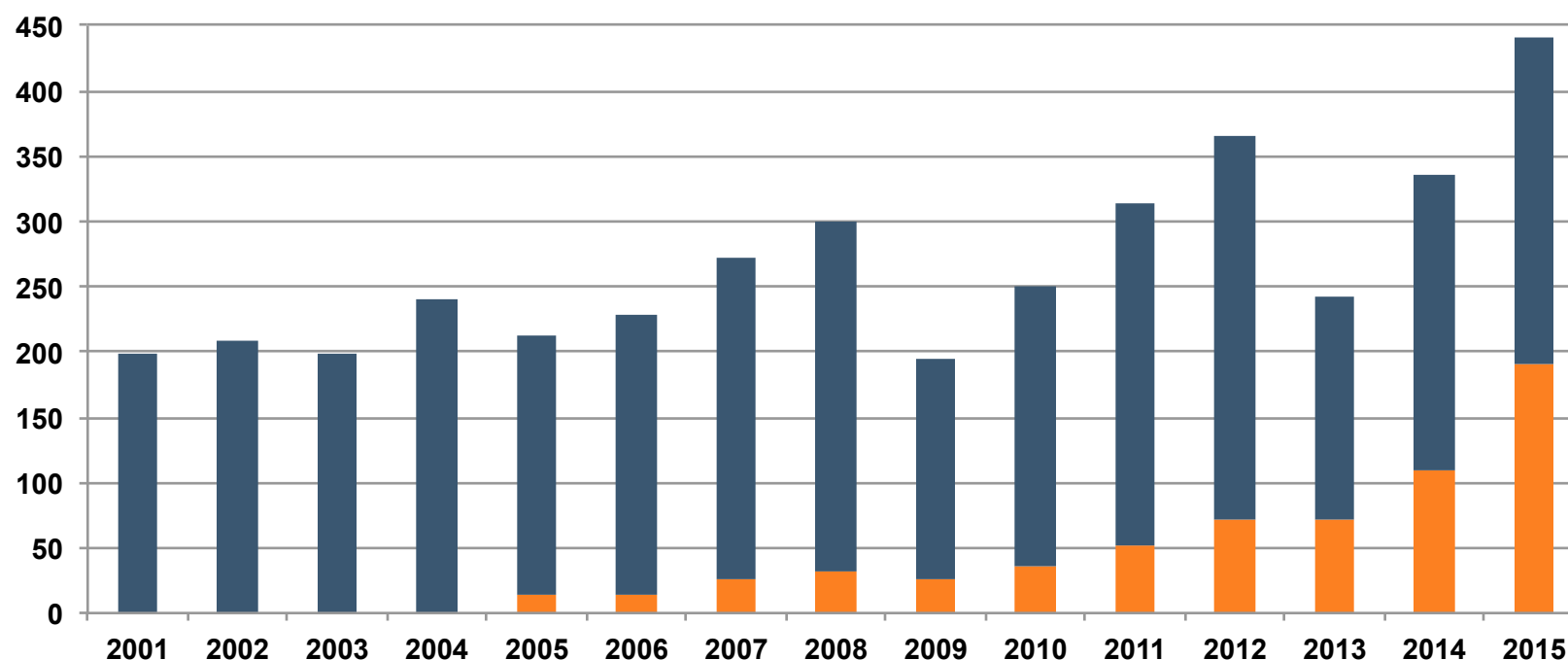
And Account Size Matters, Too...

Commercial Insurance Rate Changes by Account Size



Robust Transaction Environment

Insurance Brokerage Transactions (2001 - 2015)



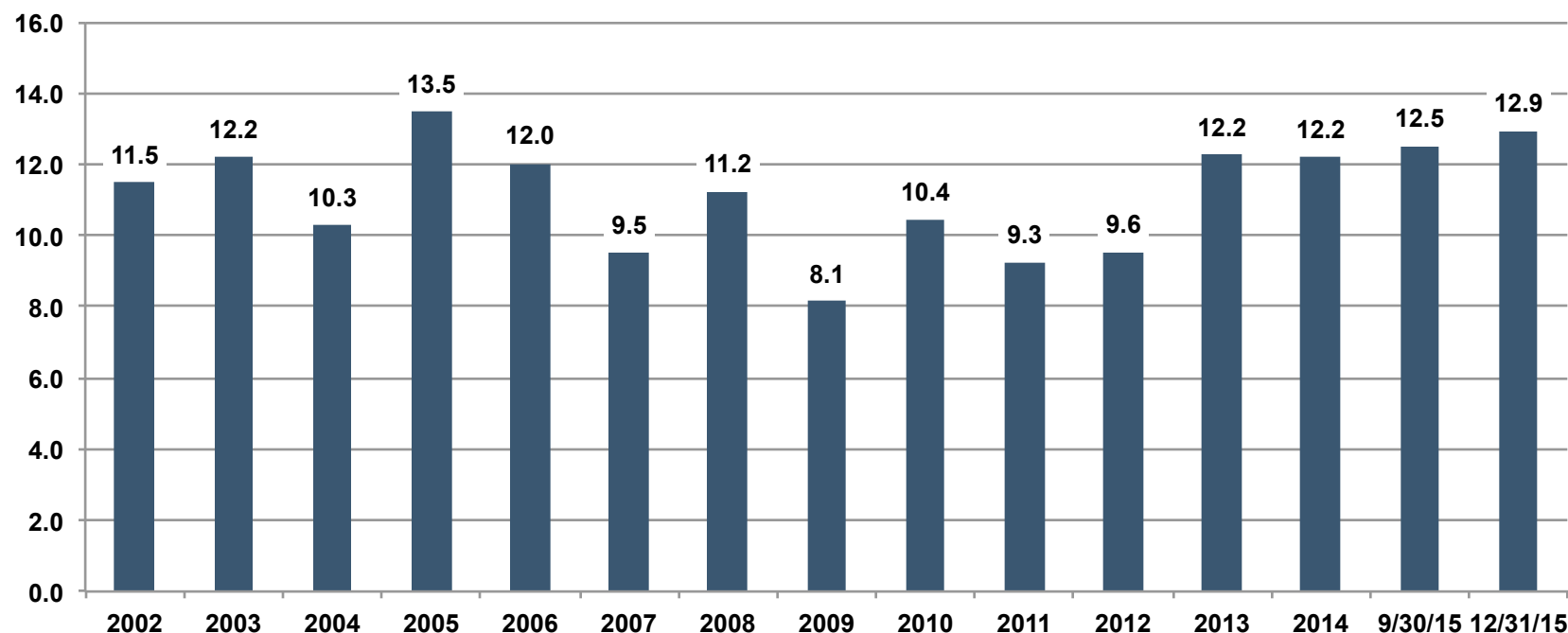
Source: SNL Financial (as of 1/14/16).
Includes all states, completed transactions only.

■ Private Equity Deals ■ All Deals Ex-PE

Public Broker Valuations

Average (last 10-years) = 10.8x

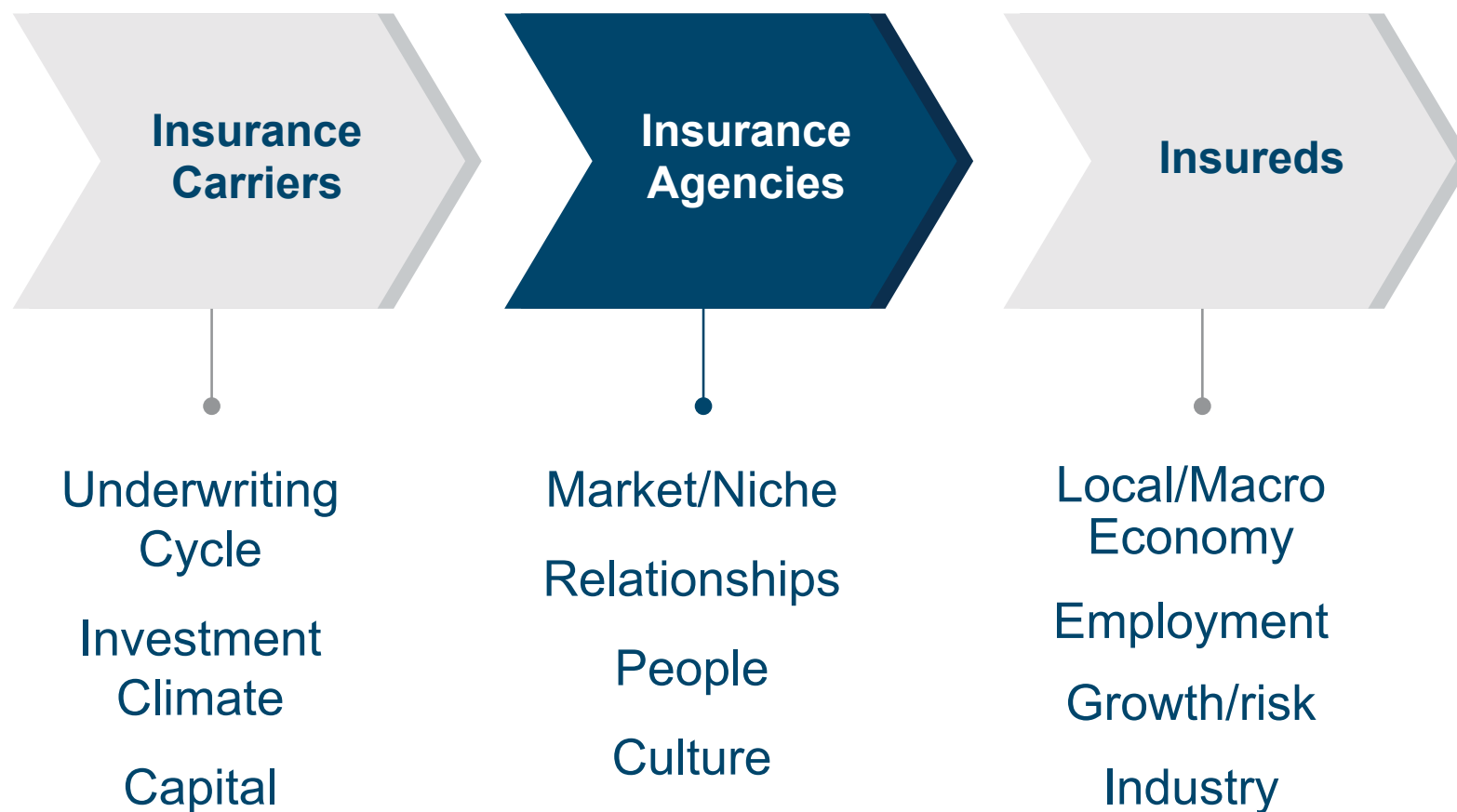
Enterprise Value / LTM EBITDA



Source: SNL Financial. Includes AON, AJG, BRO, MMC, WLTW

Key Value Drivers

Caught in the Middle?



Carriers: Pressure from the Top

Supply Side issues Typically Outside of Agency Control



Insureds: Pressure from the Bottom

Demand Side Issues Typically Outside of Agency Control



Macro Events Impact Exposure Units

Employment levels

Business and capital spending

Population growth and density

Home ownership rates

Motor vehicle registrations

Per capita disposable income

Healthcare expenditures

Impact of Catastrophes and Weather

Catastrophes (CATs) include

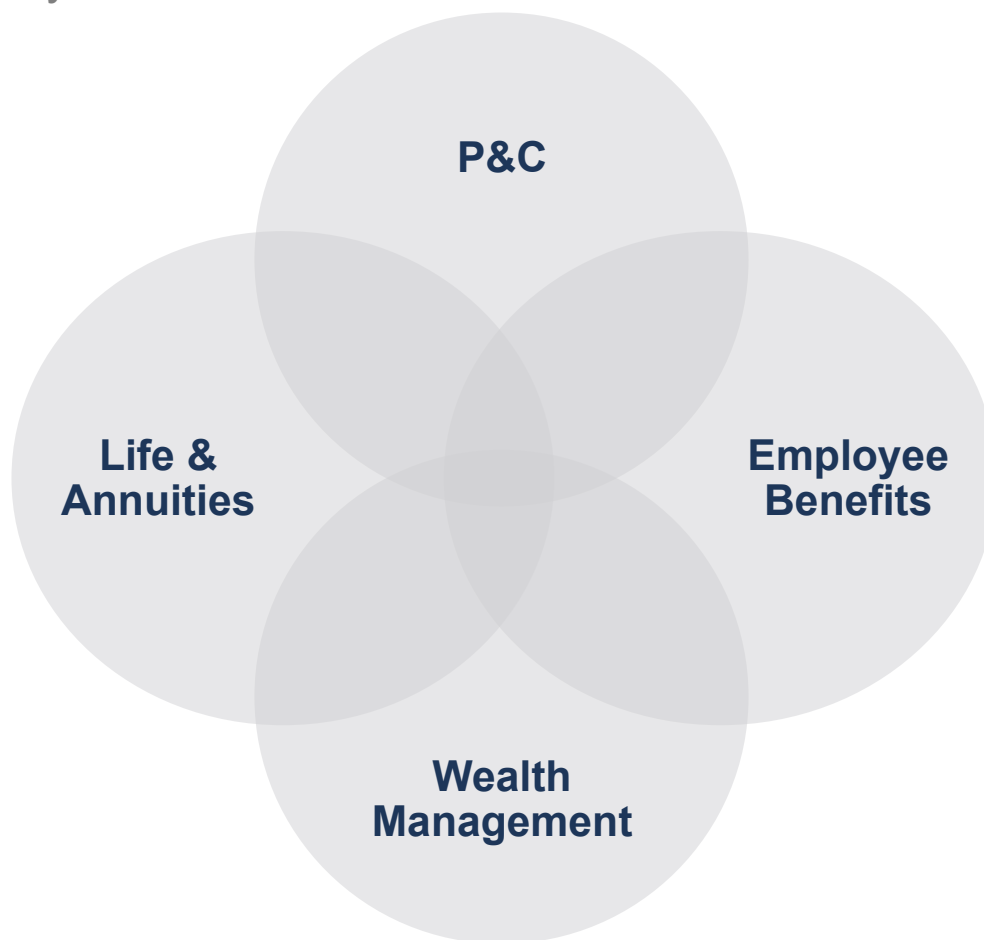
Natural disasters (hurricanes, winter storms, tornados, wildfire, earthquakes)

Man-made disasters (terrorism, fire, maritime, aviation, explosions)

CATs and non-CAT events trigger claims, impacting insurer capital levels, pricing, and coverage availability

Diversification

The Grass is Always Greener on the Other Side



Key Value Drivers of Agency Value

Industry Conditions

Local/Macro Economy



Cash Flow
Growth
Risk

Key Value Drivers of Agency Value

Quantitative

Revenue
Expenses
Profitability
Growth
Headcount
Efficiency Metrics
Concentrations

Qualitative

Management Experience & Depth
Succession Planning
Employee Relationships
Agency Culture
Brand Value
History
Community Involvement

Management and Employees

How is the agency
managed day-to-day?

Are executives also
producers?

Key-man issues

Succession planning

Management depth

Compensation policies

Commission structure

Producer development

Training and support

Non-compete agreements

Products and Markets

All lines to a particular industry or a specialty line to all industries?

Diversification vs. product focus

Growth for today or tomorrow?

Product innovation

Complementary lines

Differentiating factors?

Sales and Marketing

How do you get new clients?

Advertising

Referrals

Cold-calling

Cross-selling

Producer incentives

Community involvement

Sales culture

Acquisition History

Has the agency completed
prior acquisitions?

Businesses or books?

Pricing and terms

Integration success?

New client retention

Employee retention

Carrier retention

Contribution to growth

Customer Relationships

Who holds the relationship?

Customer retention and attrition

Related parties

Concentrations by line, customer, industry, geography?

Servicing customers

Competition

Market share in your area?

Local/regional/national?

Compete on what – price,
service, access to coverage,
reputation?

Technology

Websites and portals

It's not just the agency down
the street...

Direct carrier sales models

Competition for talent

Threats on the Horizon?

Disruptors to the Traditional Business Model or just a Fad?

Google Compare

Introduced in March 2015

Online price-comparison
insurance broker

Started with personal auto in CA,
now in other states

PolicyGenius

Founded in 2014 – Raised \$21M+
(through Jan'16)

Online price-comparison
insurance broker

“Insurance help without the
insurance agent”

Currently offers term life, renters,
long-term disability, pet

Lemonade: The Uber of Insurance?



Lemonade™

U.S. startup aims to be the first peer-to-peer insurance underwriter

Raised \$13 million seed round from Sequoia Capital in Dec. 2015

Awaiting state regulatory approvals

Business model not yet disclosed

“Mobile-first experience”

Key Value Drivers – Pro Forma EBITDA

Why look at Pro Forma EBITDA?

Ongoing revenue

Scrutinize expenses

Compensation policies

Non-recurring items

Reinvestment

Examining Revenue

Not all Revenue is Created Equal

Core Commissions and Fees

Direct revenue from
insurance policies sold

Excludes contingent/
bonus commissions

Often normalized for
multi-year policies

Examining Revenue

Not all Revenue is Created Equal

Core Commissions and Fees

Gross or net of agent
commissions?

Impact of one-timers?

P&C vs. life commissions

What about Contingent Commissions?

Weren't These Things Regulated Away?

CCs are profit-sharing
commissions from
carriers

Alternative
arrangement is
“Guaranteed
Supplemental
Commissions”, not
tied to loss ratios

May be based on

Underwriting results

Volume

Growth

Policy retention

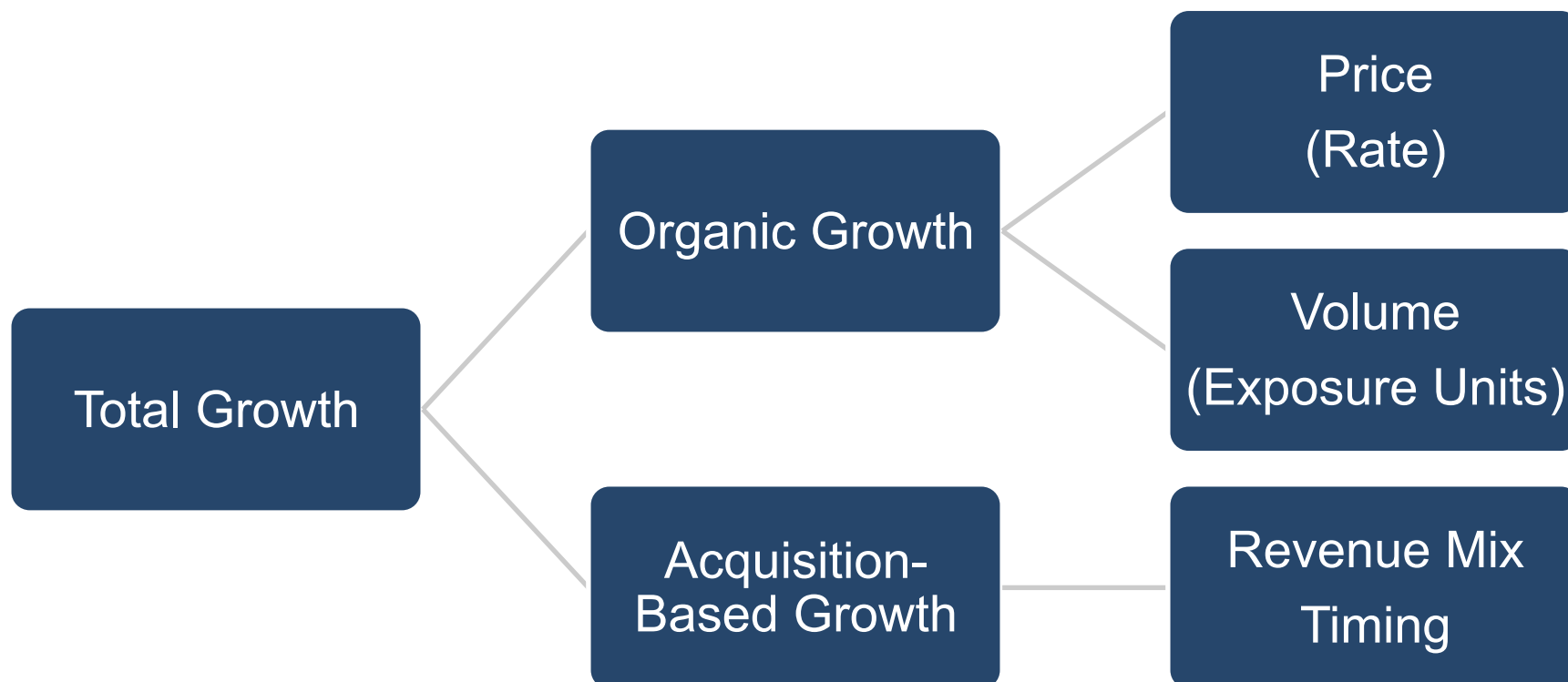
Other

Examine sources and
history of CC

Normalize to multi-
year average?

Exclude?

Sources of Revenue Growth



Projecting Revenue Growth

My Crystal Ball Appears Cloudy...

Historical

How did you grow?
Did a rising tide lift all boats?
Context of eco, rate, volume

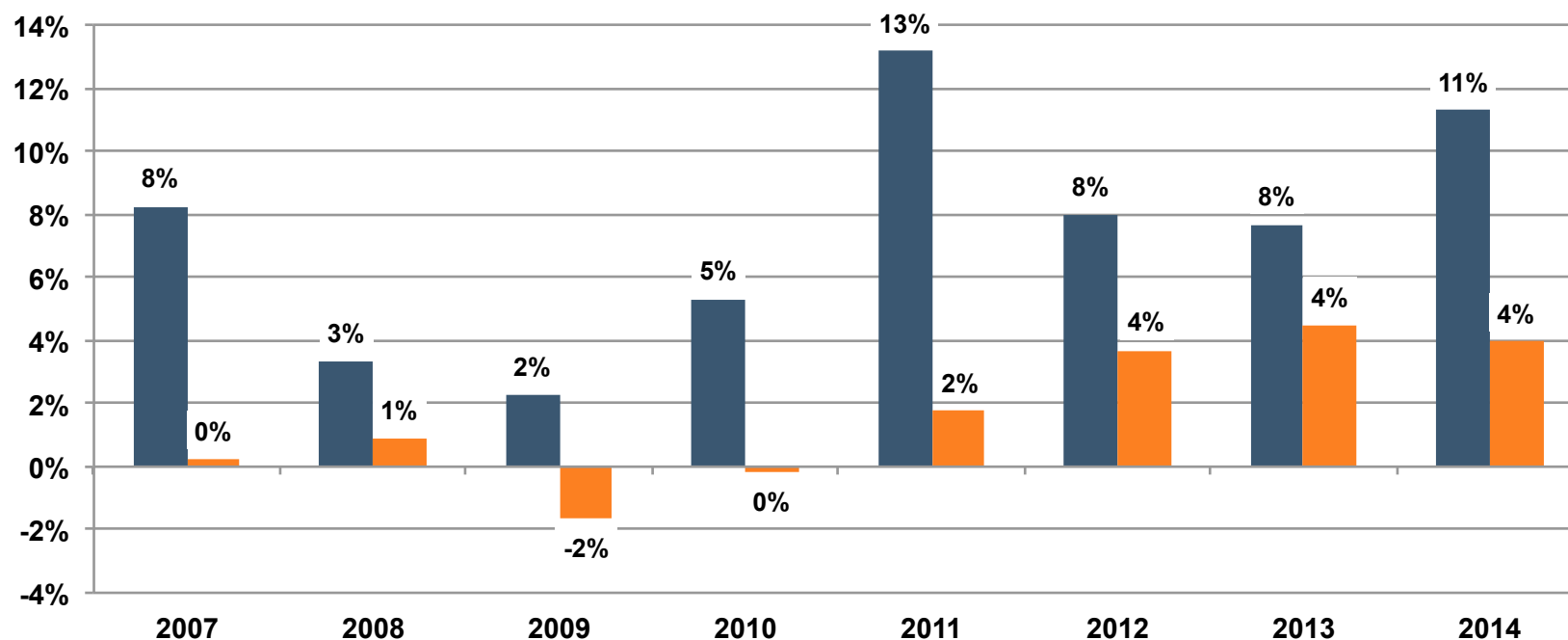
Future

Is the past relevant?
Drivers of future growth?
Why pay for past growth?

Public Company Growth Rates

Not all Revenue Growth is What it Seems...

Average Total vs. Organic Revenue Growth



Source: SNL Financial. Includes average for AON, AJG, BRO, MMC, WLTW

■ Total Growth ■ Organic Growth

Examining Expenses

Like **most** professional services firms,
the largest line item expense is people

Like **some** professional services firms,
always issues of owner/manager compensation

Owner/Manager Compensation

Returns on Capital vs. Returns on Labor

Are owners/managers the same?

Agency structure might influence compensation policies (S-corp, C-corp)

Are owners also producers?

Pro forma expense structure should properly account for all labor in the P&L

Adjust via compensation studies, agency benchmarks, other sources

Producer Compensation

Producers are Often the Highest Paid Individuals in the Agency

Compensation via
commission, salary, or both?

Different terms for different
people?

Typical structures (new/
renewal)

Does agency pay travel,
meals, entertainment, etc?

30/20

Non-competes?

40/20

Who owns the book?

Other Expense Items

Similar Considerations as for Other Professional Service Firms

Owner-related discretionary items

Non-recurring expenses

Potential Synergies (depending on the context)

- Professional fees

- Rent expense

- Marketing/advertising

- Corporate functions

Pro Forma EBITDA

For a fast-growing agency,
might be based on normalized last twelve months

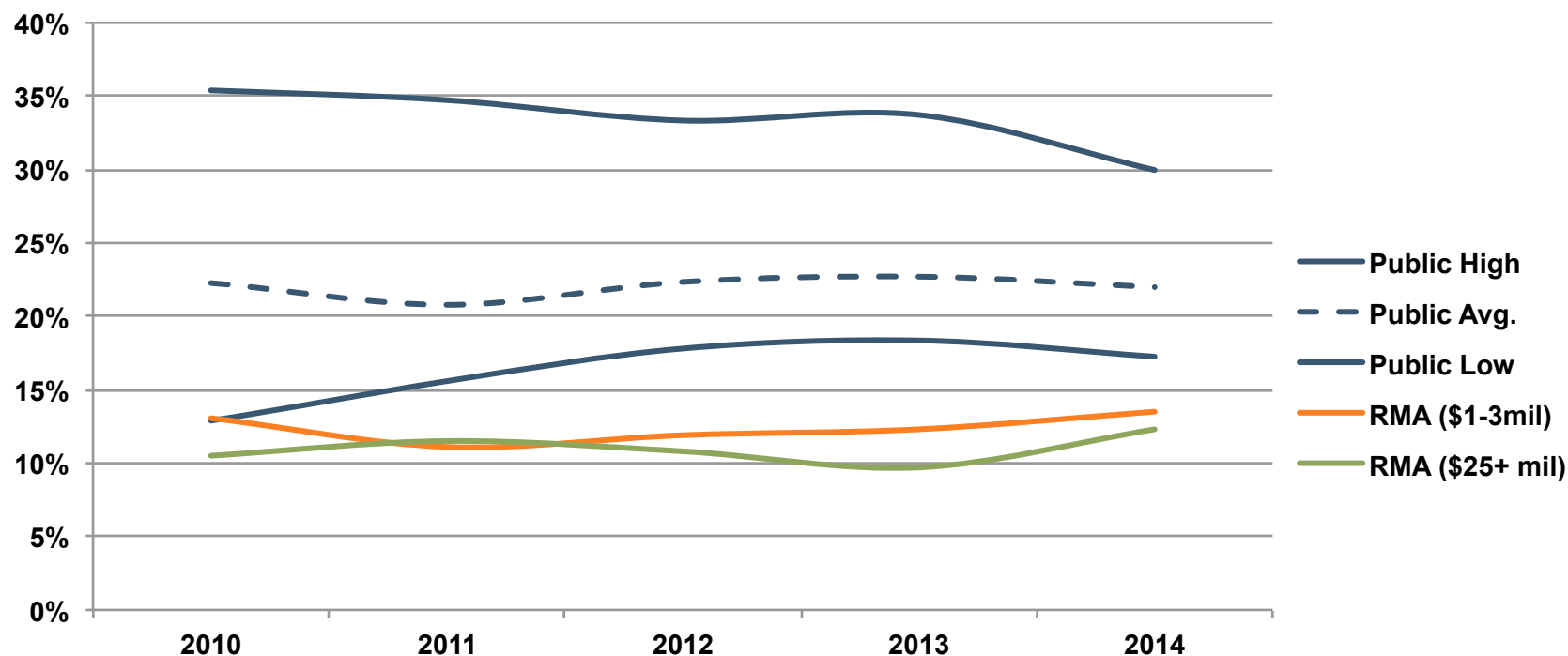
For a slower-growing, but profitable agency,
might consider multi-year perspective

For cyclical, volatile, or unprofitable agency,
use appraiser judgment...

Margins in Perspective

Is your Agency Middle of the Pack or Above Average?

EBITDA Margin Comparison



Source: SNL Financial, RMA, Mercer Capital analysis. Public group includes AON, AJG, BRO, MMC, WLTW

How Are Insurance Agencies Actually Valued?

Like Most Appraisals...

Different levels of value for different purposes

External sale

Internal perpetuation

Buy-Sell planning

ESOP valuation

Estate/gift tax planning

Other

Asset Approach

Rarely Used for Insurance Agencies

Tangible Assets

Cash

Working Capital

Computers and Equipment

Furniture and Fixtures

Building?

Intangible Assets

Assembled workforce

Customer Relationships

Carrier Relationships

Trade name

Software

Technology

Goodwill

Market Approach

Use with caution...

Guideline Transactions

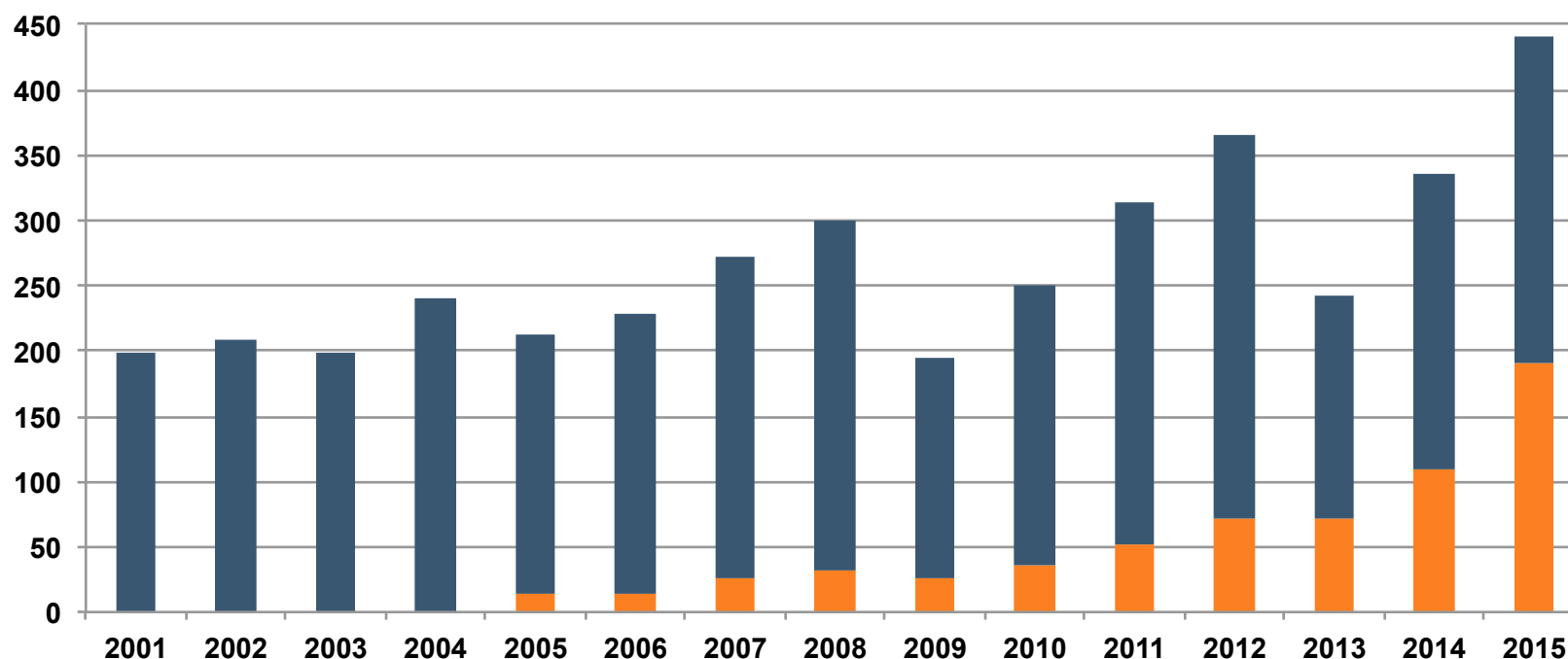
Active M&A market
Lots of activity but little
transparency

Guideline Public Companies

Few “pure” public brokers
Potential for comparability issues
re: size, diversification, growth,
etc...

Guideline Transactions Method

Insurance Brokerage Transactions (2001 - 2015)



Source: SNL Financial (as of 1/14/16).
Includes all states, completed transactions only.

■ Private Equity Deals ■ All Deals Ex-PE

Guideline Transactions Method

~440 reported deals in 2015

Filter by focus (P&C, L&H, etc...)

Filter by size

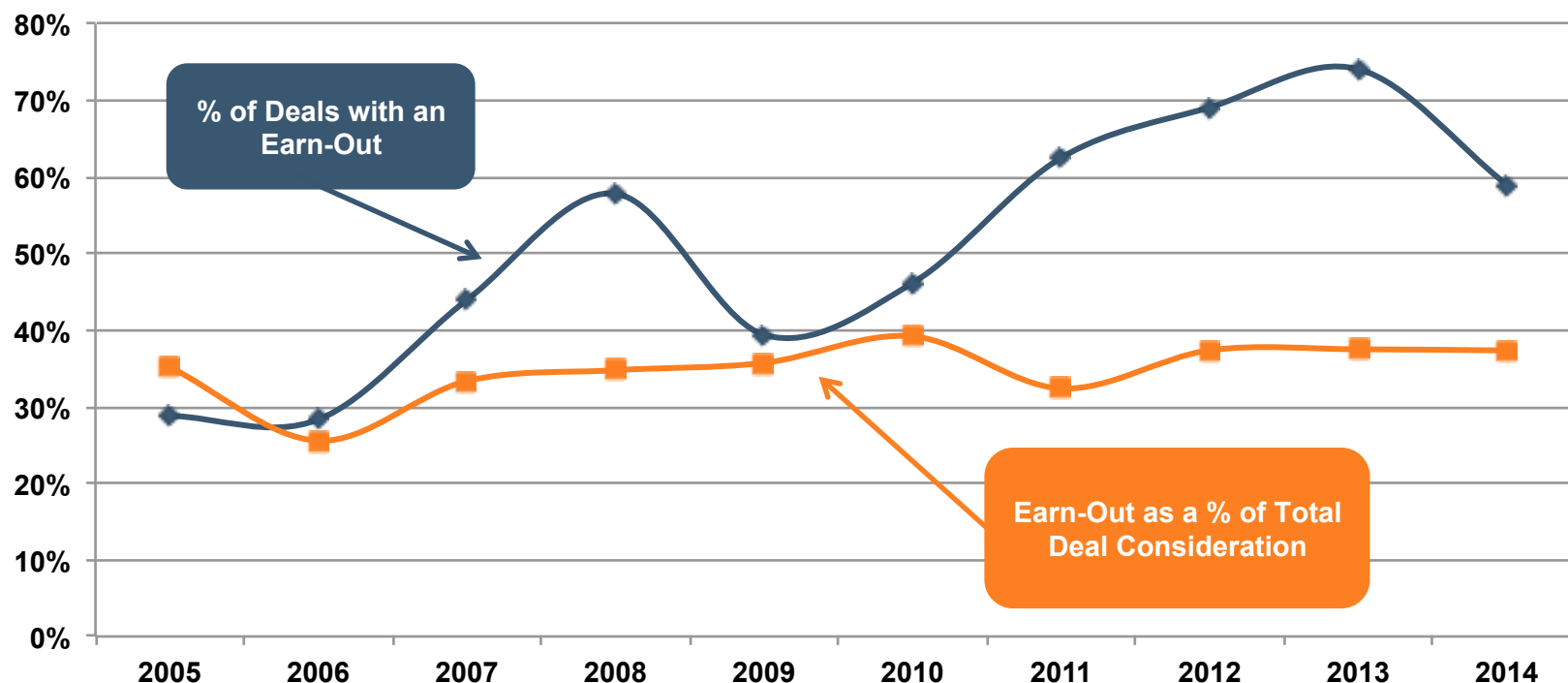
Deal value disclosed?

Deal multiples disclosed?

?

Guideline Transactions Method

Agency Transaction Earn-Out Trends



Source: SNL Financial, Mercer Capital analysis. Includes deals with reported (and classified) deal consideration.

Guideline Transactions

But my Buddy Sold his Agency for 8x EBITDA?!?

Rules of
thumb and
anecdotal
multiples are
just that

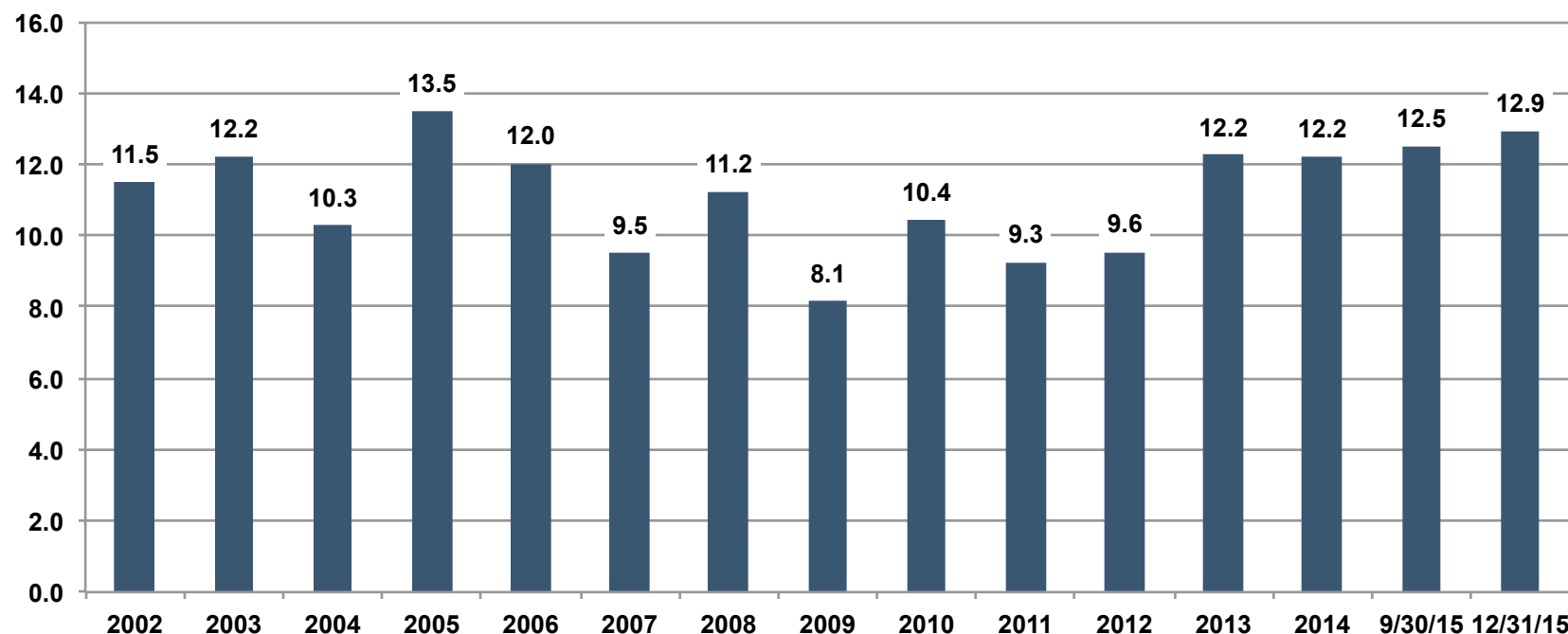
Quality of the
opinion only
as a good as
the underlying
data

With the right
data in the
right context,
this method
can be very
compelling

Guideline Public Companies

There are Comps. But are They Comparable?

Enterprise Value / LTM EBITDA



Source: SNL Financial. Includes AON, AJG, BRO, MMC, WLTW

Guideline Public Companies

Public Brokers are Large and Diversified

Company	Market Cap.	LTM Revenue	EV / LTM Rev.	EV / LTM EBITDA
Marsh & McLennan Cos Inc	\$29.0	\$12.8	2.6x	12.1x
Aon PLC	25.3	11.7	2.7x	13.5x
Willis Group Holdings PLC	8.7	3.8	nm	nm
Arthur J Gallagher & Co	7.2	5.3	1.8x	13.3x
Brown & Brown Inc	4.5	1.6	3.4x	11.5x
Average	\$14.9	\$7.1	2.6x	12.6x
Median	\$8.7	\$5.3	2.6x	12.7x

Source: Bloomberg, as of Nov. 30, 2015. US\$ in billions.

Guideline Public Companies

How do Growth and Margin Compare to our Subject Company?

Company	EV / EBITDA		Rev. Growth '15E-'16E	EBITDA Margin		
	LTM	'16E		LTM	'15E	'16E
Marsh & McLennan Cos Inc	12.1x	11.0x	4.5%	22%	22%	23%
Aon PLC	13.5x	11.4x	3.1%	20%	22%	23%
Willis Group Holdings PLC	15.6x	7.7x	64.4%	19%	22%	23%
Arthur J Gallagher & Co	13.3x	9.7x	6.1%	13%	16%	17%
Brown & Brown Inc	11.5x	9.9x	5.3%	30%	33%	33%
Average (ex-WLTW)	12.6x	10.5x	4.8%	21%	23%	24%
Median (ex-WLTW)	12.7x	10.4x	4.9%	21%	22%	23%

Source: Bloomberg, as of Nov. 30, 2015. Estimates per analyst consensus at 11/30/15.

Guideline Public Companies

Can We Really be Compared to Those Guys?

How do we compare?

- Cash flow
- Growth
- Risk

But what about?

- Scale
- Diversification
- Capital

For agencies of a certain size,
market multiples should be considered

But even when they are not, be aware of market sentiment

Income Approach

Single Period Capitalization

Value = Earnings x Multiple

Might be considered for a stable, profitable, “slow-grow” agency

Discounted Cash Flow

Allows for specific assumptions about growth, margin, and length of forecast

Commonly used

Discounted Cash Flow Method

A few caveats...

The output is only as good as the quality of the inputs

Greater precision does not necessarily contribute to greater accuracy

The conclusion must make sense in light of other methods

Use of a DCF is neither appropriate nor necessary in every appraisal

Discounted Cash Flow Method

Observations on the DCF Method for Insurance Agencies

Purpose

Status quo

Pro forma for acquisition

Something else?

Projection Term

Forecast as many periods
as necessary until earnings
are stabilized

Consider insurance cycle?

Specific industry cycles?

Discounted Cash Flow Method

Observations on the DCF Method for Insurance Agencies

Projection source

Management

Other “interested” parties

Industry sources

Bias and motivations

Discounted Cash Flow Method

Observations on the DCF Method for Insurance Agencies

Revenue

Organic vs. acquisition

Rate and/or volume

Contingent commissions

What does rate assumption
imply about volume?

What does volume
assumption imply about
rate?

Connection to product/
industry growth?

What do we assume about
existing book (retention)?

Do we have producer/CSR
capacity to sell/service this
growth?

Discounted Cash Flow Method

Observations on the DCF Method for Insurance Agencies

Expenses

What in the business is truly fixed?

How are producers compensated?

Is there enough marketing/sales spend to achieve projected growth?

Are synergies being considered?

Interest expense – how are we financing growth?

Depreciation/Amortization

Margin comparisons to history/publics/privates

Discounted Cash Flow Method

Observations on the DCF Method for Insurance Agencies

Other Cash Flow Items

Working capital – a source or use of cash?

Capital expenditures – technology replacement, system upgrades

Amortization policies

Earn-out payments from prior deals

Debt financing – is leverage part of the business?

Debt payoff for past acquisitions

If our revenue projection presumes acquisitions, do we forecast the purchase prices as an outflow?

Discounted Cash Flow Method

Observations on the DCF Method for Insurance Agencies

Discount Rates

Equity or WACC?

Industry betas are usually less than 1.0

Mature industry

High proportion of recurring revenues

Common Risk Factors

Size

Key-man risks with owner, executives, or producers

Concentrations by customer, carrier, product, or industry

Other

Discounted Cash Flow Method

Assessing the Overall Reasonableness of Your Conclusion

Relative Value Analysis

Check implied multiples against industry

Check pro forma leverage multiples

Sensitivity Analysis

How is the value impacted by key variables (rate, volume, etc...)?

Comparison to Other Methods

Guideline Public Company

Guideline Transaction

Other Income Methods

Case Studies

Case Study #1

Employee Benefits Agency

Agency A

- \$10 million in revenue. 5% EBITDA margin. 3 principals.
- 50% Employee benefits, 50% individual life/annuity sales
- Appears only marginally profitable
- Digging deeper – Agency A pays out virtually all earnings as owner/manager compensation

Potential Adjustments

- Normalize compensation to owners using peer benchmarks, public data, or other sources. Adj. margin of 20%
- Consider normalizing life/annuity revenue to average levels if lumpy
- Consider separating life/annuity business and valuing separately
- Risk should reflect stability of employee benefits side but also volatility of the life side

Case Study #2

Property & Casualty Agency

Agency B

- \$10 million in revenue. 50% EBITDA margin. 2 principals
- 100% P&C focus
- Agency B looks extremely profitable
- Digging deeper – Agency B compensates owners solely through distributions (not in operating expense)

Potential Adjustments

- Normalize compensation to owners using peer benchmarks, public data, or other sources. Adj. margin of 40%
- Contingent commissions of \$350k, \$45k, and \$110k in each of last 3 years. Consider normalizing
- Risk considerations: agency is (still) highly profitable, solid retention characteristics. Arguably lower discount rate than Agency A

Case Study #3

Potential Acquisition of a P&C Agency by a Bank

Agency C

- \$5 million in revenue. 30% EBITDA margin. 2 principals (one is a bank director)
- 70/30 personal/commercial lines
- Flat revenue for last 5 years
- A bank is considering purchasing the agency to diversify its sources of non-interest income
- Bank does not already have an insurance operation

Potential Adjustments

- Normalized compensation and entry into employment agreements with 2 principals
- Expense synergy – rent, marketing, finance/insurance, legal, benefits?
- Revenue synergy – cross-selling?
- Risk considerations: personal lines may be subject to greater competition, lack of experience, integration risk, leadership/management issues?

Other Valuation Considerations

Challenges for the Smaller Agency

Traditional small business challenges

Limited resources, competition with bigger players,
key-man considerations

Insurance-Specific

Increasing regulation, carrier-specific rules,
product/industry trends, ACA compliance

But the smaller agency also has flexibility...

How Are Insurance Brokerage Transactions Typically Structured?

Most are asset purchases, with true up for working capital

Buyers don't want the risk of a stock sale with associated liabilities

Most negotiated on a multiple of pro forma EBITDA

Disagreements in the EBITDA figure or the multiple usually are resolved via an earn-out

What Is the Typical Deal Consideration in an Insurance Brokerage Transaction?

Smaller deals might be seller-financed

Larger deals typically consist of 70-75% cash upfront, with 25%-30% in form of a multi-year earn-out on based of future profitability or retention

Affordable Care Act (ACA)

Has it Helped or Hurt?

Impact on agencies has been mixed

Created advisory opportunities for some benefits brokers

Companies need help navigating the rules

For small employee groups (<50), going with an exchange is just an option

Some reports of rate increases this year due to unfavorable losses in the pools

Employers may have trouble recruiting the talent to grow if they don't offer healthcare benefits

Likely see rise of “skinny” plans to meet minimum requirements for small groups

Consolidation is Everywhere

250+ deals a year (and that's just what get reported)

If your independent agency is doing well, chances are you've already been approached (and probably more than once)

Buyers are not just the publics anymore (PE-firms, family offices, pension funds, institutional investors)

Are you a platform agency or a bolt-on?

Consolidation is Everywhere

What are Buyers Looking for?

Internal Growth

Leadership

Deep bench

Youth

Validated producers

Sales culture

Participation

Combinations of these factors is what differentiates a single-digit multiple from a double-digit multiple

Potential Headwinds

High Public Multiples, Robust M&A Market, What Could Possibly Go Wrong?

Rising interest rates

Banks pulling back leverage

Prolonged soft market

Political/regulatory changes

Industry disruptors

Closing Considerations

What aspects of the agency are transferable, not just to a third-party buyer, but to your other partners/managers/producers?

Agencies are valued on what they'll do in the future not necessarily what they've done in the past

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Contact Lucas

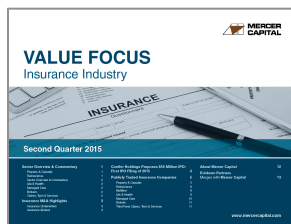
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Lucas leads the Mercer Capital Insurance Industry Team and is active in the valuation of insurance agencies, brokerages, and underwriters for corporate valuation and compliance matters.

Lucas Parris is also a senior member of Mercer Capital's Financial Reporting Valuation group, providing public and private clients with fair value opinions and related assistance pertaining to goodwill and other intangible assets, stock-based compensation, and illiquid financial assets.

In addition, Lucas co-authored the book, *Valuation for Impairment Testing, Second Edition* (Peabody Publishing, LP, 2010).

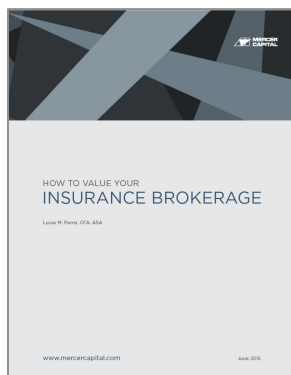
Mercer Capital's Insurance Resources



Quarterly Newsletter – Value Focus: Insurance Industry

The Financial Institutions Group of Mercer Capital publishes *Value Focus: Insurance Industry*, a quarterly e-mail newsletter illustrating trends affecting firms in the insurance industry.

Subscribe at <http://mer.cr/vf-insnc>



Whitepaper – How to Value Your Insurance Brokerage

Soft market or hard market, it is important for insurance brokerage owners to have an idea of what their business is worth. A lack of knowledge regarding the value of your business could be costly. Opportunities for successful liquidity events may be missed or estate planning could be incorrectly implemented based on misunderstandings about value. In addition, understanding how insurance agencies and brokerages are actually valued may help you understand how to grow the value of your business and maximize your return when it comes time to sell. The purpose of this whitepaper is to provide an informative overview regarding the valuation of insurance brokerages and agencies.

Download at <http://mer.cr/wp-insnc>

Mercer Capital's Insurance Services

Mercer Capital provides the insurance industry with corporate valuation, financial reporting, transaction advisory, and related services.

Industry Segments

Mercer Capital actively serves the following industry segments:

- Agencies
 - Independent agencies and brokerages
 - Bank-owned agencies
 - Retail, wholesale, and MGAs
- Underwriters
 - P&C, life & health, and managed care
 - Reinsurance
 - Captives and risk retention groups
- Services
 - Third-party administrators
 - Claims adjusters and other service providers
 - Financial sponsors and industry lending platforms

Mercer Capital Experience

- Nationwide client base
- Agency clients include single office agencies, public brokers, and private equity backed firms
- Underwriter clients range from monoline privates to publicly traded multi-line carriers

Insurance Team



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About Mercer Capital

Mercer Capital is a national business valuation and financial advisory firm.

We offer a broad range of services, including corporate valuation, financial institution valuation, financial reporting valuation, gift and estate tax valuation, M&A advisory, fairness opinions, ESOP and ERISA valuation services, and litigation and expert testimony consulting.

We have provided thousands of valuation opinions for corporations of all sizes in a wide variety of industries. Our valuation opinions are well-reasoned and thoroughly documented, providing critical support for any potential engagement.

Our work has been reviewed and accepted by the major agencies of the federal government charged with regulating business transactions, as well as the largest accounting and law firms in the nation in connection with engagements involving their clients.

For over thirty years, Mercer Capital has been bringing uncommon professionalism, intellectual rigor, technical expertise, and superior client service to a broad range of public and private companies and financial institutions located throughout the world. Feel confident in our experience and expertise.

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- Valuations for Corporate Tax Planning
- Valuations for Gift & Estate Tax Planning
- Fairness Opinions
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- Bankruptcy Related Valuation Services
- Valuations for Buy-Sell Agreements

Transaction Advisory Services

- M&A and investment banking services
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- Strategic Assessments

Litigation Support Services

- Statutory Fair Value
- Business Damages & Lost Profits
- Valuation, Labor & Contract Disputes
- Family Law & Divorce
- Tax Related Controversies
- Corporate Restructuring & Dissolution
- Initial Consultation & Analysis
- Testimony & Trial Support

Financial Reporting Valuation Services

- Purchase Price Allocation Services
- Impairment Testing Services
- Portfolio Valuation Services
- Equity-Based Compensation Valuation Services

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