

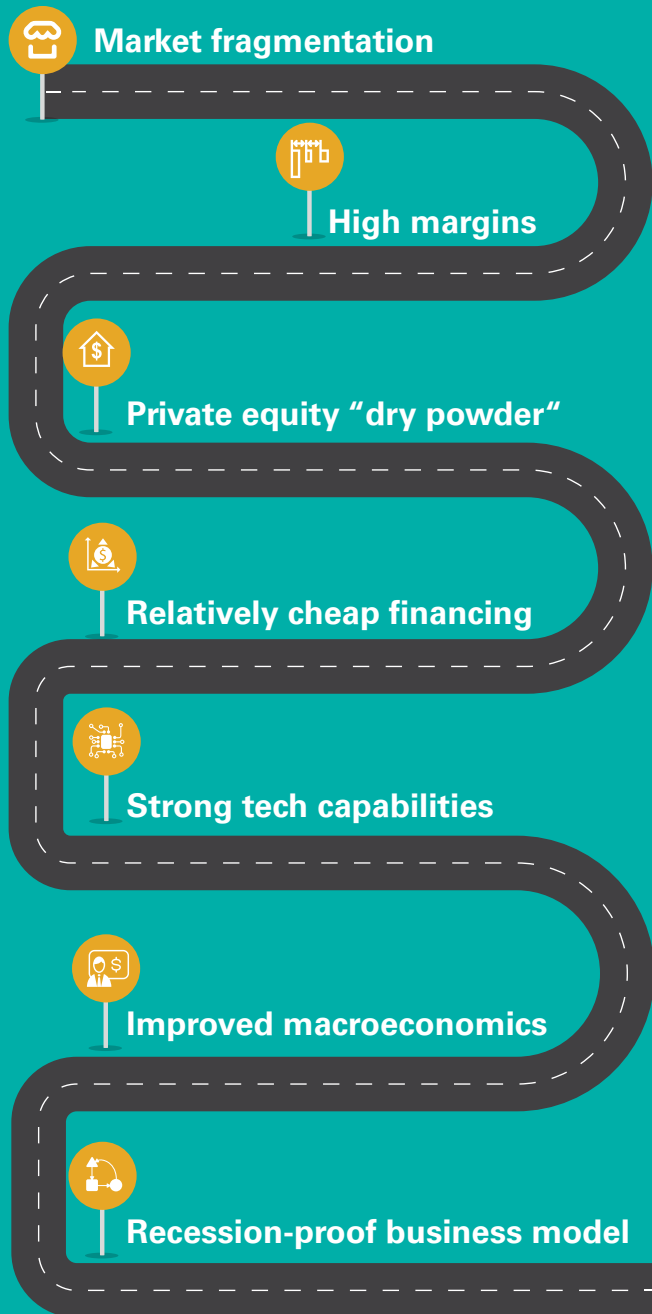


Insurance brokerage M&A

Creating and realizing value
through inorganic growth

Introduction

Market forces driving demand for insurance distribution businesses



With an estimated 30,000 brokerage and insurance services businesses in the United States, the insurance distribution segment is highly fragmented and continues to be ripe for further consolidation.

Potential acquirers have quite a few business models to evaluate and merger and acquisition (M&A) strategic options to consider. Given the diversity of these businesses, it is important to emphasize that there is no single option—or set of options—that fits every situation.

Nevertheless, we would suggest that an acquirer of business brokerage keep this one thought in mind:

Take a holistic view of the industry environment and your thesis for competitive differentiation within the industry. This should inform your business model, operating model and, ultimately, your M&A strategy choices.

Understanding the elements shaping the strategic options available in today's brokerage M&A environment is key for acquirers considering whether to buy or build.

Regardless of the M&A strategy acquirers choose, there are a number of deal evaluation considerations and postdeal integration choices to be made.

To learn more about the potential risks and opportunities of the various investment strategies available for creating and realizing value through insurance brokerage M&A, we encourage you to reach out to us.

Current market conditions

The insurance distribution segment is made up of many medium- to small-scale businesses, often lacking the sophisticated finance or information technology infrastructures of larger competitors, and often the agencies are populated with agents nearing retirement. The average age of brokerage executives is 59 years old,¹ and the U.S. Bureau of Labor Statistics indicated that nearly 700,000 insurance professionals currently are 55 years old or older, a 74 percent increase in that age group in the past decade.² Furthermore, 400,000 brokerage employees are expected to retire within the next several years.³ An estimated 25 percent of agents in the industry are expected to retire in 2018.⁴

A workforce concentrated in an older age group could be subject to succession challenges if many in the group retire in a short period of time.⁵

Average age of
brokerage executives



59 years old¹

700,000
insurance professionals

age **55** or older



74%
increase in
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group in the
past decade

¹ "Brokers Active with Acquisitions," riskandinsurance.com, April 18, 2017

² "Solving the Aging Workforce Dilemma," propertycasualty360.com, February 2, 2017

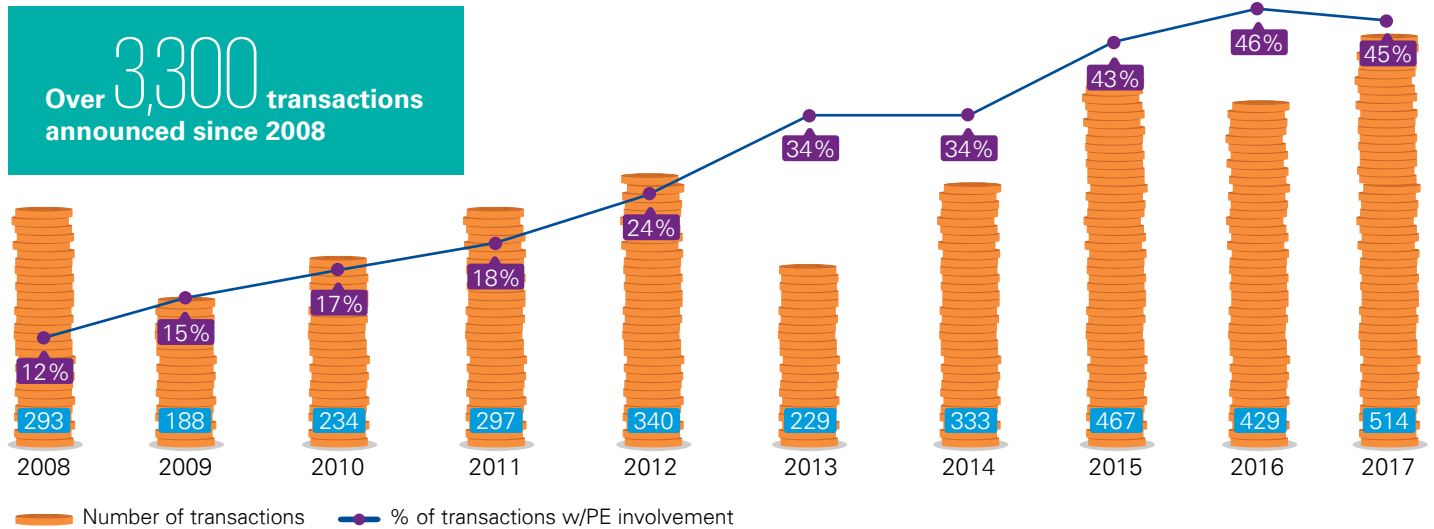
³ "Insurance Industry Rethinking Recruitment Strategies," insurancejournal.com, January 27, 2017

⁴ "Big Data for Insurance Brokerages," business.com, August 28, 2017

⁵ "4 Key Challenges Facing the Insurance Industry," iamagazine.com, December 6, 2016

We expect private equity (PE)-backed acquisitions to continue in the insurance brokerage and insurance-service sectors in the foreseeable future. After all, during the past decade, more than 3,300 businesses were traded as part of a wave of M&A deals with significant involvement from PE-backed businesses.⁶

Broker and insurance services transaction activity ^(1, 2, 3, 4)



Driving demand

Private equity
 Desire for a financial services investment in the insurance sector

- Generally, do not take balance sheet risk— therefore, brokers and other non-risk-taking insurance services firms are preferable acquisition targets for PE buyers
- Have begun to look more broadly at insurance services (e.g., managing general agents, third-party administrators, etc.) given the rich valuations of attractive broker targets

Insurance service firms

- Publicly traded brokers such as Arthur J. Gallagher and Brown & Brown continue to be acquisitive
- Especially in a soft market, inorganic growth (i.e., adding capabilities and geographic reach) has been key

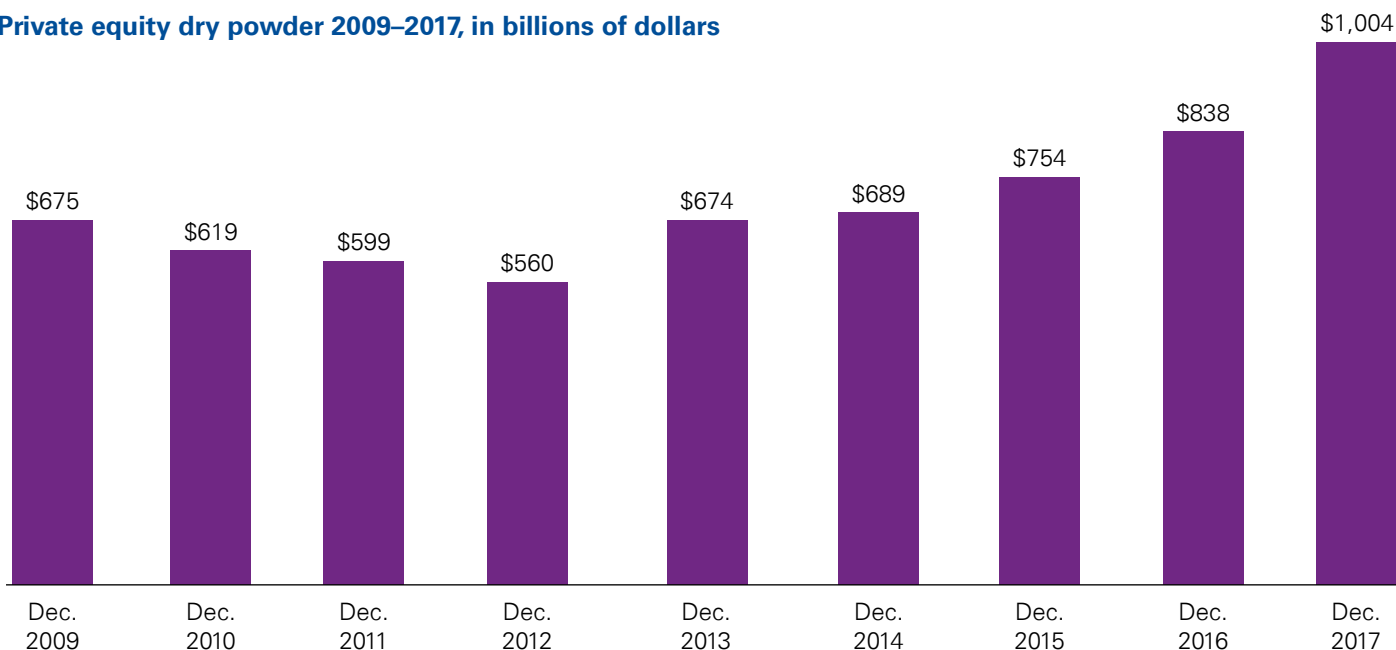
Note: (1) Includes U.S. and Bermuda targets; (2) includes the insurance broker industry category per SNL Financial; (3) PE involvement based on SNL data and includes PE involvement as either the buyer or seller in the transaction; and (4) based on year of announcement. As of January 23, 2018. Source: Crain's, A.M. Best, SNL Financial, and company Web sites

Source: "Mergers, Acquisitions & Divestitures Insurance Brokerage: KPMG's practice and perspectives on current deal issues," April 2017

⁶ Research from KPMG's Deal Advisory practice's review of company Web sites, SNL Financial (S&P Global), and a series of reports in Crain's and A.M. Best publications

PE firms' "dry powder"—the amount raised by firms that is not yet invested—stands at roughly \$1 trillion,⁷ according to Preqin, creating a situation where the demand for attractive investments remains strong, and insurance brokerage investments have historically been strong performers for the majority of PE firms who have been involved in the industry.

Private equity dry powder 2009–2017, in billions of dollars



Source: "Private Capital: Record-Setting Pace in 2017," Preqin, December 2017

Several of the PE-backed insurance brokerages possess relatively strong technology capabilities, and they have created scale that could help manage organizational, operational, talent, and other risks, making them excellent candidates for pursuing growth through acquisitions.

⁷ "Private Capital: Record-Setting Pace in 2017," Preqin, December 2017



Elements shaping options in today's brokerage M&A environment

In today's market, we believe there are a few specific strategies that make sense, given current conditions, and the conditions we see coming over the horizon.



Insurance brokerage platforms

For many, the first option is to target an existing, established insurance brokerage platform. That strategy allows a potential investor to have day-one scale and a vehicle for further acquisitions. But, that option may also come with a price, as we have continued to see multiples for insurance distribution platforms climb in recent years to as high as 12–14 times adjusted earnings before interest, taxes, depreciation, and amortization (EBITDA).



Partnerships

Sometimes, potential investors utilize partnerships with an established management team and build a platform through the execution of a number of smaller acquisitions over time. While this option may have a longer time horizon, the smaller properties tend to trade at lower EBITDA multiples.



Stand-alone brokerages

Another strategy is to identify several smaller brokerages that can be combined/rolled up into a new entity to serve as a platform on day one. Sellers typically like this strategy, as it allows them to receive a multiple closer to a level that an established platform would receive, while often retaining a meaningful equity interest in the combined entity. For buyers, this strategy can give them significant initial scale and potential synergies. This strategy has increased execution risk as the new entity needs to establish a corporate infrastructure. Leading acquirers mitigate this risk by investing in thoughtful and accelerated operating model design and execution.

The bottom line: Buy or build?

Many refer to the question of acquiring an established platform or acquiring a series of smaller agencies to build a platform as the buy-or-build question. There are a few factors to weigh when considering whether to buy or build.



The question of buy or build for many investors comes down to their general investment thesis and investment parameters. How much capital will be committed and what is the investor's objective? Buying a platform tends to be more expensive, but this strategy carries less execution risk. Building a platform requires deploying a lower amount of equity over a longer period of time, which may improve the risk profile of the investment but make the deal less attractive to investors looking to put equity to work right away. Building a platform may allow the investor to acquire businesses less expensively, but there is a need for more "sweat equity," as the business needs to be assembled in smaller pieces to create a platform.



Time horizon –

Building a platform from scratch takes time. Buying a platform may allow an investor to achieve investment objectives in a shorter time period. Whereas building a platform results in equity being deployed over a longer period of time, buying a platform means that a higher amount of equity must be deployed at the investment date. Both options can be attractive, depending on the expectations of the investor.



Operational expertise –

Investors who have previous experience in the insurance brokerage space and those who have successfully executed "roll-up" strategies previously might be better positioned for the complications related to the build strategy.

Develop a detailed operating model and value creation plan for the target in diligence

With acquisition multiples at record highs, acquirers cannot afford to have operating cost leakage post acquisition. While rules of thumb and top-down benchmarks were once sufficient to identify the postacquisition operating model and synergy pathway during diligence, the need for bottom-up operational assessment is increasing. Leading acquirers conduct this work in diligence allowing them to price this value into their bid and confidently pay a premium to competitors. This can also accelerate the integration pathway and value realization of the asset as the planning commenced predeal signing. Conversely, it also allows bidders to walk away from bad deals when the operational complexities do not justify the multiple.

Deal evaluation considerations

Regardless of the strategy investors choose for entering the space, there are a number of issues to consider when evaluating the risks and opportunities of various investments.



Recent acquisitions make platforms difficult to evaluate

Most of the existing large platforms have grown inorganically through multiple acquisitions. The degree of recent acquisitive growth can complicate the analysis of recurring EBITDA and other business matters.

In many cases, a portion of the consideration for add-on acquisitions is in the form of a contingent “earn-out” payment—additional compensation a seller receives in the future if the business reaches certain financial goals. There is a risk that earn-outs and other purchase considerations for recent acquisitions may be replacement compensation or commission for key producers or owners and, accordingly, the current reported cost base may not be sustainable post-earn-out.

It is critical that as part of diligence, potential investors evaluate historical, current, and expected compensation levels and other contingencies to help ensure they are factoring in a cost basis that is reasonable for supporting the current levels and projected growth of the business (including after the earn-out has expired). In some cases, platforms factor in certain integration synergies that ultimately may not materialize or may change postacquisition.



Organic growth: A key result from a successful M&A strategy

While many of these platforms have grown inorganically, one of the common selling points is their ability to drive organic growth on existing business or in recently acquired add-ons.

Companies with an organic revenue growth story have traded at higher multiples in recent transactions. While demonstrating the organic growth story through empirical data can be challenging, the ability to do so is a significant driver of transaction value.



Multiples for bolt-on acquisitions are rising

As the number of PE-sponsored platforms has increased in recent years, competition for acquisitions of brokerages with EBITDA of \$1 million to \$10 million is driving multiples higher. The current valuations, dependent on the type of business and several other factors, are in the 8 times to 9 times EBITDA range. Just a few years ago, valuations were in the 6 times to 7 times range. Given the large number of potential insurance agency targets, it is important to consider what the overall M&A strategy is for the platform. We have observed that properties with niche markets and products are more attractive and typically command higher multiples.



Pro forma adjustments are becoming increasingly aggressive

With increased market competition, there has been not only an increase in multiples but also an increased aggressiveness in the number and types of pro forma adjustments. In our view, buyers need to be increasingly aware of potential changes in markets for acceptance of pro forma adjustments, and they would be well served by taking realistic views of the likelihood of certain pro forma adjustments ultimately producing real cash EBITDA postclosing.

The integration decision

We have seen investors achieve success both through integration and by maintaining stand-alone operations of acquired firms. Those that choose to integrate back-office operations and systems achieve the benefit of eliminating duplicative headcount and costs and having a plug-and-play platform for further acquisitions.

While there are significant costs with integration, there are many investors who see value in an integrated organization and are willing to pay a premium for that arrangement. On the other side of the spectrum, an argument can be made against full integration as it minimizes business disruption and allows producers and former owners to focus on revenue growth. Many selling owners and producers are entrepreneurial types and they may prefer to retain more autonomy by not having to integrate into a larger corporate organization.

Certain benefits can still be realized without full integration, as scale benefits from consolidation of carrier and wholesaler contracts can be realized, resulting in the possibility of an immediate increase in revenue due to the higher volumes of the combined organization.

There is no doubting that synergies from integration are real and significant. The question is how much do you integrate? Accounting, payroll, and HR are the typical

targets, and many sellers relish the opportunity to offload back-office administration to an acquirer. This allows them to focus on what they do best: producing. Further along the integration spectrum are operating model components such as agency management systems, network cross-sell, carrier contracts, producer commissions, branding, and facility consolidation. The strategy adopted for each of these items will differ for each company and typically evolves within each company over time. For example, serial acquirers may prioritize accelerated acquisitions in the short term, with end-to-end operating model design and integration a medium-term focus once sufficient scale is realized. Others with a strong platform in place are typically more focused on deep integration of acquisitions to ensure immediate operating model alignment and synergies.

Whatever the extent of integration, integration requires substantial planning and execution, ideally in the form of a standardized best practice playbook addressing operating model design and a bottom-up synergy realization plan. In our view, integration actually may be more of a powerful attribute for sellers. There is a level of investment a seller would want to make in integration to show that the business is capable of functioning at a level that it should for its size, but sellers must be cognizant of diminishing marginal returns for spending above a certain level.

How KPMG can help

In recent years, certain properties have traded quickly (less than three years from entry to exit for some investors) with attractive investment returns. As investors begin to think about the exit, there are a number of factors to consider. We believe that there are three factors that should be at the top of the list for consideration:



It is critical to take control of the narrative of the business and how potential buyers should comprehend multiple and often-connected nuances associated with a business that has grown inorganically and quickly in the past few years. Our team of specialists gets involved in the task of helping an organization integrate people, processes, and technology.



The demographics of the producers may present some considerably difficult future issues due to an aging workforce. It is vital to involve a third party with broad experience in successfully identifying ways to meet the challenge in recruiting younger brokers in the years ahead.



We have noted that sellers have achieved high returns around the ability to execute on inorganic growth strategy in the short term as well as the organic growth story. Accordingly, we believe sellers should consider investing in tools and capabilities that can accumulate and generate transaction-level information and then conduct in-depth analysis that demonstrates and supports its organic growth levels, which would likely result in higher valuations on exit.

For more information about KPMG's insurance capabilities, please visit our Web page:
kpmg.com/us/insurance.

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Whether acquiring a new business, selling an existing business, or conducting a business restructuring or transformation initiative, KPMG member firms have a range of services to help our clients enhance value. As a leading adviser on several M&A transactions each year, working with many of the largest and active insurance brokerages and services corporations, and private equity investors, KPMG's Deal Advisory & Strategy practice is well-placed to guide you through your journey of creating and realizing value through inorganic growth. Our integrated business diligence leverages proprietary data and analytical tools from deal sourcing and strategy through to deal evaluation and execution and ending with integration and value creation.

We help our clients:



Identify targets with unique strategic fit and value creation potential



Identify and prioritize the primary synergies of a deal, including the unique synergies that only your company can create



Conduct due diligence that is focused on the strategically relevant parts of the business



Value targets based on how they fit uniquely with your business (rather than just rely on average multiples)



Suggest deal type and structure to align with your competitive strategy



Plan for an integration approach that will foster the unique synergies that will create and achieve maximum value



Set in place a posttransaction performance assessment that tracks value creation on an ongoing basis.

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