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HAS THE INSURANCE BROKERAGE MARKET PEAKED?

by Arik Rashkes and Richard Forgione

Improving economic conditions and asset prices could increase overall demand for insurance coverage.

OVERVIEW OF ECONOMIC CONDITIONS

Despite current volatility from global growth concerns and the lower price of oil, the U.S. economy's ability to weather the storm will be a large driver in how 2016 pans out. The Federal Reserve recently increased interest rates after a long period of near-zero borrowing costs since 2008. While some predict a very slow increase in interest rates over the next few years, Fed officials point to a much more methodical and robust movement in a shorter period of time. The impact of rising rates is expected to not be as hard-hitting on U.S. consumers given that household debt has contracted since the financial crisis, suggesting that consumers can more readily absorb an increase in borrowing costs.

GDP figures are currently improving in the United States. Typically in this financial situation, both businesses and individuals reevaluate insurance needs, leading to an increase in spending on insurance-related products. This trend could present an opportunity for organic growth in the insurance market.

As unemployment hits lower levels and per capita disposable income increases, the need for insurance expands with purchases of cars and homes. An increase in per capita income also allows individuals to broaden their coverage because they can afford higher premiums. Insurance rates could go higher in certain lines, which could support growth and profitability in the market. Improving economic conditions and asset prices could increase overall demand for insurance coverage.

MERGERS & ACQUISITIONS (M&A) ACTIVITY

In the insurance industry, the insurance broker segment continues to be the most active in M&A. Private equity is a significant catalyst for activity. In an extremely competitive environment and a constant search for yield, private equity firms are looking for predictable cash flows, high margins, and downside protection. Combined with readily available leverage, brokers present an outstanding option for private equity investors.

A growing number of private equity firms are involved in the brokerage market than ever before and many are implementing a roll-up strategy. This strategy involves investing in a business with a strong management team to grow both organically and through bolt-on acquisitions. Over time, it becomes a "multiple arbitrage" when a private equity firm acquires smaller agencies at a lower valuation and builds a franchise valued using a higher multiple. The exit strategy is often a sale to yet another private equity investor that would try to do the same at a larger scale, before it trades again or makes an initial public offering.

Certain pension funds have also entered the space in recent years. With a longer investment horizon and a lower cost of capital, investing in insurance brokers is almost a natural choice. The pension funds are investing directly in brokers or indirectly through private equity investments.

Technology is anticipated to be a major driver in the future of insurance brokerage.

Strategic buyers are trading at historically high multiples and therefore can afford to pay a premium for agencies. Combined with cost synergies and low debt financing rates, those large brokers are still very much at the forefront of M&A activity.

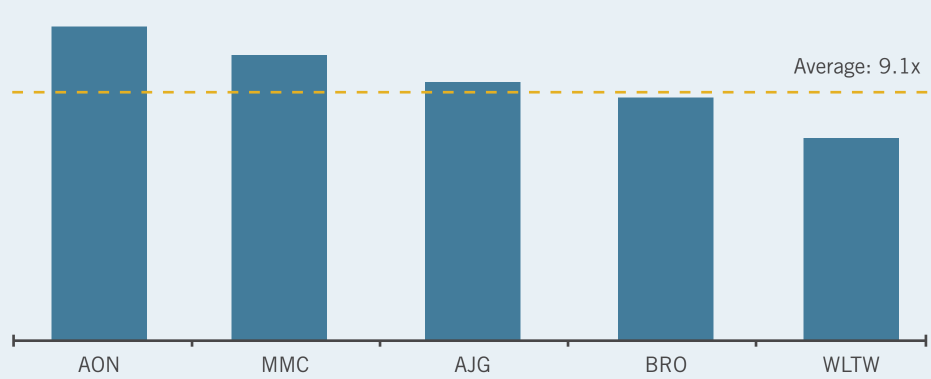
INDUSTRY TRENDS

Technology is anticipated to be a major driver in the future of insurance brokerage. It is already deeply entrenched in the securities industry and is slowly gaining momentum in the insurance space. While initially focused on personal lines and small commercial, it is quite possible that technology will penetrate more complex parts of large commercial and specialty lines within a few years. These competitive pressures come mainly from direct insurers and online brokerage businesses, pushing down overall profit margins. Insurers are attempting to reduce reliance on brokers and agencies by selling products directly to customers. Online brokerage businesses also continue to reduce costs and capture new customers. To combat these headwinds, brokers are forced to provide insurance advisory expertise as the only differentiator and are more focused on quality hires than ever before.

VALUATION

EBITDA multiples continue to be the leading valuation metric for insurance brokers and agents. Multiples reflect the level of risk associated with a company, as well as growth prospects. Pro-forma EBITDA multiples (adjusted EBITDA for expected growth) are typically used for M&A.

Average Industry Group Forward EV-to-EBITDA Multiples Based on NTM as of December 31, 2015



Source: SNL Financial

It will be necessary to offer a competitive compensation plan and make up for the difference in structure with other perks and benefits, as well as consider earn-out or new business bonus structures to keep new employees motivated.

Current valuation levels are at historical highs and are less correlated to the stock market than in the past. Multiples expansion over the past couple of years was mainly driven by positive business sentiment and convenient accessibility to inexpensive debt financing to fund acquisitions.

Growth trajectory is a major valuation driver in cyclical industries, especially the agency and broker insurance industry. Organic growth is a desired attribute for acquirers and often would imply a higher multiple. Growth through acquisition is another critical measure for value. It relies on the brokers' ability to acquire agents, along with their books of business, at much lower multiples, hence creating a "multiple arbitrage." Most, if not all, consolidators are creating value this way. Acquiring a small agency for 6x while trading at 11x makes great sense from a financial perspective—the real challenge is "hunting" for those agencies and agents in this uber-competitive environment.

Another commonly used valuation methodology is the discounted cash flow (DCF) method, which forecasts company cash flows and discounts those earnings based on a minimum required return rate expected to yield a present value. Furthermore, there are three ways to address cyclicality in a DCF valuation: (i) select appropriate growth rates for the forecast; (ii) normalize earnings and cash flows in the forecast year; and (iii) focus on more stable earnings streams.

M&A TRANSACTION CONSIDERATIONS

In a roll-up strategy, value destruction comes from not retaining key agency producers, especially when the target's compensation plan is richer than the acquirers'. It will be necessary to offer a competitive compensation plan and make up for the difference in structure with other perks and benefits, as well as consider earn-out or new business bonus structures to keep new employees motivated.

Additionally, understanding the historic nature of sign-on bonuses for new producers and retention payments to existing brokers will help determine the one-time versus on-going costs of the business. A larger concern would be identifying any potential people issues regarding attracting talent to the platform or retaining current producers.

As brokerages continue to build out technology enhancements, another key transaction consideration will be around capitalized versus expensed development costs and their impact on earnings. Understanding these costs will help the buyer grasp one-time implementation and ongoing development and maintenance expenditures. This area will be an important factor in deriving deal value from EBITDA if certain expenses are improperly deferred.

As the insurance industry continues to face challenges produced by low interest rates and intense competition, organic growth is expected to remain the main focus.

BOTTOM LINE

The insurance brokers industry could be at a peak. With consolidators and financial sponsors competing for more business, the question is: Could valuation levels ever go down? The answer is: Probably, but it's pretty hard to predict when and why. As the insurance industry continues to face challenges produced by low interest rates and intense competition, organic growth is expected to remain the main focus. Improving macroeconomic conditions and technological efficiencies could become a catalyst for maintaining high valuation levels for the foreseeable future.

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ABOUT HOULIHAN LOKEY

Houlihan Lokey (NYSE: HLI) is a global investment bank with expertise in mergers and acquisitions, capital markets, valuation, financial restructuring, and strategic consulting. The firm serves corporations, institutions, and governments worldwide with offices in the United States, Europe, and the Asia-Pacific region. Independent advice and intellectual rigor are hallmarks of our commitment to client success across our advisory services. Houlihan Lokey is ranked as the No. 1 M&A advisor for all U.S. transactions, the No. 1 global M&A fairness opinion advisor over the past 15 years, and the No. 1 global restructuring advisor, according to Thomson Reuters.