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Managing General Agency Market and M&A Trends

Historical Perspective and Recent Trends

Not unlike the fluctuations of the pricing cycle inherent in the property & casualty ("P&C") insurance industry, insurance carriers' view of the managing general agency sector ("MGAs") has oscillated significantly over the years. Toward the tail end of the previous extended soft market in the P&C industry, the prevailing view was negative as rogue MGAs like Unicover Managers, LLC dominated headlines as the millions of dollars of underpriced business it produced ultimately led to billions of dollars of losses, several lawsuits and even insurance company insolvencies. While MGAs like Unicover that underwrote business with little regard for profitability were more the exception than the rule, this well-publicized debacle caused many insurance carriers to scrutinize and pare back their exposure to MGAs. Over the past 10 years, however, insurance carriers have focused on correcting many of the issues inherent in a carrier-MGA relationship. Today, it seems as if the P&C insurance industry's view is positive, as insurance carriers are clamoring to form new underwriting relationships with and/or acquire MGAs.

Amidst the extended soft market period in the P&C industry in the 1990s, insurance carriers hungry for premium growth often contracted with MGAs to produce specialty insurance premium. In some cases, MGA-insurance carrier agreements were structured with misaligned incentives. MGAs were compensated based on the amount of premiums produced, with little or no motivation to produce profitable business for the insurance carrier. In addition, some insurance carriers even gave full underwriting authority to the MGAs, known in the industry as "giving away the pen." This broad discretion to underwrite a range of lines or classes of business often led to substantial underwriting losses for the insurance carrier.

Fast forward to the present day soft market pricing conditions, and it seems as if insurance carriers have learned from their past mistakes. Today, agreements with MGAs typically contain a profitability component (usually in the form of multi-year contingent commission or swing-rated commission structures) and premium caps to prevent unfettered underwriting of business. In addition, insurance carriers often restrict MGA writings by class of business or by providing certain underwriting criteria that they would like their MGA partners to abide by, known as the underwriting "box." In short, while insurance carriers still put significant trust in MGAs, they also exert more control than they have historically over the relationships.

Recent M&A Activity Drivers and Near-Term Outlook

Control over the MGA relationship, however, only extends through a defined contract period. The MGA still ultimately controls the premium it produces, and it can move

the book of business to another insurance carrier upon termination or expiration of the contract. This is one reason why insurance carriers have increasingly been acquiring MGAs, as a defensive maneuver in today's soft market in order to seize control of the premium. Other key M&A activity drivers include heightened private equity interest in insurance distribution businesses, increasing operational challenges in today's market and generational transfer issues facing MGA owners.

Since the end of the last hard market in the 2005, P&C insurance carriers, especially publicly-traded companies, have found it more difficult to grow their top lines organically and have thus turned to acquisitions to provide premium growth. While some insurance carriers have acquired other insurance carriers, MGA acquisitions are usually cheaper, faster and easier. The value of an MGA is typically not tied to the size of its balance sheet, but instead based on the free cash flow it produces (i.e., EBITDA) or the profitability of the book of business it underwrites. This is in stark contrast to capital-intensive insurance carriers that must meet regulatory and rating agency capital adequacy requirements and are typically traded as a multiple of book value or surplus. Not having to pay for surplus makes acquiring an MGA much cheaper, on a dollar per premium basis, than an insurance carrier. For example, an MGA that underwrites $50 million of premium, produces $7.5 million of revenue and earns $1.5 million of EBITDA may trade for $7.5 – $10.5 million, or 5 – 7x EBITDA. An insurance carrier that underwrites $50 million of premium will likely have at least $25 million of surplus and likely be valued in excess of $25 million, depending on the profitability of its book of business. In addition to being cheaper on a dollar per premium basis, MGAs are not as heavily regulated by state insurance departments, and thus do not require Form A approval when they are sold. Finally, MGAs are usually easier to due diligence because there are typically no balance sheet issues that can plague an insurance carrier such as low-quality investment portfolios or inadequate loss & LAE reserves.

The entrance of several private equity firms into the insurance distribution space over the last five years has also helped to drive MGA M&A activity. A significant amount of the activity stems from private equity firms that were able to acquire wholesalers from large retail agencies who were forced to divest them by Eliot Spitzer in 2005. One the largest wholesale brokers in the U.S., AmWINS Group, Inc., has acquired three MGAs since being acquired by Parthenon Capital, LLC in September 2005. Other high-profile private equity backed insurance distribution businesses that have been active M&A participants include J.C. Flowers & Associates' Crump Group, Inc. and HM Capital's Swett & Crawford, Inc. (which has subsequently been acquired by Cooper Gay in July 2010).

The third significant trend that is driving M&A activity in the space is the current challenging operating environment. Although an MGA does not typically assume balance sheet risk, its commission revenue is usually structured as a percentage of the premiums underwritten, so soft market conditions depress both MGA revenue and insurance carrier revenue. Margins can also be negatively impacted by a fall in contingent commission revenue, which tends to drop straight to the bottom line. Shrinking top lines and contingent commission income declines lead to margin pressure and potentially difficult decisions regarding expense reductions. Operating leverage for MGAs is often high, so a 10% decline in commission revenue can severely impact EBITDA margins, especially if MGAs want to retain their underwriters in anticipation of a future turn in the P&C pricing cycle. Rather than cutting expenses or waiting until the next hard market to grow their way back to profitability, many owners are choosing to explore the M&A route.

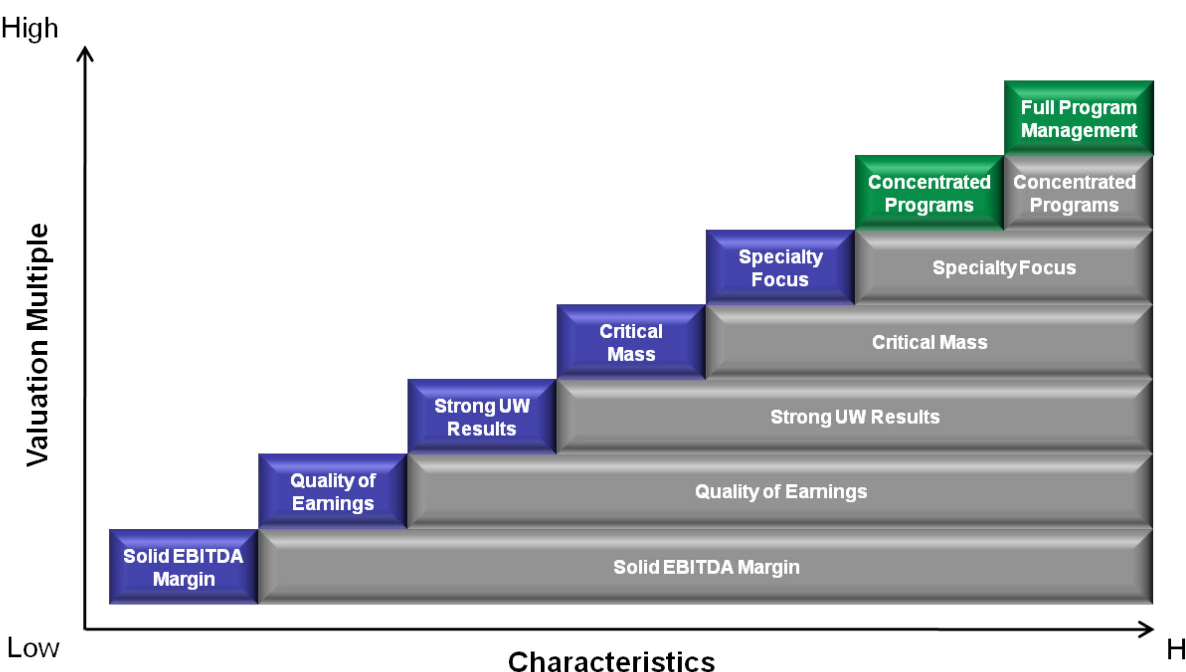
Finally, estate and tax planning by MGA founders continues to be a significant M&A activity driver as well. Many MGAs were started by entrepreneurs who became dissatisfied after working at insurance carriers at the beginning of their careers and founded their MGAs 25 – 30 years ago. While some have successfully transitioned ownership to their children or trusted managers, many have children/managers with no interest in or who are

incapable of running the MGA going forward. These individuals are selling in order to diversify their financial holdings as they reach retirement age and to avoid paying higher capital gains and income taxes in 2011, as capital gains tax rates are set to increase by 5% at the end of 2010 and the top end of ordinary income tax rates will increase from 35% to 39.6%.

Despite these burgeoning trends, MGA M&A activity actually dropped in 2009 as debt financing markets contracted and insurance carriers focused on internal balance sheet issues. With that said, we do expect a rebound for MGA M&A activity in 2010 and into 2011. Soft market conditions continue to prevail in the insurance industry, and insurance carriers continue to look for growth alternatives. Financing markets have started to rebound, and the marketplace is seeing the comeback of staple financings, PIK toggles and covenant-light debt agreements. Additionally, debt leverage multiples have started to creep up, with financing levels reaching 5.0x+ EBITDA leverage multiples for large transactions.

Key Valuation Drivers for MGAs

The most common question that we are asked as investment bankers is "what is it worth?" The answer is, "it depends." As a general guide, MGAs have historically traded in the 4 – 6x EBITDA range, but certain MGAs have been sold in the 7 – 9x EBITDA range. Every transaction has its idiosyncrasies, but based on our experience, MGAs that command higher valuation multiples possess many or all of the following characteristics:



- **Solid Operating EBITDA Margins** – While strong contingent commission income is a positive because it means past underwriting results have been profitable, it is also difficult for an acquirer to put a full valuation multiple on income that is subject to change based on underwriting results. EBITDA generated from base commission revenue indicates that the MGA is profitable and able to withstand potential variability in underwriting results.

- **Quality of Earnings** – While as a private company it is inevitable that there will be some combination of owner-related expenses running through the G&A expenses of an MGA, it is much easier to evaluate an MGA that has a limited number of addbacks to EBITDA.

- **Consistently Profitable Underwriting Results** – MGAs that are able to produce consistently profitable underwriting results in all market cycles will get the attention of carriers, who often assume most of the premium underwritten by an MGA after an acquisition. An MGA with large loss ratio swings and excessive policy limit losses will see its valuation multiple adversely affected.

- **Critical Mass** – As with many transactions, the larger MGA the larger the valuation multiple. Unless an MGA is underwriting at least $15 to $20 million of premium, it may be difficult to get the attention of potential acquirers that have the ability to pay as they may decide their efforts are better focused on building programs organically.

- **Specialty Niche Focus** – Generally MGAs that write specialty classes or lines of business are more sought-after and highly-valued as specialized underwriting expertise is scarce. More recently, we have been hearing that MGAs writing public entity business and healthcare classes are being increasingly targeted due to the increasing role of government in the U.S. economy.

- **Concentrated Programs** – An MGA that specializes in two or three $10 – 15 million programs is generally a more attractive target than one that writes 10 – 15 $2 – 3 million programs.

- **Full Program Management Capabilities** – A turnkey operation that is essentially an insurance company without a balance sheet is highly valued by an acquirer. These operations typically have full underwriting and claims staffs and write specialized lines or classes of business.

While there are other factors that come into play, such as strong management or capable technology, we believe that these seven criteria listed above are often the key determinants of valuation in an MGA M&A transaction. Sometimes sellers can have unrealistic value expectations based on a historical valuation multiple that a large, profitable, niche-focused MGA received in an M&A trade. In these situations, it is critical to examine these criteria to determine why a high multiple was paid.

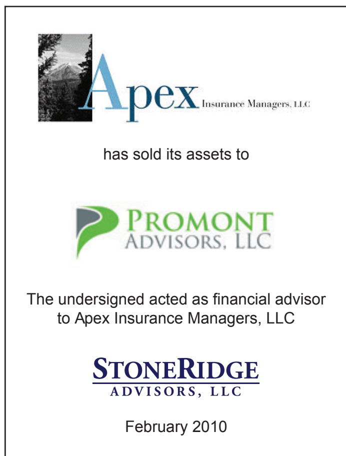
As we look at the landscape of MGAs today, there are only a few independent MGAs that possess many or all of these criteria. Given the scarcity of attractive properties, we would expect that valuation multiples for this limited universe to increase as potential buyers bid up the value of these businesses. Valuation multiples for the majority of MGAs should remain near long-term historical levels of 4x – 6x EBITDA. The number of MGA M&A transactions in 2010 should significantly surpass the number of M&A transactions in 2009, as a backlog of sellers from 2009 and the 2010 sellers enter an improving M&A market.

Recent Transaction Description – Promont Advisor's acquisition of Apex Insurance Managers

StoneRidge Advisors represented Apex Insurance Managers, LLC, a program manager focused on underwriting hospitality and habitation classes of business, in the sale of its assets to Promont Advisors, LLC, an MGA formed by two former members of Apex's senior management team. Going forward, Promont will underwrite on behalf of First Mercury Financial Corporation (NYSE: FMR).

StoneRidge Advisors' Insurance Distribution Expertise

StoneRidge Advisors has been an actively involved with the insurance distribution space since its formation in 2006. StoneRidge Advisors' recent transactions include:



has acquired

Deep South Holdings, L.P.

The undersigned provided a fairness opinion to North American Insurance Leaders, Inc. in conjunction with the acquisition

STONERIDGE ADVISORS, LLC

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About StoneRidge Advisors

StoneRidge Advisors is an investment banking firm that specializes in the insurance industry. Our clients include property, casualty, life and health insurance companies, reinsurance companies, as well as insurance brokerage, managing general agency, claims management and other related service companies. Our firm combines extensive experience and best practices to help our clients achieve their strategic goals and financial objectives.

Services

StoneRidge Advisors provides services related to all aspects of an M&A transaction, including identification, valuation, negotiation, structuring and financing. In addition, we assist companies in developing and executing upon capital raising initiatives.

Mergers & Acquisitions

- Buy-Side Advisory
- Sell-Side Advisory

Capital Raising

Financial Advisory

- Business Valuations
- Fairness Opinions
- Consulting Services

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