

The Real Deal?

The hype—and truth—about valuation multiples

Some principals of insurance firms are boasting of sale prices with record-high multiples. But a closer examination reveals that the numbers may not be all they're claimed to be.

Here's a multiple-choice test that lives up to its name: it's a choice of multiples.

The sale price of an insurance firm is based on a multiple of:

- A. 1.5 times revenues
- B. 3 times revenues
- C. 7 times EBITDA*
- D. 5.5 times EBITDA*
- E. Depends on whom you ask.

If you picked "E," you get an "A." The "hard" market, nontraditional buyers, and rising expectations have clouded the once-clear view of valuation multiples. Toss in a large dose of human nature—the tendency to brag about a terrific deal—and you have a formula for confusion and error.

Is there a better answer? We think so. In our 15 years in business, we've consulted on more than 50 sales and acquisitions and observed hundreds more. Here's how we survey the current valuation landscape.

Does the Hard Market Matter?

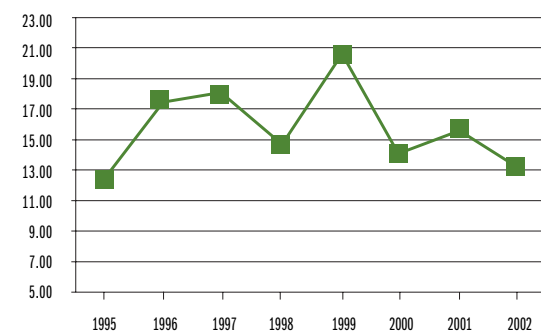
Conventional wisdom used to dictate that the value of a privately held insurance intermediary was about one and a half times revenues or five and a half to six and a half times EBITDA. But now that the insurance industry is in a hard market—the cost of the goods you sell is going up, and so are your revenues and profits—does it follow that valuation multiples should rise correspondingly? Are the same privately held firms selling today for

two, two and a half, or even three times revenue? Are buyers paying seven, eight, or even nine times a seller's pro forma level of EBITDA?

The publicly available data says no. In fact, the hard-market rationale is a red herring. Here's why.

First, in early 2001, valuations of public insurance brokers hit an all-time high. Even in the worst of times, public brokers trade at higher multiples than private firms because they have more capital and a liquid market for their stock. But the 2001 bubble convinced many owners of private firms that the change was permanent (echoes of those "Dow Jones will hit 35,000" predictions) and that the hard market was increasing multiples across the board. Since then, public-broker multiples have come down to their historic norms of eleven to twelve times EBITDA – a 30 percent drop in less than a year even in an ongoing hard market.

Historical EBITDA Multiples for Public Brokers



* Earnings Before Interest, Taxes, Depreciation, and Amortization. Most buyers use EBITDA as a basis for calculating the expected earnings that a service business such as an insurance agency can be expected to sustain.

Second, the hard market made owners believe they could easily grow their businesses—and raise their multiples—simply by renewing the insurance coverages they sold to their existing clients. Sure enough, this raised revenues, earnings, and total prices. But the hard market is part of a cycle, and while valuations tend to fluctuate, the relationship between valuation and sales price—which is all that a multiple is—is conservative by nature. It simply doesn't want to change.

New Players, Big Boasts

The market has also been affected by the entry of new buyers, namely banks, which began acquiring insurance agencies in the late 1990s. The buzzword was “synergy”: Many bankers believed an acquired brokerage would grow faster because it could cross-sell to the bank's clients. Accordingly, some paid premium prices for acquisitions. And some of those deals got burnished after the fact, when locker-room chatter and poor Wall Street analysis inflated the multiples to match the egos of the sellers.

But the long-range impact of these new buyers on valuation multiples appears to be minimal. For one thing, the pace of banks' agency acquisitions has slowed considerably from its peak two years ago. For another, not all banks used inflated multiples to set their purchase prices; as the data for publicly disclosed deals make clear, many were, in fact, conservative. And many of the banks that did overpay—based on wished-for synergies—have been punished with post-deal declines in their valuations.

Finally, while some banks are buying agencies, others are selling them. The signals, then, are mixed at best—and not a strong influence on valuation multiples.

What Really Matters: The Deal Structure

If the hard market and new entrants aren't causing “multiple inflation,” what is? And why, when both buyer and seller know and presumably understand the exact terms of the deal, do they have such differing views of valuation multiples?

We believe the confusion arises from structured transactions, which have been common for about two decades. In these transactions, the buyer pays part of the purchase price now and the remainder in the future. Usually, the future payments are contingent on the future performance of the company being acquired.

When they compare purchase price to revenues and pro-forma EBITDA, most sellers with a structured deal ignore the fact that the payout depends on much higher revenues and EBITDA than the seller delivered at the time of the sale. Instead of looking ahead, the seller will add all current and all contingent payments and compare the result to revenues and EBITDA delivered at the time of the sale.

The buyer, however, is well aware that he will not pay future installments of the purchase price if the seller fails to grow revenues and EBITDA to negotiated levels that in many deals are significantly higher than historic levels.

The bottom line: both parties compute the same total purchase price. But when the sale is contingent, sellers tend to divide the price by a much lower level of revenues and earnings than the buyers do.

How This Works: A Real-Life Example

Let's look at an example in which the selling agency generated \$10 million in annual revenues and \$2.5 million in pro-forma EBITDA*. Here's how the deal broke out:

Cash paid by to the seller at close	\$9.0 million
Equity (ownership) in buyer given to the seller	\$2.5 million
Note payable from buyer to seller	\$3.5 million
Contingent payment (if EBITDA grows 15% per year for 3 years)	\$4.5 million
Total purchase price	\$19.5 million

To the seller, this was a \$19.5 million deal. When he compared the bottom line to revenues and EBITDA delivered at the time of sale, he concluded that he received 1.95 times revenues (\$19.5 million purchase price divided by \$10 million in revenues) and 7.8 times EBITDA (\$19.5 million purchase price divided by \$2.5 million in EBITDA).

What the seller ignored was the fact that the \$4.5 million contingent payment is just that: contingent. In effect, it's a promissory note payable only if the seller grows EBITDA by 15 percent each year for three years after the transaction closes. If the seller succeeds, his firm will generate more than \$15.2 million in revenues and \$3.8 million in EBITDA at the end of the third year. If he doesn't, the buyer will pay only \$15 million.

As a result, the buyer computed two sets of valuation multiples. The first set was based on the noncontingent portion of purchase price and the level of revenues and

* Pro Forma is EBITDA is typically defined as the sum of the intermediary's actual EBITDA (see previous footnote) plus all discretionary expenses related to the owners (such as excess bonuses and excess perks) less any non recurring revenues.

EBITDA delivered by the seller at the date of closing. Using that formula, the buyer reasoned thus: one and a half times revenues (\$15 million divided by \$10 million) and six times EBITDA (\$15 million divided by \$2.5 million).

Then, factoring in the contingent portion of the sale, the buyer computed the end game multiples by dividing the total purchase price, \$19.5 million, by the target revenues and EBITDA. This calculation yielded a revenue multiple of 1.28 and an EBITDA multiple of 5.13.

What Terms of Publicly Announced Deals Tell Us

It isn't easy to get beyond the hype to the real numbers and valuation multiples, and the reason is simple: transactions involving privately held companies are done in strict confidence. Knowing that comparable values aren't readily available, some advisors pick examples from their own deals to present a valuation metric that pleases their client. When the client is a seller, the valuations will look impressively high. When it's a buyer, they seem like a bargain. Then the advisors say, "Trust us."

We aren't satisfied with this approach. So we searched the market to uncover deals in which terms were publicly disclosed. We found six deals in which, for regulatory reasons, the buyers had to publicly disclose the specific transaction terms (and in many cases the actual purchase documents themselves).

On an aggregate basis, these six deals produced more than \$365 million in insurance commissions (not premiums—commissions) and transaction values in excess of \$575 million. The average firm produced more than \$60 million in annual commissions. The six deals represent a very large portion of the total deal volume over the past two years.

Although the numbers are much larger than the average transaction among insurance intermediaries, they still involve primarily retail insurance brokerage operations. The deals were all completed during the hard market, and they represented a broad range of buyers, from established large public brokers to new entrants such as regional banks. We think they're a good representation of the market as a whole.

We divided the six transactions into two groups: those in which part of the purchase price was dependent upon future performance ("structured" deals) and those that involved no contingent purchase price ("nonstructured" deals). As the data

show, for structured deals, 25 percent to 43 percent of the total purchase price was subject to the future performance of the seller post acquisition.

The three structured deals:

Greater Bay Bancorp's (GBBK) acquisition of Alburger Basso deGrosz Insurance Services, Inc. ("ABD") – a \$100 million full-service broker in California. GBBK viewed this as a strategic transaction aimed at acquiring a firm capable of aggressively growing GBBK's insurance line of business. Opportunities for strategic acquisition are limited and often result in the buyer paying a premium (in fact, only 16 brokers produced more than \$100 million in revenues in 2002). Both buyer and seller knew this, and it enhanced the seller's value. Were those expectations fulfilled? The verdict is still out but the 2003 GBBK annual report reveals that hoped-for high rates of growth have yet to materialize.

BNCCORP's acquisition of Milne Scali & Company, one of the largest employee benefit brokerage operations in Phoenix. The North Dakota bank asserted that the acquisition would allow it to rapidly grow its insurance business while enabling it to establish banking operations in Phoenix. (Some observers thought it was a strategic acquisition to allow senior management to winter in a place slightly warmer than North Dakota, but we never saw a press release to this effect.)

Hilb, Rogal & Hamilton's (HRH) acquisition of Hobbs Group, LLC, a multiple regional insurance broker that focuses on large accounts. According to many industry experts, this deal was intended to enhance HRH's large account capabilities and its current base of business throughout the Hobbs' footprint.

The three nonstructured transactions, in which future performance was not a factor in the price:

Summit Bancorp's (now Fleet) acquisition of Meeker Sharkey Financial Group (MSFG), a \$22 million revenue full-service broker in New Jersey.

Hub International Limited acquisition of Kaye Group, Inc., a publicly traded insurance broker. We'd expect the acquisition of a public company to require a premium over the multiple of current share price. In addition, Kaye was one of the first two primary acquisitions by Hub International

[Chart 2] Valuation Multiples for Non-Contingent Portion of Purchase Price

Seller	Date of Acquisition	Non Contingent Purchase Price	Revenues at Purchase Date	Adjusted EBITDA at Purchase Date	Price to Revenues at Purchase Date	Price to EBITDA at Purchase Date
ABD	12/18/2001	\$130,000,000	\$100,000,000	\$18,219,804	1.30	7.14
Milne & Company Insurance, Inc.	3/22/2002	23,388,839	10,089,300	2,906,242	2.32	8.05
Hobbs Group LLC	7/1/2002	175,802,994	98,139,950	24,494,011	1.79	7.18
MSFG, Inc.	2/29/2000	27,440,048	22,170,289	4,649,703	1.24	5.90
Kaye Group, Inc.	1/19/2001	130,102,040	77,594,000	15,894,000	1.68	8.19
Riedman Corporation	1/1/2002	92,087,000	57,155,000	9,026,000	1.61	10.20
Total /Weighted Averages		\$578,820,921	\$365,148,539	\$75,189,760	1.59	7.70
Average For Structured Deals		\$329,191,833	\$208,229,250	\$45,620,057	1.58	7.22

in pursuit of its strategy to build its U.S. brokerage operation, making the acquisition of Kaye strategic rather than purely financial.

Brown & Brown's acquisition of the agency business—related assets of Riedman Corporation. This Riedman subsidiary had very low EBITDA margins (less than 16 percent, compared to an average EBITDA multiple closer to 20 percent for similar operations and the 26 percent or greater margins enjoyed by Brown & Brown). The buyer would certainly have expected to restructure the operations and realize substantial bottom-line growth after the deal closed. This created significant short-term valuation arbitrage opportunity, a fact both buyer and seller knew. The seller wanted to receive credit, arguing for a higher valuation multiple based on actual results or a higher pro-forma level of EBITDA on which more normal valuation multiples are applied. The buyer wanted to keep to itself any value gain from post-close restructuring efforts. Usually, this situation results in the parties splitting the expected valuation gains arising from the cost savings.

What Did These Buyers Really Pay?

Do the facts support buyers' "bargain-basement" boasts or sellers' "record-high" claims? To decide, we compared apples to apples: the noncontingent portion of each purchase price to the levels of revenues and EBITDA delivered by the seller at the time of close.

Chart 2 reveals the results: an average multiple of 1.6 times revenue and a range between 1.24 and 2.32—well within the ranges cited by most buyers.

However, these six deals produced an average EBITDA multiple of 7.7—higher than the range cited by most buyers (5.5 to 7.0). One transaction is responsible for the skew: Brown and Brown's acquisition of Riedman's insurance-agency assets. But remember: this was a very special case involving an insurance agency operation with EBITDA margins of only 16 percent. Look at the revenue multiple in this transaction and you get a number much closer to the "buyers' norm": 1.61. And if you adjust the Riedman results to the 26 percent operating margins realized by the buyer, the EBITDA multiple falls to 6.2—well within the normal range cited by most active buyers.

Without Riedman, the average noncontingent EBITDA multiple drops to 7.36—to 7.14 if you incorporate Riedman at the buyer-adjusted EBITDA level. The buyer most likely assumed that it could easily restructure the acquired operations, and both parties negotiated a transaction price that split some of that value arbitrage.

Does Contingent Purchase Price Increase Valuations?

The total amount paid to a seller is almost always greater in transactions in which the seller is willing to take part of the payment based on future performance. (See Chart 3.) This is only logical: The buyer wants to provide the employees—the agency's key assets—with a strong incentive to continue to aggressively grow revenues and earnings after the deal is completed.

In our examples the purchase price could be increased by 25 percent to 43 percent as long as the seller hit the predefined targets of revenues and/or EBITDA as set by the buyer in the purchase agreements. Assuming that three sellers met the

[Chart 3] Required Growth in EBITDA to Earn Contingent Purchase Price

Seller	Non Contingent Purchase Price	Present Value of Total Purchase Price	Estimated Revenues at End of Earnout	Estimated Annual EBITDA at End of Earnout	Required Annual Growth in EBITDA
ABD	\$130,000,000	\$195,129,129	\$179,111,111	\$40,300,000	15.7%
Milne & Company Insurance, Inc.	23,388,839	25,026,513	10,089,300	2,906,242	0.0%
Hobbs Group LLC	175,802,994	263,423,820	141,676,705	39,582,643	27.1%
MSFG, Inc.	27,440,048	27,440,048	22,170,289	4,649,703	0.0%
Kaye Group, Inc.	130,102,040	130,102,040	77,594,000	15,894,000	0.0%
Riedman Corporation	92,087,000	92,087,000	57,155,000	14,860,300	0.0%
Total /Weighted Averages	\$578,820,921	\$733,208,551	\$487,796,405	\$118,192,888	11.6%
Average For Structured Deals	\$329,191,833	\$483,579,462	\$330,877,116	\$82,788,885	14.3%

stated targets in the three structured transactions (transactions involving a contingent payment based on performance), the cumulative price for the three transactions would be increased on average by 38 percent.

Yet even with a 38 percent increase in the actual price paid, the value to revenues and EBITDA on these transactions decreased under a scenario in which the sellers met the targets. Why?

While aggregate purchase price for these three goes from about \$329 million to about \$484 million, aggregate required revenues grow from about \$208 million to an estimated \$331 million (a 59 percent increase) and required EBITDA grows from \$46 million to \$83 million (an 82 percent increase). Remember, an annual required growth rate of 15 percent translates to a 52 percent increase after three years, 75 percent after four years and 100 percent after five years over the starting figure.

The figures we need to look at, then, are those for the end of the earn-out period. When we do that, the average revenue multiple for both structured and nonstructured deals is 1.46 and the average EBITDA multiple is 5.84. For all six deals, the multiple of total purchase price (contingent and noncontingent) to ending period revenues equaled 1.5 and the EBITDA multiple was 6.20—well within the ranges cited by the buyers and close to historical valuation multiples.

We could even argue that these six deals involving very large firms should yield valuation multiples that are higher than multiples for smaller firms. Why? First, in the insurance intermediary market valuation premiums have always been

given to larger firms. Second, in the current hard market, during which at least five of the six transactions were completed, larger firms with greater clout have competitive advantages over smaller intermediaries that must resort to wholesalers—and in the process give up some of the revenues per account. Third, buyers often prefer to do fewer, larger transactions because they are easier to manage after the close.

But My Peers Say...

So why do sellers still claim deals priced at eight, nine, or even ten times EBITDA? Because they're comparing apples to oranges. When you hear a seller say he "got nine times EBITDA" or "three times revenues" for his firm, remember to ask him how much of the price is based on future performance and what those expectations are.

Even on the six public deals, if we compare the total price (including the contingent portion) to the revenues and EBITDA delivered at the close, we conclude that they went for 9.75 times EBITDA and an average of 2.01 times revenues. (See Chart 4)

Of course, on the three structured deals 38 percent of the deal price will not be paid if the sellers simply maintain the levels of revenue and EBITDA delivered at the time of sale. By comparing total price to starting revenues and EBITDA we incorrectly imply that historical levels of revenues and earnings will suffice. Without the substantial increase in revenues and EBITDA required to achieve the contingent payout, multiples drop back down to an average closer to seven.

[Chart 4] Valuation Multiples vs. Required Revenues and EBITDA

Seller	Price to Purchase Date Revenues	Price to Purchase Date EBITDA	Price to End of Earnout Revenues	Price to End of Earnout EBITDA
ABD	1.95	10.71	1.09	4.84
Milne & Company Insurance, Inc.	2.48	8.61	2.48	8.61
Hobbs Group LLC	2.68	10.75	1.86	6.66
MSFG, Inc.	1.24	5.90	1.24	5.90
Kaye Group, Inc.	1.68	8.19	1.68	8.19
Riedman Corporation	1.61	10.20	1.61	6.20
Total /Weighted Averages	2.01	9.75	1.50	6.20
Average For Structured Deals	2.32	7.25	1.46	5.84

What About the Hard Market?

Many sellers with lofty expectations may dismiss this analysis as not reflecting the impact of the hard market on valuation multiples. But recall: All of our six public deals were started and completed during a period when both sellers and buyers were aware of the hard market. If we rank the deals in order of the date announced, no clear trend in multiples emerges.

While some public brokers have experienced increases in their price-to-earnings, price-to-EBITDA and price-to-revenues multiples, not every broker has shared in the gain. And all have fallen considerably from the peaks seen in late 1999. (It would appear as if Wall Street thinks that the hard market party for the brokers may be less beneficial than originally thought or, worse yet, ending before many people expected.)

The hard-market cycle isn't the only reason experienced buyers are conservative about multiples. It's based on corporate-finance principles, and it goes like this: Both public and private firms that buy other firms must price transactions at levels that provide them with returns that match or exceed their own internal requirements for return on their equity. Thus, the amount of equity—the piece of the purchase price not funded by debt—that a buyer must employ to acquire an operation has to produce annual rates of return in excess of 25 percent and closer to 30 percent for public brokers to sustain their current valuation multiples.

Furthermore, buyers expect that the current value of earnings—in the form of future cash flows or an eventual sale of the acquired property—must exceed the present value of consideration given to the seller. (In finance terms this means

the net present value—present value of returns less present value of costs—is positive.)

A Closer Look at Deal Structure

To show that noncontingent purchase prices, measured as multiples of closing EBITDA, result in negative returns to both public and private buyers, we performed an analysis of the returns accruing to a buyer for an acquisition producing \$2.5 million in EBITDA, growing by 5 percent each year and under an acquisition structure of 50 percent paid in the form of cash at close and the remainder in a five-year note paying 8 percent interest. The analysis assumed that the public buyer could sell the acquisition at the end of five years at the public multiple of EBITDA of 11.0, and the private buyer could sell the acquired firm at the end of five years at a multiple of 7.5. Furthermore, we assumed that both discounted the projected cash flows and eventual after-tax sale proceeds by 15 percent, a rate used by many buyers in their own analysis.

These returns, shown in Chart 5, show that for private buyers, who can realize a future exit at a maximum of 7.5 times EBITDA, the net present value approaches zero at an up-front purchase price of 7.5 times EBITDA delivered at the time of sale. This is why private buyers cannot afford to pay higher prices than this and prefer to pay a multiple of less than seven. Would you incur the headache and risk of an acquisition if you expected just to break even?

The same table shows that public buyers appear to have an advantage in acquisitions. This is true if the only measure that a public buyer must meet is the expected net present value accruing from the deal. Indeed, with its higher theoretical exit multiple, public buyers realize break-even net present values

[Chart 5] Buyer Returns vs. Price Paid to Purchase Date EBITDA

EBITDA Multiple Paid to Seller	Private Buyer	NPV	IRR	Public Buyer	NPV	IRR
6.0		3,005	22.9%		6,891	30.8%
6.5		2,041	20.1%		5,928	27.9%
7.0		1,078	17.5%		4,965	25.2%
7.5		115	15.3%		4,001	22.9%
8.0		(849)	13.2%		3,038	20.7%
8.5		(1,812)	11.3%		2,075	18.7%
9.0		(2,775)	9.6%		1,111	16.9%
9.5		(3,738)	8.0%		148	15.2%
10.0		(4,702)	6.5%		(815)	13.7%

only when the total purchase price paid approaches ten times up-front EBITDA. However, to realize an EBITDA valuation multiple of 11, the market expects these public brokers to provide returns on equity in excess of 25 percent per year. As shown by our analysis, the returns accruing from the deal, even for a public broker, drop below this level once the deal price exceeds seven times up-front EBITDA. Of course, both parties could afford to pay more if post-close EBITDA grows by more than five percent. Conversely, neither could afford to pay more than six times EBITDA if EBITDA fails to grow. This is why experienced and knowledgeable buyers will insist on structured deals or, when a noncontingent purchase is required, will price the deals closer to six times expected EBITDA.

This does not mean that we never see deals priced at unusually high levels—we do, from time to time. But to price a deal above these levels generates positive results to the buyer only if post-close EBITDA grows at double-digit rates. If a buyer offers you a high price and does not require such levels of growth in EBITDA, make sure you are paid in cash and not in the form of the buyer's equity; this equity will most likely decline in value, especially if the buyer continues to pay high prices to other sellers. From our experience, we know that when a buyer pays an inflated price and the seller fails to continue to grow EBITDA at double-digit rates, the marriage begins to fail, and very often the selling principals find themselves jobless.

A Dose of Reality

This analysis shows that valuation multiples for privately held brokers have continued to approach industry norms of five and a half to seven times EBITDA. Anecdotal “evidence” about

deals suddenly trading at ever-higher multiples is a result of comparing apples to oranges—not a fundamental change in the value of brokers. It also reflects the tendency of some merger-and-acquisition experts to tailor their definition of “industry norms” to suit the interests of a given audience. Our clients have told us that one respected expert even contradicted himself about valuation multiples during a single meeting! When discussing the opportunities presented by a sale, he argued for a high multiple; when supporting the firm's most recent ESOP valuation, he defended a lower multiple.

Not only has the hard market failed to increase multiples, it has had a negative effect on brokers and on prospects for growth and value. The hard market has already resulted in numerous reductions in commissions splits and has forced many smaller firms to use wholesale distributors. In the process, they've had to give up more commissions than can be offset by increased premiums.

When the soft market returns, and it will, it's unlikely that carriers will increase commission splits or improve profit-sharing agreements to pre-hard market levels. Wall Street is taking note and has brought public broker valuations back in line with their long-term trends. Buyers have taken note as well.

As a result, agency principals should base their choice of whether and when to sell or acquire not on hopes or fears about the next market cycle but rather on more substantive strategic issues. We often recommend that prospective buyers and sellers ask themselves whether a transaction will further the strategic interests of their firms. Only if the answer is “yes” should they begin to determine price and structure. Without a sound strategic rationale and good fit between the parties, even carefully structured deals can fail. ■

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