Mergers & Acquisitions in the Program Industry Segment: "Positioning Your Firm for Success"

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Target Markets

October 22, 2014

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Format

- Open format … Q&A throughout

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Services:

- Mergers & Acquisitions Advisory Services
- Due Diligence
- Valuation Support Services
- Strategic Consulting
- Perpetuation Planning
- Capital Raises
- Expert Witness

Locations:

- New York, NY
- London, UK
- Charlotte, NC
- Denver, CO

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Mystic Capital Advisors Group, LLC

- Founded in October 2001 by three former employees of The Hartford Financial Services Group, Inc.
- Firm professionals have prior experience at **Big 4** accounting firms, large investment banks, and insurance brokers (KPMG, Deloitte, Ernst & Young, PricewaterhouseCoopers, Merrill Lynch, and Benfield Group), and
- Professional designations of employees include Certified Public Accountant (**CPA**), Chartered Property Casualty Underwriter (**CPCU**), Certified Insurance Counselor (**CIC**), Certified Valuation Analyst (**CVA**), and Chartered Financial Analyst (**CFA**)
- Wholly owned subsidiary Mystic Capital Markets Group, LLC is a licensed broker dealer and a member FINRA/SIPC

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Clients include:

- Insurance Agents & Brokers,
- Insurance Wholesale Brokers,
- Insurance Companies,
- Program Administrators,
- Managing General Agents (MGA's),
- Managing General Underwriters (MGU's),
- Lloyds and London Brokers
- Third Party Administrators (TPA's),
- Insurance Technology Firms,
- Financial Institutions, and
- Private Equity Groups

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Agenda

- Part I: State of the Marketplace
- Part II: Factors Affecting Values of Program Administrators
- Part III: Deal Structure & Tax Implications
- Part IV: Positioning your firm for Acquisitions

Agenda

- **Part I: State of the Marketplace**
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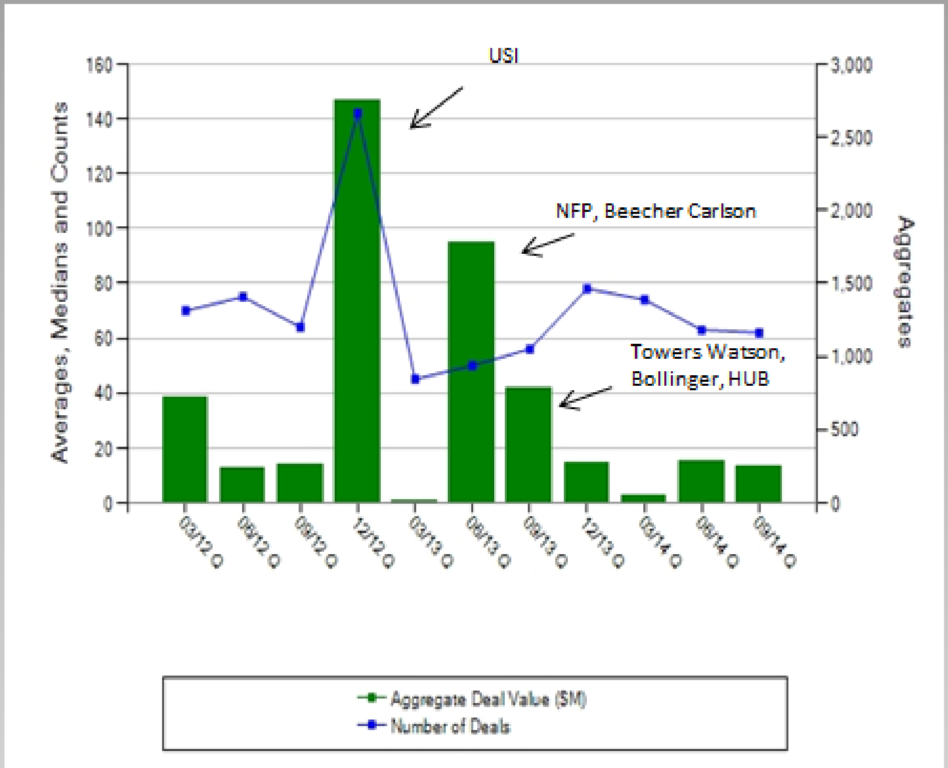
Recent History

- A Large number of transactions were completed in 4th Quarter 2012, driven by change in capital gains
- 1st Quarter 2013 was slow due to front loading of transactions in 4th Quarter 2012
- Number of deals steadily increased throughout 2013 and has remained steady through 2014

U.S. Insurance Brokerage M&A

Source: SNL Financial



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Recent Larger Transactions

- Large transactions are going for large multiples, often over 10x
  - Private equity firms buy USI, HUB, NFP and others
  - Brown and Brown acquires Arrowhead, Beecher Carlson, and Wright Risk
  - Ryan Specialty acquires Westrope and WKFC
  - BB&T/CRC acquires Crump
  - Markel acquires Thomco
- High multiples for larger deals has trickled down to smaller deals
  - Historically 5x to 7x EBITDA has increased to 6x to 8x EBITDA
  - Buyers need to work harder to distinguish themselves

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Types of Acquirers

- Publicly traded brokers
  - Low organic growth make acquisition critical
- Private equity-backed brokers and roll-ups
  - Cheap and easily accessible debt
- Regional brokers
- Insurance companies
  - Potential to buy premium they can underwrite
- London brokers or international players
  - Looking for an entrée into US Market
- Private equity without a platform
- Banks are less active, often divesting

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Driving Factors

- **Expectation gap still exists**
  - Sellers hear multiples for larger deals and have high expectations
- **Low organic growth** means people need to buy revenue
- **Private Equity**
  - Historically it was unusual for P/E owned brokers to be "flipped" to other P/E firms
  - Now P/E firms are competitive with strategic acquirers
  - Carousel keeps turning until the music stops (i.e. Capital Markets tighten and interest rates rise)

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Different Segments

- Retail vs. Wholesale
  - Direct relationship with insured = more control of business
- **Wholesale brokers vs. Program Administrators/ MGAs**
  - **Broker mentality vs. underwriting mentality**
  - **Well underwritten book may attract interest from insurance companies**
- Uncertainty in Health Insurance Sector
  - Benefits brokers (especially those focused on small group or individual markets) are under pressure, and have seen multiples down

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Do Your Programs Make Money for the Carrier?

- The most valuable MGAs and PAs have programs that are very profitable for their markets.

- **Profitability of Program** leads to controllability and sustainability.

- Make sure you **independently assess the loss ratio**. Use your own actuary.

- Make sure you independently **Maintain Your Loss Data**. If in a pinch you need to move a program to a different carrier and can't prove that its profitable, you could be dead in the water.

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Factors that Affect Value

- #1: Profitability of Programs
- #2: Corporate Structure (C, S, LLC)
- #3: Profit Margin Potential
- #4: Strength of Key Markets
- #5: Key Employee Retention

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Factors Affecting Value (*Cont'd*)

- #6: Size of Broker/Agent Network
- #7: Exposure to Top Brokers
- #8: Competitive Programs
- #9: Tangible Balance Sheet
- #10: Risk/Reward – Deal Structure

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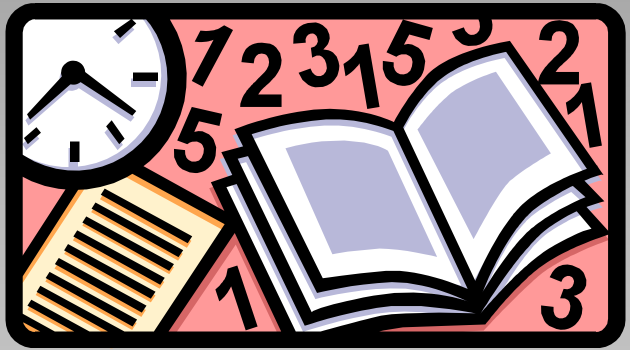
Valuing a Program Administrator

- Do not believe everything you read
- There is no quick and dirty answer
- Failure to properly value a business can put you out of business fast
- Stupid Costs you Extra



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Valuation: Where to Begin

- Primary Driver of valuations is CASH FLOW.
- CASH FLOW typically = Earnings Before Interest, Taxes & Amortization (EBITA)
- Net Revenues or Earnings?
- Normalize or Pro Forma EBITDA (i.e., what would it look like for a third party?)

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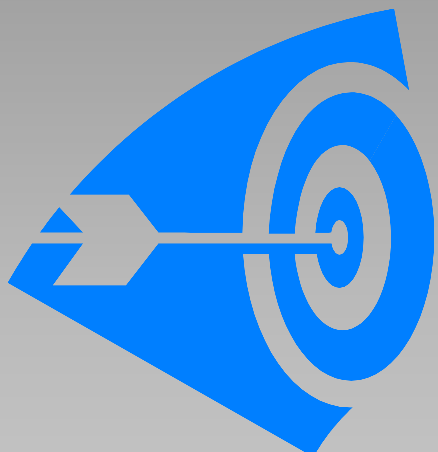
Example: Why not to use Revenue Valuations



- Assume 2 similar sized brokers and 1.5x Revenue and 6x EBITA Valuation Examples
- Revenue Valuation for $4 million Net Retained Operation = $6 million
- Capital Expenditures

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Cash Flow Valuation

Retained Rev	$4,000,000	$4,000,000
Profit Margin	25%	10%
EBITA	$1,000,000	$400,000
Multiple	6x	6x
EBITA Value	$6,000,000	$2,400,000
Value/ Ret. Rev	1.5x	0.6x

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What is an Earnout?

- The "earnout" is the non-guaranteed, variable portion of the deal
- If a deal has a variable component or "earnout" component, then consideration paid at closing is only a portion of the Base Purchase Price
- Consideration paid at closing can vary significantly, often 50%-90% of Base Purchase Price, and is often dependent on the riskiness of the deal
- Length of earnout varies, but 1 to 3 years is typical

Simple Example

Revenue of Seller	$	1,000,000
EBITDA	$	300,000
EBITDA Margin		30%
Multiple of EBITDA for Deal		6.0x
Base Deal Value	$	1,800,000
% of Deal Paid at Close		70%
Payment at Close	$	1,260,000
Multiple of Guaranteed Payment		4.2x
Amount of Earnout	$	540,000
Potential Deal Vaue	$	2,340,000
(Assuming maximum earnout with a 30% upside cap)		

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Factors Affecting Valuation and Deal Structure

- Size of deal
- Asset vs. Stock
  - C-Corp
  - S-Corp, LLC, Personal Goodwill Transaction
- Risk Profile of Deal
  - Account concentration, carrier concentration, other
- % of Deal at Risk
  - The more at risk to the seller, the higher the multiple needed to entice seller
  - More guaranteed, the lower the multiple

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Taxation Issues

- **INSTALLMENT SALES**
  - Installment Sale
    - Sale of a business over time
    - Seller recognizes gain as the payments are made
    - Exception – Depreciation recapture must be reported in the year of sale
    - Depreciation Recapture = Ordinary Income
  - Seller's Perspective –
    - Capital gain as payments are received based upon the gross profit %
    - Exception – Depreciation Recapture
  - Buyer's Perspective –
    - Purchase price is allocated in the same manner as an all cash deal
  - Interest – Must be stated in the agreement, or it will be imputed
    - Purchase price is allocated in the same manner as an all cash deal

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Acquisition Risks

- Due Diligence!!!!!
- Financing
  - Buyer's ability to pay
  - Matching cash inflows from operations to financing obligations

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Mindset for Acquisition

- Buffett Quote
- Avoid EGO
- Evaluate Culture
- Avoid Lunacy

Availability of Capital

- There are very few commercial banks that are lending for acquisitions.
  - Oak Street, is specialist
- Higher Price = Seller Financing
- Maintain a strong Balance Sheet
- Get pre approval from lenders. Don't wait!

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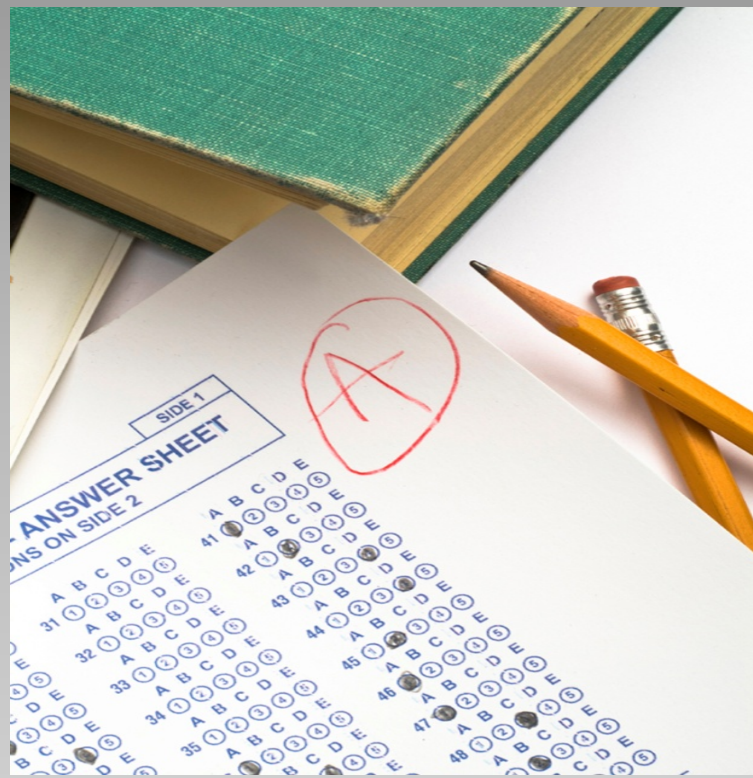
Questions & Answers



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