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SPECIAL FOCUS ON AGENCY MANAGEMENT

Not Another M&A Article

By: Skip Hagerty and David Salmon

It should not come as a shock to anyone reading these pages that the past few years have seen a dramatic rise in merger and acquisition (M&A) activity for insurance agents/brokers. According to SNL Financial, 311 agent/broker deals were announced in 2014, up 63% over the 191 deals announced in 2009. If this year's current pace holds up, 2015 will see even more deals than 2014.

Given this surge in deal volume, it is no surprise that a lot has been written about agency acquisitions and perpetuation planning recently. And while much of it is helpful information written by well-informed people, many of these pieces cover the same topics. Consequently, in this article, we have tried to highlight a few aspects of the agency sale process that are not as widely considered, but are nonetheless useful to achieving a successful transaction.

Don't Wait Until Your Retirement Date To Sell

Agency principals often tell us that they want to retire in the next year or two and, therefore, they want to begin the sale process now. Our immediate reaction is that they should have called us at least three years ago.

If an agency owner plays a role in the agency operation, especially in regard to client relations, buyers want that owner/principal to remain engaged at the agency for as long as possible after a sale. Acquirers do not want an agency that they just paid a lot of money for to start shrinking because the key person left shortly after closing.

Granted, in some situations the owner may no longer be critical in operating the agency, generating new business or retaining clients for the firm, so the buyer may not be as adamant that he/she keeps working. However, in most cases, a buyer is going to want a minimum two to three year commitment from a seller after closing. If a seller is committed to staying longer and can convince the buyer of their continued passion for the business, it gives the buyer further confidence in the future success of the acquisition, which in turn usually translates into a higher purchase price.

Choosing An Advisor

If you want to know the value that an M&A advisor will bring to a transaction, check their references. But, here's the twist: we suggest you call some of the attorneys that the advisor worked with in the past.

Why ask the attorneys? First, you can be pretty confident that an attorney is going to be professional and keep your conversation confidential whereas that might not be the case if you reach out to an advisor's former client (i.e., another agency). That agency owner might tell a friend who tells a friend and pretty soon the word is out that you are selling.

Second, M&A attorneys have worked with a lot of different advisors, so they have a solid frame of reference. They can speak to how knowledgeable and engaged the advisor was in the sales process through to closing. If the attorneys don't have much to say about the advisor, then you can likely assume that the advisor functioned more as a "finder" than a value-added advisor.

Now, if the advisor you are considering hesitates in providing you with the names of attorneys that he/she has worked with previously or tries to tell you that calling the attorney doesn't make sense, you probably should talk to some other advisors.

Choosing An Attorney

Over the many agent/broker deals that PhiloSmith has advised on, we have had the opportunity to work with a long list of deal attorneys. Choosing the right attorney is critical. When the topic of deal attorneys comes up, and we hear an agent say, "I have that covered, I know tons of attorneys," it immediately puts us on alert.

Selling your agency is not the same as settling a claim or selling your house. It is a unique transaction with unique legal elements that need to be dealt with by an attorney who is experienced in mergers and acquisitions, and preferably experienced in insurance agent/broker mergers and acquisitions. The friend you play golf with on Saturday mornings may be a good attorney, but unless he can point to multiple agencies that he has helped sell in the last couple of years, you should think twice before hiring him.

Working Capital

Sellers very often receive letters of intent that have a working capital requirement. More often than not, the sellers don't really know what it even means. Sometimes it's phrased as, "the seller needs to supply 30 days of working capital," or sometimes a fixed dollar amount is given. Either way, the working capital charge can be significant, and it is effectively a decrease in purchase price. In the first example (30 days of working capital), it would amount to approximately a month of an agency's operating expenses. That could be $50,000, $100,000, maybe $500,000+ depending on the size of your operation. Be forewarned that the way your agency operates and the structure of the transaction dictate the appropriateness or fairness of a working capital requirement. Don't find comfort in the phrase, "this is industry standard."

Earn-Out

You may have heard the term "earn-out" thrown around when discussing agent/broker M&A. While deal structures are getting more aggressive in this market (a topic for another time), a typical deal structure involves a guaranteed, up-front payment plus an earn-out payment. The earn-out is paid at a future date (usually two or three years after the closing) and is based on the agency's performance after closing.

Earn-outs can be calculated in a multitude of ways, but often an earn-out is tied to the future profitability of the agency. In these cases, a seller needs to be cognizant of any charges that a buyer might allocate to them during the earn-out period. Some of these charges may work in a seller's favor, for example if the seller was paying $25,000 annually to an IT consultant, and the buyer is going to service the seller's IT needs in-house and charge them half of that, the seller benefits. But if a seller is being charged for nebulous "corporate overhead" that will not help the seller drive growth or lower expenses, then this will hurt the seller's earn-out. For an agency that is growing, earn-out payments can represent a significant portion of the total transaction value, so it is important to understand how your earn-out will be calculated.

While we've really only scratched the surface of things to consider prior to selling your agency, hopefully we got you thinking about a few topics that people are not necessarily talking about but that are important to getting a deal done the right way. ■

Skip Hagerty is a partner and David Salmon is a director at PhiloSmith, an insurance-focused M&A advisory firm based in Stamford, Conn.