

State of M&A: Dead Calm After the Perfect Storm?

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2007 and 2008 were banner years in the agency-brokerage merger and acquisition market, with more deals at the largest aggregate value than at any time in history. But everything began to change at the end of 2008: the economy entered the most severe recession since the Great Depression; the stock market had crashed and the global economy was in shambles. To add to the pain, the insurance market remained soft, with the possibility the economic turmoil would exacerbate or prolong the soft market in a “perfect storm” scenario.

In spite of this, however, the agency-brokerage business has been, is and will remain attractive to buyers, as its cash flow is reasonably predictable and it is not overly capital intensive. However, along with the perfect storm events, the need to preserve capital or the inability to raise capital has created the current “dead calm” environment. Many of the active players on the M&A scene have grown cautious and conservative due to the inability to predict when any semblance of economic recovery and market firming will occur. A no call may be the best call.

This cautious approach is a far cry from 2007 and 2008, which clearly represented a “seller’s market” era for insurance agency transactions. There were 237 publicly announced transactions in 2007, followed by a whopping 264 transaction in 2008, the largest number in the past 10 years—and keep in mind that publicly announced transactions represent only 15 to 25 percent of all deals.

The group of buyers was diverse: from public brokers to regional and local brokers to new and existing bank acquirers to the newly emerging private equity acquirers. These buyers were anxious to improve top and bottom lines, acquire niches or specialties, expand geographically or simply enter the business. Pricing was aggressive, at record-breaking multiples.

But although there were still some big deals on the horizon, the M&A market started to slow in mid-2008 and seemed to come to a crashing halt as we finished 2008 and turned the calendar to 2009. In October 2008, Willis Group closed the acquisition of HRH, and it appears both of those firms are actively engaged in the integration of the two operations. In early 2009, Arthur J. Gallagher, HUB International and USI Holdings agreed to purchase the policy renewal

rights of all of Liberty Mutual/Wausau Insurance Co. middle-market business. While not as significant as the Willis-HRH transaction, these three brokers, each of whom have been very active on the buy-side, will be engaged in integrating their respective components of this transaction. At the same time, CEOs of several companies have stated publicly they do not expect 2009 to have the volume or flow of M&A deals, and their willingness to be as aggressive on pricing will be substantially less until the economy settles down and returns to some degree of normalcy.

Consequently, several of the large brokers that made many acquisitions will likely have a more cautious attitude toward deals in 2009. Deal volume in the first quarter of 2009 is down substantially from the same period in 2008. The hard reality is the large active buyers are the trend setters, both in creating a certain deal fever and setting the pricing standards with many of the remainder of potential buyers following suit.

For potential sellers, the question is how long to sit on the sidelines and wait, and what can be done in the interim. Unfortunately, the crystal ball we normally use in these situations is a bit cloudy, so we have to rely on more traditional financial analysis. Although unemployment continues to climb, the economy remains rocky and insurance pricing is still falling, most pundits say there are glimmers of hope, and recovery is likely to begin by the end of 2009. The Dow Jones has climbed more than 25 percent since its most recent bottom, reinsurance pricing is on the rise and there appears to be a little more optimism in the press and in the minds of many Americans.

Given prior cycles, the traditionally active buyers will likely return coincident with the economic recovery, and there could be an uptick in M&A activity in 2010. In addition, as before, there may be new entrants—perhaps a new wave of private equity or financial institution-type buyers. As the larger firms will struggle to grow organically or achieve adequate scale in the next cycle, acquisitions to supplement the top line will be back in vogue. Further, the desire to expand geographically or to enter or enhance niches will be seriously influenced by a “buy” versus “build” model.

Things may already be turning around. In a recent national survey of middle-market merger professionals conducted by the Assn. for Corporate Growth and Thomson Reuters, 88 percent of respondents said the current M&A market is fair or poor, but 56 percent said they expected the number of transactions to increase in the next six months.

Assuming that an active buy-side market will return, prudent prospective sellers should use this interim period to position their firms to capitalize on the market turn. Run the firm like a business—focusing on organic growth and profitability. Direct attention on efficiency, process and incremental improvement as you trim the fat and streamline operations. In short, transition the firm into the well-run business you would want to acquire.

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