Agency Valuation and Finance: What's My Agency Worth?

LEE McDONALD: I'm Lee McDonald of the A.M. Best Company. Welcome to our webcast, "Agency Finance and Valuation 2009: What's My Agency Worth?" We have a nice show set for you today and we have some very interesting guests. Lynna Goch is the editor of Best's Review. Hello, Lynna.

LYNNA GOCH: Thank you so much for joining us.

McDONALD: Keep your questions polite and family friendly because Lynna is the first one that reads them. We have Skip Hagerty. Skip is with Philo Smith. Why don't you tell us what you do there and a little bit about Philo Smith?

SKIP HAGERTY: Sure. At Philo Smith we're a specialty investment bank. We have focused on insurance since 1962. We have two divisions. We have an asset management division and we also have a corporate finance division. Within corporate finance most of our work is mergers and acquisitions advisory work. Some of those clients range from property/casualty insurance companies, life insurance companies, MGUs, MGAs, TPAs and the like, including retail agents. Our typical transaction size in M&A is typically north of $4 million up to about half a billion. Since '03, just to give you some numbers, 34 transactions for an aggregate value of about $1.4 billion. I've been with Philo Smith for 10 years. I'm a partner there. Prior to that I was with GE Capital for quite some time.

McDONALD: Great. Thanks for coming, Skip. We brought Skip in because one, he's knowledgeable about the M&A market for the producer side and he also has a specialty as he mentioned in some of the more specialized areas and some of the larger areas. Next I'd like to introduce Bob Pettinicchi. By the way, both of these gentlemen are well known. As we talked about this panel I hear their names mentioned back to me over and over. So I'm sure a lot of you have already met Bob through his activities. Bob is with InsurBanc. Bob, can you tell us what you do there and a little bit about InsurBanc?

ROBERT PETTINICCHI: Sure. Thank you, Lee. It's a pleasure to be here. InsurBanc is a bank that was formed in 2001. It is primarily the brainchild of the IIABA and our business is that we act as a community bank for agencies around the country. We specialize in providing credit and noncredit services. That is, we specialize in making loans to agencies around the country and we specialize in cash management tailored specifically to the industry.

McDONALD: Thank you, Bob. We're going to go to Washington right now. We have Madelyn Flannagan. Madelyn is with the Big I, the IIABA. Madelyn, could you tell us a little bit about yourself and about the IIABA?

MADELYN FLANNAGAN: Sure. I'm with the education and research department at the Big I. I head up the Best Practices program and agency education nationwide. The Big I is the oldest and largest national trade association representing property/casualty agents in the U.S. We were established in 1896 and we represent about 300,000 independent agents and their employees across the country. We provide lobbying on Capitol Hill, education services, product assistance for agents to offer their clients as well as a host of other services to help agencies grow and prosper.

McDONALD: Well thank you, Madelyn. Madelyn again is an extremely busy person. The Big I just had an event last week. I know she was everywhere and her name comes up all the time. The last person to introduce is also going to be the first person to speak, is Tim Cunningham. Tim is a principal at Optis Partners in Chicago. So Tim, could you tell us a little about yourself and about your organization?

TIM CUNNINGHAM: Optis Partners is a specialty investment banking and consulting firm. We work exclusively in the insurance distribution sector, agents, brokers, TPAs, MGAs, MGUs and so forth. The practice is split into three pieces: a fair amount of mergers and acquisitions, buy side, sell side type projects. The second piece is valuation, traditional valuation work, appraisals of fair market value for ESOP companies, for estate planning and similar type events. Then lastly what we refer to as strategy which has a fairly significant financial piece to it generally. But it might be a compensation plan, producer compensation, staff compensation, to perpetuation planning to succession planning and growth and whatever the case might be. I've been in the business my entire career. As you can see from some of my gray hairs it's been quite some time. Spent about 16 years in the agency business. In 1987 joined a specialty firm that was similarly structured to what I do today. In '97 started what is now the prior iteration of Optis Partners.

McDONALD: Tim, let's get started. Before we get into the actual valuations and some of the ways of determining it and some of the viewpoints on getting there, what's the market these days? If you could start with some overview information on basically the state of the market. Slow, busy, changing, when did it change?

CUNNINGHAM: Not withstanding the fact that there's always a good market for good firms, 2009 I would say is a challenge at best. I would say that unless a firm for some reason has a compelling reason to have to sell I would not say that 2009 is a good time to go into the market.

The market by and large is very buyer driven. I'll talk in a bit about what the buyer universe looks like. But the large brokers, the active buyers that have been in the marketplace for many years, they really set the stage. They kind of establish the standards. They create the activity. They create the criteria for price and terms. That's not to say that everyone needs to line up behind them but they really kind of set the framework.

We're dealing today with what I would refer to as kind of the perfect storm events. The combination of the economic crisis with the soft property/casualty market, that's created the challenges I referenced before. I believe we're in what I would secondarily refer to as kind of a dead calm environment. The evidence is very strong that even as we sit here in May that the number of deals done in 2009 will be significantly less than we saw in 2008, 2007 and before.

2007 and 2008 were kind of record setting years in the publicly announced transactions. It's hard to determine of those publicly announced transactions and this is within the entire distribution sector, but there were nearly 300 in 2007 and slightly over 300 in 2008. That probably represents somewhere around 10 to 25 or 30 percent of the entire deals. The most active firm in that period in 2008 did 41 deals. In the period from 2000 to 2008 they did nearly 200 deals. In the first quarter of this year that firm did two deals compared to seven deals that they did in the first quarter of 2007.

The second most active firm is in kind of a similar position. In their recent first-quarter earnings call their CFO, in fact, mentioned that this is going to be a very slow year for them from a deal standpoint.

But this is not a phenomena that's really affected just the insurance broker industry. Midmarket transactions are down all over. I saw a statistic from Robert Baird, the investment banking firm, that the first quarter of '09 there were 45% fewer transactions in the middle-market area than there were in 2007.

So we may have not the same perfect storm events as in other industries, certainly affected everyone. 2009, on balance, will be way down. I think the situation is that a number of firms on a capital basis are under challenge so they really can't spend capital to do deals. On the other side, those that have capital I think are kind of keeping their powder dry so to speak. In some respects the no call may be the best call.

2010 and beyond I think will be a different environment. I think we'll see some pent up demand. I think, too, as we see some more certainty about the economic recovery and we see some market correction there will be more activity. I think, too, that the large brokers, the public brokers, the private equity owned firms are struggling through this kind of no-growth period in 2009, assuming they see a clear horizon will be back in the market.

So in summary if a firm is looking to put themselves in play it's probably better to wait and see what the future brings and not necessarily do it today.

McDONALD: Thank you, Tim. That's an excellent way to get us off on the right foot. Madelyn, I want to turn to you very quickly for one of the slides that you have prepared today. What was most interesting that I thought from one of the studies that you've been doing is how prepared agencies are today if they were going to have to make a change, whatever they were doing in terms of perpetuation, whether they're keeping it in the organization or selling it. Could you talk about the state of preparation of agencies right now?

FLANNAGAN: The 2008 Agency Universe study and that's a study we conduct every two years about the independent agency system, shows that only 29% of agency owners said they had a formal written perpetuation plan, that they were ready, prepared to pass the reins of their agencies over to someone. We thought that a little bit surprising but looking back in the past studies it's always been in the mid to low 30s of percentage that people don't have those plans in place.

It's also a little bit confusing to us that because many carriers say they require that of agencies. Having that plan in place is just so important for an agency today to know: what are they worth? Who is going to take over the reins if something should happen? I really can't tell you the number of times in my career here at the Big I that I've gotten that call, 'Daddy passed away, I have to sell the agency, I don't want to keep it. What do I do?'

A lot of times people are making some people bad deals because they don't know what to do. So perpetuation planning, from working with your employees to look for an internal plan as well as looking outside of your agency, those things are so important especially now when things are a little but in flux and there are a lot of agents nearing that retirement age where they're going to want to sell their agency or some financial malady is going to occur and they're not going to be ready.

McDONALD: Well thank you, Madelyn. Right now we're going to turn to Bob Pettinicchi of InsurBanc. He has a couple of observations. We'll be returning to Bob throughout the discussion. Let's start with state of the market versus state of the agency.

PETTINICCHI: Well we feel that the state of the market is much less important than the state of the agency. That the sound agency management is for agency owners a continual value building process. That kind of goes with our next slide that agency principals need to make their own luck in this market. That an agency with a sound financial plan, run professionally and one that has access to capital will have opportunities in this market. We'll see as we go on that maybe there's perceptions of values that declining or there are changes in activity. Nothing changed in the market in terms of the amount of agencies, the amount of potential sellers, the amount of people who may have a need to sell. There will be opportunities but agency principals need to create their own luck.

McDONALD: Let's just take a little bit deeper look at the state of the market. Retail agencies, if we're going to break them out between MGAs, MGUs, wholesalers, things like that. Is the story any different depending on what flavor of an agency you have?

PETTINICCHI: We've provided financing to the full spectrum of agencies, retail agencies, MGAs, MGUs, wholesalers. Predominately our bread and butter has been the small-to-medium-sized P/C agency. That's where we see the bulk of our business. But in terms of the principles, Skip and Tim will talk about how you arrive there, the ideas are the same. It's how you generate value.

McDONALD: OK, let's turn to Skip here. MGAs, MGUs, are they facing the same market that retailers are in terms of being able to pass along, sell their agency?

HAGERTY: I think Tim touched upon a very important point earlier in that well performing agencies that can show good cash flow and have a competitive edge in the marketplace, they're always going to be desirable from a buyer's perspective. That's always going to be true regardless of what the market situation is. From a buyer's perspective, they're feeling the pressure as well. Organic growth rates certainly aren't what they were or what they have been over the last four or five years ago. Consequently their desire to acquire growth certainly is still there. So hopefully that gets to what we're trying to find out, in terms of there is a market. It continues to exist. But really I think it's on a case-specific basis. Sure, macroeconomic conditions coupled with a soft P/C market have made it more challenging.

McDONALD: Bob, let's just return to you for a quick equation here. Can you explain this?

PETTINICCHI: I'm not trying to scare anybody with this. It's our feeling, it's always been mine that for an agency it's better to be excellent than big. There are a lot of things you can do every day when you operate your business to strive to be excellent. Like being profitable before the receipt of contingencies, watching your expenses, bringing in good producers when you have an opportunity. The concept that I'm trying to get across here is that if you don't have an agency that runs particularly well don't expect to be able to use that agency, to leverage it to grow your agency. You're going to be looking at some problems.

But there are some good uses of leverages. Leverage I guess now is a bad word with everything that's gone on.

McDONALD: It's a scary word.

PETTINICCHI: It's a scary word. Certainly with what's going on in financial markets. But leverage for an agency if used properly for the right thing like being able to bring in a good producer or develop a producer, to buy a book of business, do a lift out of a group of producers from another agency. Things like that that don't take a lot of money but can really build value in your agency is an appropriate and good use of leverage. But just having a lot of debt in an agency that's not growing, is not adhering to those best practices that we'll hear about later, you're not going to fare well.

McDONALD: Ok. Tim, sticking with agencies and those who may be coming to market in hopes of selling or doing something when you look at them in terms of where they're located, the type of business they're handling, what carriers they're working with and what niches they may be focusing on, is there a desirable and an undesirable there that you can pick out?

CUNNINGHAM: Part of it is it's in the eyes of the beholder. Back to what I commented on earlier and Skip kind of picked up on it in terms of, for good firms there's always a market for those firms. Each firm has its relative strengths and weaknesses. Geographically it depends on the strategy of the buyer. If they're looking to plant a flag in a different geographical area, then in their eyes that firm in a different geographical area may be worth more than for a potential buyer in that same area. Stability of carriers, I think that's a given. Here there's a lot of business with A-rated carriers certainly is worth than a lot of business with B-rated carriers obviously. Niches are a particular strength, if there's one of those criteria elements that will add value is if the agency has a demonstrated expertise in a niche or certain niches.

McDONALD: Well thank you. Skip, anything to add to that?

HAGERTY: Certainly Tim did a commendable job in outlining that. I would say one thing about one particular segment that there's been probably a little more activity than there had been in prior years, and that is insurance companies looking to buy underwriting entities, be it program administrators or MGUs. It's a little different scenario where their focus is more on a specialized underwriting capability coupled with good underwriting profits. That valuation process is a little different than what we're seeing on the purely distribution side. But we can talk about that a little bit later.

McDONALD: Ok, let's talk about the state of the buyers. If you could just look it over in terms of these are the most actives buyers in past years: you've got your national brokers, then your smaller brokers. You've got carriers themselves, banks, private equity. If you had to pick them apart, is any one more active than the other? Are they all subdued at this point? If you were looking to acquire a buyer, where would you most likely find one these days?

HAGERTY: Let's take it from the top. The national brokers, I think they're going to continue to be quite active in the marketplace. That is their model, to go out and acquire agencies, bring them into the fold. Some are platforms, some are fold-ins. But at the end of the day their method is to grow through acquisition. I don't envision that being curtailed as much. It might be a little slower certainly but not as dramatic as what you might see among banks and what you might see among private equity funds.

Certainly last year with the credit crunch it did put a dent into private equity players' ability to access cheap capital which is certainly one of the things that pushed us into a hyper M&A mode among those folks. However, I will make a caveat that private equity funds that already have a platform in place, I think they will continue to look even though capital isn't quite what it used to be in terms of being able to get it at a cheap price.

Banks, you can look around and simply see what the activity has been there. Some of them will continue to be active, folks like BB&T and so forth. Others, you've seen some banks get out of the insurance distribution business, some rather significant deals have transpired. Whether it's a situation where their focus is more on their core business of banking or it didn't quite pan out the way they wanted it to. So you're probably not going to see as much activity at least in terms of aggregate number of transactions happening among banks.

McDONALD: Tim, could you take us through that universe of buyers as well? Who is most likely and who is least likely?

CUNNINGHAM: I approach it the same, slice it and dice it as appears on the slide. On the big large global brokers, there's been a lot of talk about Marsh and the Marsh Retail Agency. Their Q1 earnings call, though they did talk about and euphemistically they said they have a lot of stuff in the pipeline. There's a lot of rumor about who they might be going after. Aon has made the same comments, less definitively but nevertheless have made the same kinds of comments. Willis, I think, will be on the sideline. They're currently digesting the HRH platform.

The national brokers, what I refer to as Gallagher, Brown & Brown, USI, Hub, Alliant and so forth, not withstanding the last three are private equity owned, I differ a little bit with my friend, Skip, in that I think just the anecdotal evidence is indicative that they may be on the hunt but I don't think they're going to do a lot in 2009. Where they have a fair amount of debt leverage, the private equity owned ones and the like; they're focused on running the day-to-day operation.

The regional and local brokers, given this scenario and if someone buys into my core hypothesis of the dead calm environment, if you're particularly a primary regional owned or local broker, then maybe it's the same thing with the local bank, the community bank, there may be some wonderful opportunities out there today simply because there isn't the same universe of buyers. So if you've got capital, if you've got capacity one might be able to do the deal.

I'll echo Skip's comments about private equity. We've got the three that are owned and we've got a couple of others. The smaller firms I don't see new entrants. The banks will have a little bit of activity we'll see on the buy side from community banks that are looking at doing it strategically. But I think we may also see some of the medium pure banks, the agencies are not part of their core operation, perhaps even exiting the business.

McDONALD: Thank you, Tim. I'm going to go to Bob now to touch on the same topic. Then right after that we're going to go to Madelyn.

PETTINICCHI: Based on the deal flow that we see at InsurBanc, we've been primarily playing to regional and local brokers. The pace and the activity has picked up.

McDONALD: Really?

PETTINICCHI: We've seen more local brokers trying to do "things." Buying a neighbor. Buying another agency that they've been talking to for some time. But we've also seen them as buyers of smaller bank owned agencies or departments from bank owned agencies. So we've actually seen quite a pickup in that.

McDONALD: Well that's good to hear. Madelyn, I know you do a lot of tracking of the state of your own membership, in particular the people most likely to sell at this point. What can you say about where they are in terms of their career, their age, the life cycle of their agency? What do you see there?

FLANNAGAN: Well we look at agencies across the board every two years. We're beginning to see what I call the 'pale, male and stale' group. They're in their mid-50s, they're white, they're male, they're agency owners and they want to retire. We're seeing that across all industries and they want to sell their agencies. They are pretty much mixed property/casualty agencies. We have though seen and I would sort of agree with everybody in that middle-market agencies, and I call that the $2.5 million to $5 million in revenue, we've seen that group of agencies sort of finish buying each other up as they become very large agencies.

We're beginning to see sort of the dwindling of agencies that want to be bought by a bank. We're seeing, as Bob said, things happening now. A lot of mergers and a lot of quasi types of cooperates that agencies are doing. Rather than sell their agencies they're entering into other types of arrangements to sort of keep their agency going but maybe to step away from the business.

McDONALD: Now we're coming to what I call the second act. We've got a lot of feedback in advance of this. Everybody wants to know how do you figure out what an agency is worth, and of course that's what the heading of our presentation is. So we're going to start with Skip. Let's talk about the state of valuation today. The first thing, we've been talking a lot in advance of this presentation, between Skip, Bob, Tim and Madelyn of course, everybody cautions you: there is no secret sauce. There is no one answer. But how do you get there?

HAGERTY: You can't quite do it all the justice in a short presentation like this but I'll start off with this comment. That is, and this comes out of your Finance 101 textbook where it says that the value of any asset is equivalent to the net present value of its cash flows. Simply stated, what is that?

Well I'm going to buy something. The price I'm going to pay, there has to be an adequate return to justify that price. The reason I bring that up, it's important for people to understand that it's really the cash flow of a company or in this case a distributor that is the focus, the starting point of looking at valuation. Historically, people have talked in terms of multiples of revenue and the like. At the end of the day, when you really think about it, you may have $10 million of revenue but if you have no earnings today and the prospect of earnings in the future is nil, then the valuation is effectively nil, academically speaking.

So it's important to look at it that way. There might be an example that we have, a slide to try to point that out. Very simplistic here, so bear with it. At the end of the day you have basically Agency A and Agency B. Both have the same revenue. But one has twice the profit margin, and so just conceptually speaking one is technically worth twice what B is. I know that's overly simplistic but at the end of the day you look down at the bottom there and you look at the value of revenue. Well yes, that's how it would pan out. Again, if you're going to invest in something you've got to make a return. Unfortunately I think in the past some people have valued things on price to revenue and I don't think that's an accurate way to do it.

McDONALD: One of the bottom lines that I hear is, and you've talked about this, is does revenue even matter?

HAGERTY: Well I think it does. I don't want to ever say it's irrelevant because at the end of the day your profit is a byproduct of how much revenue you're able to generate. So it's a little hard to make that statement. But at the end of the day the focus is really in the EBITDA, which is the earnings before interest, taxes, depreciation, amortization which is essentially cash flow.

McDONALD: Do you want to go into this slide on EBITDA?

HAGERTY: Sure. One thing about EBITDA and those out there that are agency owners can say if you printed out your P&L statement today and I calculated the EBITDA it may not truly be reflective of what your earnings capability is or will be. So consequently you have to make some adjustments to that. Up on the screen there's a number of those types of adjustments. Again everything is very specific to the firm that we're dealing with. But at the end of the day the way to view it is, there may be expenses running through your P&L which are not relevant or do not pertain to the true earnings capability of the firm. In other words, there could be excess expenses running through that could be arguably eliminated and you would want to do that obviously because you would want to illustrate the true earnings power of the firm.

So most of the time the EBITDA is higher than what you might presently have on your QuickBooks sheet. That's something that you would walk through and we could go through all those. But I think everyone kind of understands that.

The heart of today's discussion, probably people want to know, if you value this off of EBITDA, what is the multiple you get paid? The historic range, five to eight times EBITDA, I'm sure you've read that in publications, people talk about it quite a bit. Again, it's simply a range. Because valuations fall on both sides of those parameters. You could see four times, you could see 12. As a matter of fact, you could see that kind of range on just one particular transaction when you get the letters of intent, to be quite honest with you. Again, it goes back to what Tim mentioned before, beauty is in the eye of the beholder. So the value ascribed could be tremendously different than what another buyer ascribes to you.

But it also points out the fact that you also have to question; did I talk to the right person who is going to pay the most and have the most and saw the most beauty in my organization? That's always an open question as depicted on this slide. But more importantly, when we talk about five to eight times, the real important thing there is that you just can't think about five to eight times. For example, if I had $1 million of EBITDA and I was going to be paid six times, that would be $6 million. Well the only problem with that is there might be a little more detail to this transaction structure. Are they actually going to pay you $6 million in cash or is it in the form of $3 million in cash and $3 million in earnout? So there are all those things. I try to categorize them into things to think about from a deal structure standpoint. Again, these are groupings and I'm trying to give a quick overview.

The first one you've got to think about is somebody is going to pay you X multiple. Think about the details, look at the timing of the payments negotiated with the transaction. For example, up here I just used a quick example and it's really based on the time value of money, which some people don't necessarily factor in, take it into account when they're looking at an offer. You're paid eight times. Well that's what the offer is. That could in fact be six equal payments over the course of five years, one at closing and then five additional ones.

Well there's an opportunity cost for that money because getting eight times in cash at the closing versus getting it spread out over five years is certainly different from a time value of money standpoint. You need to factor that in. So if you just follow through that example, if you use an 8% opportunity cost, which in banking they talk about the discount rate, that may or may not go with what the seller's perceived cost of capital is. The multiple is really only 6.7 times based on that example. So it's not an eight times multiple. Arguably it's only 6.7.

The other aspect you need to consider is the riskiness of the payments. Again, if you were to get installments and usually they're not structured this way. If you were going to get paid out over time, what's the risk that you won't get paid? Who is the buyer and how good is their credit, essentially? Do you secure that by a pledge of stock or personal guarantees or a letter of credit or what have you? Those are other things that you need to consider.

But I think the biggest piece within the risk of payments if the function of an earnout, which is typically, and you'll probably ask this question later, what is typically the holdback or typically the earnout portion of a transaction? At the end of the day it's roughly, and again they're very different; you can't always say a hard and set rule and make generalities. But let's call it 70% cash upfront and 30% could be in the form of an earnout.

The earnout is structured where the buyer wants that earnout in there because obviously they're trying to mitigate their risk that if things are not going to pan out the way they had hoped they would pan out in terms of cash flow growth. That's really what their goal is. They pay you a higher multiple, the idea is well, you need to help us earn that so we're going to get an adequate rate of return on our money. I'll use a hyperbolic case just for example's sake, someone may offer you 10 times EBITDA. That's certainly a very rich multiple but the point is that the earnout could be hurdle rates of 20%, 25%. The question you have to ask yourself is, will I ever really achieve that? What really is the multiple? Am I really getting paid 10 times in the fact that I had so much at risk and such a high hurdle rate?

I think the last thing; again there are a lot of details here but the form of the payment. Yes, you can get cash at close. You can get cash paid over installments. You could also get paid in the form of a seller note. Well what's the term? How long is it? What's the rate of interest? What's the security you're going to get paid? Then of course there's stock. Am I going to get stock in the acquirer, be it a publicly traded company? Is it restricted? Is it nonrestricted or unrestricted? Is it a private company that's buying me that's going to give me shares? I guess the question there is it's probably not liquid so what kind of a haircut do you take to that form of consideration? If it's illiquid and you're not really sure on the valuation which you probably wouldn't be, so you have to walk through the steps and say if I'm getting stock in a privately held company and their valuation is 12 times EBITDA, is that the right number?

It's those types of things that when you delve into it, just applying multiples just as a general thing can be quite dangerous. Because it doesn't really get to the essence of how the transaction is structured. The devil is certainly in the details.

McDONALD: That's quite a review there. I'd like to go to Tim at this point. Before we go to an analysis of terms, Tim, the things that Skip just reviewed in terms of ratios, timing of payments and the form of payments, what would you add to that?

CUNNINGHAM: Honestly not much. I think Skip did an excellent job of summarizing all of those things. I would add a further summary; it's really not what you gross but what you net. Maybe the one piece that Skip didn't talk about because it does get a little complicated is what is it after tax? Consideration can come over either as a capital transaction, which is taxed typically at capital gains rates, versus something that may come over as a contractual or similar type of payment, which is going to be taxed at ordinary income tax rates.

So you always need to factor in the tax piece of the equation to really see again it's not so much what you gross but what you net. A lot of what Skip talked about as to the time value of money, that goes back to that net factor. What is it? Always bring it back to what is the present value net transaction value.

McDONALD: There was a slide that Skip had where he compares three offers and explains how they really differ.

HAGERTY: I think this is just simply a quick example. Let's assume you were selling your agency and you had three different offers. On the surface you might just look at, well what's the EBITDA multiple that they're quoting in the first sentence of the letter of intent? Right off the charts you might say 8.4 is quite attractive. Again, not to hammer this point too much but when you pull apart the pieces of it and you start to look at it you see what the composition is of the different offers. Again, this is purely a hypothetical one but I thought it was a pretty good illustration.

At the end of the day, you could make the case that the 7.3 multiple is actually superior in that depending on what you think the ability is to reach the earnouts of offer one and offer two, offer three might be actually in their best interests. So I guess you also have to think about who the acquirer is when you think about earnouts. Some may be able to provide you with the tools to help you make that earn out more easily than you would if you were to partner with someone else.

It's those types of things and again you can go into a lot of detail about it. But I think it's important to recognize that. Don't always say that the deal is 8.4 versus 7.3 is superior because that may not in fact be the case when you actually delve into the details.

McDONALD: Tim, let's talk about the terms. From what I'm hearing and I guess it's been quite a while now, the days of just going to the closing table and turning over the keys and walking away are pretty much gone. So basically if you could address how long the sellers are staying on after the deal and what you're seeing in down money, the length of time of the payout and how they're structuring the earnout, the big picture after you make a deal.

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CUNNINGHAM: It depends in part on the nature and complexion of the agency and how long of a transition period would be required. For example, a $2 million revenue book of personal lines and small commercial doesn't require a long transition versus similarly sized firm that all of the business is commercial and employee benefits and the top 10 accounts constitute 50% of the revenue. That's going to take a longer transition period.

I would typically say that if a buyer wants the seller to stay for minimally a year, likely no longer than three to five, unless they continue as a producer and handle a book of business and are compensated as a producer only.

In terms of price and terms, if you look at the larger, the frequent buyers, typically, Skip alluded to it a little bit, it's in the 70% plus or minus range down, balance over two to three years, sometimes one, sometimes longer. Skip mentioned the buyer manages their risk with the earn out. I think sellers can also maximize their value in the earn out. It's kind of a little bit of a scenario where if you postulate that you can put up great numbers and continue to grow and therefore you want a superior price, a prudent seller would be in a position to put that at risk and roll the dice and so forth.

What we see, too, and Skip talked a bit about it, would be the earnout structure is again you really need to strip the pieces down and really see how much is at risk. If it's got a great big hurdle rate, virtually all of it could be at risk. We see a lot of deals that have, although it looks like an earnout you would have to have virtually Armageddon for none of that to be delivered. I know one of the very large, very active acquirers in the acquisition business, they did a study of all their earnouts going back over some 10-plus years and they hit the maximum on somewhat close to 98% or 99% of it.

The best scenario and a good deal structure is in fact for both sides the buyer and the seller, is indeed the seller could maximize their earnout. Because it means they would maximize their value and for the buyer it means they got a great run-up and a great level of momentum.

McDONALD: Thank you, Tim. Madelyn, let's go to you for what you may have seen as far as any of the research and studies you've been doing on how long principals are staying with the agency they sell and what kind of terms they've been seeing.

FLANNAGAN: We're hearing all kinds of things. Mostly agency owners are staying in the three-to-five year range, they'll stay on that long to see if the combination of them being there and the new ownership is going to create additional value for the agency and see that revenue stream. It doesn't always work out that way. A lot of agency owners found that they didn't make a good deal, that their customers were leaving and the value was decreasing.

We do receive a lot of calls and our studies do reflect that. A lot of agency owners do feel that they made a mistake. Actually in the last two years, in the last two-year study saw new agency startups that were being started up by some of these agency owners that had sold their agency and their noncompetes had run out. We thought that was pretty interesting.

McDONALD: So, if you're a seller you'd better take a pretty good look at that noncompete?

FLANNAGAN: I think the noncompete is important. I also think that for a lot of agency owners, there were some great deals out there. Obviously that's why they sold. They were given an offer they couldn't refuse. But if the combination wasn't the right combination, they didn't really sit down and work with a professional valuation firm or somebody that really helped them think through all the processes that they needed to think through. Some of the deals were done pretty fast and a lot of agencies weren't happy. So I would always caution and the research shows, take your time. Do your analysis. Know what you're doing.

McDONALD: That's good advice. Skip, anything else to add to the terms at this point?

HAGERTY: I think that was a pretty decent overview. You could certainly get into a lot more detail than we covered today. A couple of cautions I would have in related to deal structure is the fact that you need to think about those potential seller pitfalls that do exist out there and there are a number of them. Tim touched upon one which is a great one to talk about and that is tax implications of the transaction that you should strike and making sure you're going to maximize the value of the price you're actually going to receive on an after-tax basis. Capital gains treatment versus personal income tax and then of course you get into S versus C corporations and the selling of assets out of a C would not be a good situation. So I would add that, too. That's a good point and there are plenty of other pitfalls that people need to be aware of as well.

McDONALD: We're going to move along to financing here. So you've made a deal, or you'd like to make a deal. The biggest issue is always how do you pay for this or how do you get paid for it. We're going to go to Bob, who is our expert on financing, and talk about who's lending and what kind of terms they're coming to and things like that.

PETTINICCHI: On financing, what we see is that many deals do need to have an element of seller financing, particularly on internal deals. Also on pure M&A deals when somebody is being purchased there's a degree of seller financing, whether it's a seller holdback, a seller note or some other holdback.

In terms of who is lending for these other than sellers, institutional sources includes banks. Of course InsurBanc has been very active making loans and in fact we haven't stopped with the credit crunch. We find with the terms that we offer are typically five to seven years for a term loan. Many people would like to see more, 10, 15 years but then at what point does it not make sense? When we had this discussion before you asked me how mainstream lenders view insurance M&A. They view it as a leveraged transaction, which is a bad word right now and we feel that based on what we see in the market that the credit crunch, even though there are signs that the credit crunch in general and the economy is loosening a bit, the credit crunch will persist indefinitely for leveraged deals, which includes M&A. We're pretty confident that's the case.

So, it's going to be a case of more creativity, more seller financing and if an agency is trying to control their destiny or do something internally there aren't many options other than some seller financing and a bank like us.

McDONALD: That is my question. You're a very specialized bank of course. Has the nature of who you compete against changed?

CUNNINGHAM: Well, we found that almost every bank in the country has done one or two of these somewhere in their portfolio. But we have also found that in these tighter times banks, they're very adept at getting out of a business they don't want to be into and tearing up their portfolios of leveraged deals. So if you're a borrower and you have a loan from a bank, take out your loan documents, read them carefully, make sure you're adhering to all the covenants, which are the promises you've made in terms of financial reporting and various performance criteria that you agreed to. Make sure you're meeting it. You don't want to be in a situation where your credit line or your loan is in default. Because that will prevent you from doing anything else.

As far as other lenders, there are some credit companies out there that get involved in this space and they take much more of an approach the way a premium finance company would as a factor of commission. We take the approach that we're a senior lender. We're a bank. We take bank-oriented risks and we're pretty unique in this case.

GOCH: I think that we failed to define some of the terms that we've been using and we have a question from Paul and he'd like to have us explain what an earnout is. That's a great question.

HAGERTY: I'm sure Tim can add some insight here too. An earn out, we'll call it the at risk portion of a transaction. To simplify it, let's assume that you have a $10 million transaction. The value that's been ascribed to your firm is $10 million. Let's use the metric of 70% is cash you get at close and then 30% would be put at risk. We'll call this at risk portion an earn out. To get that additional $3 million again as Tim had mentioned and we talked about before, it's probably over maybe a course of a two, three, four-year period that you could earn that additional consideration from the transaction and the way you earn it is you have to produce X amount of incremental growth in EBITDA or in revenue or what have you. That's really the earnout. That would be the earnout portion of the transaction, about 30% in that case and hopefully that summarizes it. Tim brought up a good point, it's an opportunity for the seller to maximize their value and it's an opportunity for the buyer to mitigate some potential downside risk.

GOCH: So it's money that whoever sold their agency, it's the additional money that they get on top of the first monies that they get when they sell the agency?

HAGERTY: That's correct.

GOCH: And the better their sale, the more earnout they'll get.

HAGERTY: That's right. As Tim put it, it's a good opportunity to maximize the transaction because if you grow then you're going to share in the rewards with the buyer and the buyer is more than happy to do that and they like to see you achieve that. Because if they're winning, you're winning.

GOCH: A win-win.

HAGERTY: That's right.

McDONALD: I'd like to go back to Tim at this point and we're going to jump to the concept that you're considering a sale. A lot of folks are telling us that they're fishing around to see whether it's worth it, what they could get. Obviously they're not selling this minute but they're thinking about it. What should they be doing now to make sure that when it's time to sell they do the best they can?

CUNNINGHAM: The thing that I admonish my clients and others to do all the time and it really fits in this context and it's a bit of an exaggeration but I say always manage your firm as if you needed to sell it tomorrow. What that means is that you run it like a business and the two criteria of running it like a business is you're growing and you're profitable.

Now in terms of preparing to go to market is recognize that the cleaner the platform the greater the value and that most buyers do not want turnaround. So, I'd say first make sure that you present very clean financials. On the P&L or income statement side you have to have, and Skip alluded to it, you have to have an easy to understand pro forma. Nothing makes buyers crazier when they see a multitude of pro forma adjustments to take it from historical EBITDA to pro forma EBITDA. If you've got to have 15 or 20 adjustments to get it from 0% EBITDA to 25% and you have a lot of math adjustments, buyers are skeptical. So have a very clean financial statement and have a very simple pro forma that's easy to understand. As Skip talked about before, you strip out maybe excess owner's compensation, some soft dollar stuff. It needs to be kind of a minimal number. It may be a big nominal sum, but in terms of the number of those adjustments it must be relatively small.

Secondly, is in the financial side, your balance sheet needs to be clean. Again nothing makes buyers crazier than when they see a balance sheet that's just fraught with problems, things don't reconcile, things don't come out, and so forth. We still see a number of firms, for example, they have buildings and nonoperating assets on their balance sheet. I would urge anyone in that situation to talk to your accountant and tax adviser and see if there's any way possible to get those nonoperating assets off the balance sheet.

Even if you're structured as a pass-through, an S corp. or an LLC or whatever and you're able to sell assets the buyers still look at the balance sheet and the quality of the balance sheet. That's clean financials and make sure they're very easy to understand.

On the operations side have good structure, good staffing, good IT use, all that kind of stuff. Again the better the platform the better it shows and ultimately the greater the value.

In terms of timing, I talked in my early comments about 2009 probably is not the best time to go to market. But this is a good time to prepare yourself to go to market if that's what you want. 2010, 2011 I think will certainly be a better environment to sell into.

McDONALD: Skip, could you tell us about some of the potential pitfalls of people who are considering selling?

HAGERTY: There are a number of them. I want to point out one that I find exceptionally important and that is, understanding execution risk. That is looking at the person across the table and I'm thinking from the perspective of the seller and understanding the ability of the buyer to actually come through with what they've said they're going to do. A quick scenario: let's assume that you were to get three offers and one of them seems to be an outlier. One of them has a valuation that you say wow, this sounds really good. The question you have to ask yourself though is that deal actually going to come to fruition and can that person, do they have the wherewithal, do they have the track record of doing a transaction and can you trust them.

Because the reason being if you go down the road with one particular party they probably will presumably ask you to enter into an exclusivity arrangement where you pick them and you go down the road. If you find out 30 days later that either they can't finance it or they're going to change the terms on you at the 11th hour, you're going to have to circle back and talk to the number two and number three person. That is not the best negotiation position to be in when you're trying to market your company.

So again I would say execution risk, think about that when you're going into it. Maybe the highest offer may not be necessarily the best at the end of the day.

Other things to think about, we talked a little bit about asset sale versus stock sale and the C and S corp., that's important. The other thing is I will caution people that they may have a very good friend who is an attorney and they're very smart people and they do great work at what they do. But I would advocate that they hire someone who has done transactions before, an attorney that's done it because it can really simplify the process. Trust me; it will be worth it because it will probably be cheaper at the end of the day. Although it may not seem that at the outside I think it will be. Those are some of the most important aspects of it I think people need to consider.

McDONALD: We just talked about the top things you can do now to build your agency. By the way, these are all questions that were submitted directly by the people who registered for this event. This came up several times. Banks. What are we seeing here in terms of what they're selling and what they're buying, particularly buying? There was a lot of noise, then they seemed to be in reconsideration mode. Where are we now?

HAGERTY: Well if you go back in history and you look back at the early 2000s, 2001, the number of transactions that banks were doing as a percentage of the total was probably pushing, if memory serves me correctly, 40% to 50% of the transactions were being done by banks, at least of the ones that were being reported. Now I would say it's probably closer to 10% or 15%, I think. So just on a macro level when you look at those numbers you can say well banks aren't quite as active. But in addition to that also look at the facts of 2006, 2007, 2008. You saw a lot of transactions where banks were selling their insurance operations. Notable ones were you look at Webster Bank, Commerce Bank, Hibernia, Bank of America and you go through those and you say that's certainly a trend that you weren't seeing back in the early 2000s. So just by looking at those numbers roughly, well you could say they would be more of a net seller than a net buyer.

Now that does not include, I'm not including the smaller regional and community banks because they continue to buy. But you don't hear about them as much because they're not as much in the press. But you couple that with what's going on in the banking market and I'm sure they sit around the board room and say OK, is that a core business and do we really need to focus on our capital structure versus going out and acquiring. So that's probably an element that we have to consider, as well.

McDONALD: Tim, here's an actual question from an attendee: "I have two commercial carriers. Does that reduce my value?"

CUNNINGHAM: It may, Lee. It depends on the overall size of the firm. It depends on the book of business, the complexion. Is it two strong national carriers versus weak carriers? Are they small regionals or whatever the case is? There's a certain relativity to it. On balance if you're looking at a two-, three- four-, five-million dollar deal, that probably diminishes the value of it a little bit. On the other side it's back to the eyes of the beholder. A buyer may see that as opportunity to be able to roll that book into their book and possibly leverage their position with their existing carriers. Maybe they have the same carriers. That puts them in a different contingent category or whatever the case is. I think on balance what a buyer is going to look for is what is the risk presented by those two.

McDONALD: This one came out from someone who has an agency out on the West Coast. Maybe we can start with Skip and I'll throw it to Bob if he has anything to add. What's the best valuation method, capitalizing the earnings or discounting future earnings? They point out that discounting appears to give a higher value. What do you see there, Skip?

HAGERTY: Well, even playing multiples to some degree you're doing that. Discounted cash flow or discounted future earnings, the challenge and you go back to the days of finance where discounted cash flow is the way to value an asset, to challenge it: it's only as good as the assumptions you make but that's with anything. But implied in the multiple essentially you're kind of doing it in a quicker way.

McDONALD: Bob, anything on that?

PETTINICCHI: I agree with the concept of the capitalization. The multiple is derived from that. So the discount rate that you use for the multiple, that is supposed to be built in. One thing I do want to add about the valuations is that we've seen and this is a good takeaway, is that agencies that have actually commissioned a professional valuation have a much clearer view of the due diligence that's needed for an M&A transaction and as a result have a much easier time obtaining financing if they've actually been through that exercise. So, we can't stress that enough because when we ask for information and they say why do you need that, that's a back question, one we don't like to get. Really agencies are so unique from agency to agency that you owe it to yourself to actually know what your agency is worth.

McDONALD: Lynna has some real time questions from our attendees. Lynna, what are we being asked?

GOCH: We have two questions from Jeremy. The first one is regarding deal structure. Are you seeing stock sales for Main Street retail agencies?

HAGERTY: The sale meaning the receiving stock as a form of consideration?

GOCH: Yes, I would imagine so.

HAGERTY: Well on a private side. Yes, let's just assume a Main Street, we'll call it a smaller agency, in fact that may be a lot of what gets done. I don't focus on the smaller set but I know that does occur for the simple reason that a lot of smaller agencies that might be down the street may not have the cash at their disposal to make that transaction. It's a little more complex but again you need to feel pretty darn comfortable with your partner. Because at the end of the day their wealth and your wealth are either going to increase or decrease based on the same tide. So from that standpoint if you're assuming stock it's a merger of sorts. You're in bed together for sure.

McDONALD: We're going to take the second question and we're going to send it Tim's way. Is that an appropriate question for Tim?

GOCH: I guess so. What are the typical credit metrics? In other words, debt versus EBITDA that are underwritten in a term loan?

McDONALD: Would that be better for Bob?

CUNNINGHAM: I think it's a Bob question.

PETTINICCHI: I think that's a Bob question also.

McDONALD: Fortunately we have Bob here.

PETTINICCHI: Typically we'd like to see adjusted EBITDA of the borrower to exceed the required loan payment by 125%. That means we usually like to see a debt service coverage ratio of 1.25%. Now adjusted EBITDAs that's used for the purposes of getting a bank loan aren't necessarily the same as a professional valuation. Close but not always the same.

McDONALD: Madelyn, was there anything you wanted to add to those last two or three questions?

FLANNAGAN: It's good to hear all the professional evaluators say what the best practices are. You have to understand the value of your agency and the financial statements, track you're pro forma. This is what the best agencies are doing and this how they're creating high value agencies. So for anybody out there that's thinking about selling their agency, those are the things you're going to have to do to become a high value agency. That was a nice little pat for Best Practices.

McDONALD: That sounds good. Thank you everyone for registering. It's been a great turnout and I've really enjoyed this presentation. From my point of view it's been everything I hoped it will be. Thank you to Skip and Bob and Tim and Madelyn.