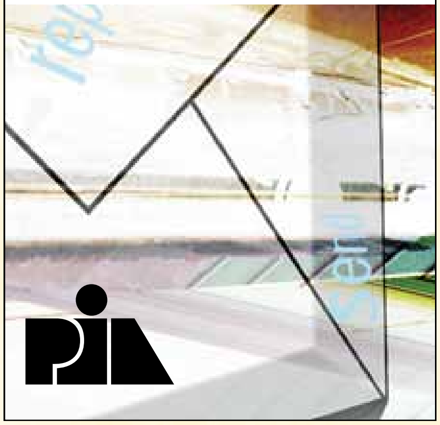
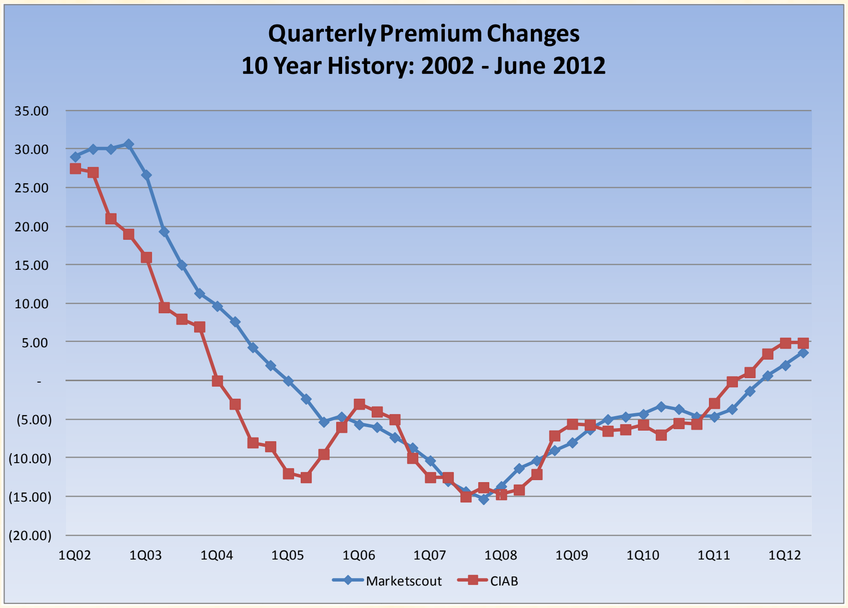


The table below shows a more detailed view of changes in premium rates over the past 10 years as reported by the Council of Insurance Agents and Brokers and MarketScout:

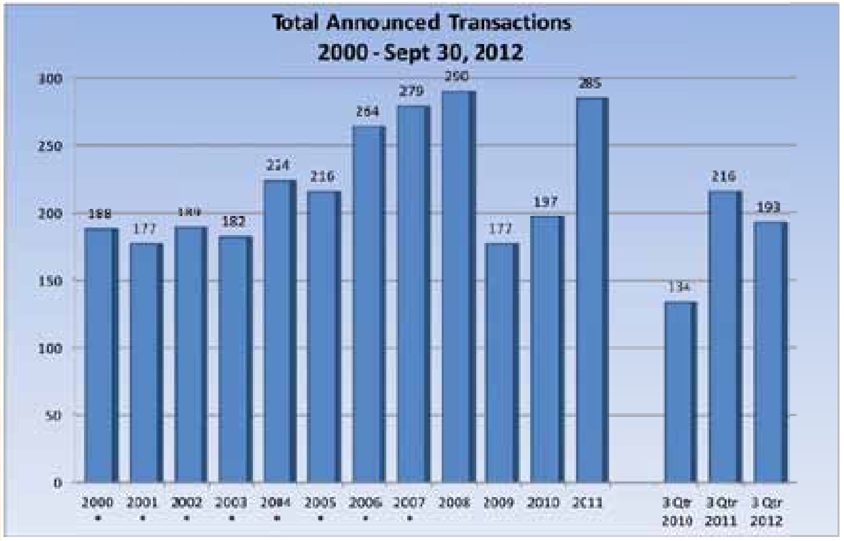


The magnitude of increases and decreases are much more significant on this chart compared to the premium chart above, with the end of the last hard market yielding rate increases approaching 30 percent while the bottom of the soft market saw rates declining at 15 percent. This is certainly a painful process to go through at both ends of the spectrum.

Both industry sources saw prices increase starting in late 2011 or early 2012, with the good news thus far being a more modest form of pricing actions in the marketplace. While a more traditional hard market may still come, if this pattern continues, maybe we won't see the huge spikes in rates seen in the past. It certainly would create a more sustainable level of pricing and less angst on the part of brokers and buyers.

M&A in 2012

The peak year for announced M&A transactions in the broker world in the last 10 years was 2008 when approximately 290 transactions were reported by banks, insurance companies, public brokers and various independent brokers. See the table below for some historical perspective on M&A transactions:



(*) Source for years prior to 2008: Insurance M&A Insights – 2008 Sourcebook

M&A activity fell off by nearly 40 percent in 2009 as the impact of the recession and the continued soft market caused agency values to drop, forecasts of future growth to be uncertain, and both buyers and sellers to be less willing to take on the acquisition risks. There was a slight rebound in 2010 as sellers were trying to avoid the expiration of the Bush tax cuts. When Congress extended the lower tax rates through the end of 2012, it would seem that a number of transactions that may have been targeted to close in 2010 actually got pushed out to 2011. The chart below shows quarterly announced M&A transactions, with a dramatic spike in early 2011 followed by more reasonable quarterly changes:

After the spike in announced transactions in the first quarter of 2011, the activity levels were relatively stable through March 2012. Buying activity dropped off during the last two quarters, primarily from banks and privately held firms. Several of the large active buyers have indicated they have a strong pipeline of M&A opportunities. We also have another wave of potentially significant tax changes coming into effect on Jan. 1, 2013, that could materially reduce take-home sale proceeds, and yet 2012 would appear to be just an "OK" year on the M&A front.

With the improving economy and the firming prices in the market, sellers may think about holding on to get one more hard market under their belt. The problem with this approach is twofold: First, if the "financial cliff" they talk about in Washington, D.C., comes to pass and tax rates do go up on Jan. 1, 2013, this would have a dramatic impact on the after-tax proceeds a seller takes home. Between the proposed 33 percent increase in the capital gains tax rate (from 15 percent to 20 percent) and the new 3.8 percent Medicare tax on capital gains, the real tax on capital gains will increase from 15 percent to 23.8 percent, or an increase of nearly 60 percent. All things being equal, a seller would have to sell their agency for almost 12 percent more in 2013 to net the same after-tax proceeds as a sale completed by Dec. 31, 2012.

Second, if the seller waits until the hard market finally hits, in whatever form it ultimately develops, the future growth assumptions after the hard market likely become much less optimistic. The seller would then be selling into a presumed softer market, and therefore growth much harder to achieve. The fiscally prudent agency owner should be able to generate incremental profits of 40 percent to 60 percent on the hard-market lift. Assuming the owner can sell the agency for six times the profit, which equates to about three times the added value from the market lift, if the owner sells the agency going into the hard market.

As we've seen in the table above, hard markets historically have not lasted more than a year or two, so the seller that rides out the hard market will get to keep all the extra profits during the rise, but at best it's only two years' worth, compared to three years' worth of value if sold ahead of the hard market (not including the tax differences between capital gains on the sale versus ordinary income from running the business, which only further damages the hold-outs).

In addition, as buyers continue to build in growth in the future performance-based purchase price calculations, if the hard market is behind you, growth becomes much more difficult and the maximum purchase price harder to achieve. The net result will most likely be a small earnout of purchase-price payments over a three- to five-year period, and the seller will take the risk that nothing will happen (internally or externally) to him or her or the agency before it is sold.

Perpetuation

Are agency principals heeding the message about preparing for their exit? Like death and taxes, every agency principal (or their heirs) will at some point have to deal with exiting the business. There are a couple ways to accomplish this:

1.) Sell the agency, either to an outside buyer or to current employees of the agency.

2.) Gift the business to one or more people if the seller doesn't need the money.

3.) Run the business into the ground until it's worth nothing.

4.) Die and leave the problem for someone else.

While most people will choose option No. 1, there are other alternatives should the principal prefer a different solution. For purposes of this discussion, we're going to focus on the group that would prefer option No. 1.

Unfortunately, while most agency owners know they want to sell the agency at some point, internally or externally, "tomorrow" all too often seems to be the best time to start preparing for it. Many times, something happens within the principal's world (e.g., someone close dies or gets sick, etc.) that causes him or her to take stock in the situation. Until this happens, it can often be difficult to get people to focus sufficiently on planning for their exit if they're not ready to think about it.

Although there is no one source for accurate information on the independent agency industry in the U.S., it is clear from various industry commentaries the vast majority of the agents across the country remain woefully unprepared for a planned exit of the business, let alone an unplanned event knocking them out of the picture. Some industry prognosticators say as many as 75 percent of independent agents do not have an actionable perpetuation plan. These same individuals estimate the total number of independent insurance agencies throughout the U.S. is 30,000-40,000, so it's a meaningful number of businesses unprepared for the inevitable.

In fairness, potentially as many as 50 percent of the independent agencies across the U.S. are small firms, most with one producer/owner. In these situations, perpetuation virtually is impossible because of the investment required to make it work. That still leaves the other half of the agency population, of which half of them likely aren't doing what they need to be in order to perpetuate the agency successfully.

Talking with various insurance companies about their agency plant and looking at the demographics of agency ownership, the average age of owners continues to increase and insurance companies remain concerned about their exposure to unfriendly buyers of their independent agency representatives. Insurance companies have a strong vested interest in the long-term sustainability of their agency partners, and would much prefer they find a way to perpetuate internally where the risk of major change is dramatically reduced. Hopefully, with the improving insurance market and general economy, more resources will be directed at helping agents establish and implement meaningful perpetuation strategies.

For those agents who aren't as interested in the traditional perpetuation approach, and know they want to sell the agency when the time comes, their best preparation is similar to creating a successful perpetuation strategy. Actions such as the following will yield a positive impact on the value of the business in a third-party sales transaction as well as help the agency prepare for an internal perpetuation transaction: continue to hire quality producers and staff to lead the agency in the future; create a sales and growth focused culture throughout the organization; run the business as if it were owned by someone else in order to maximize long-term value and profits; and reinvest profits into the business, either in the form of additional growth capacity or building up that "rainy day fund" that may have been depleted over the last few years.

All these strategies will facilitate an internal sale for agency principals. But equally important, they will result in significant payback in a sales transaction through more aggressive purchase multiples on higher-profit margins and more achievable growth targets in maximizing the value of the transaction. Hopefully, some of the agency principals approaching the time of their exit have heard the message and acted on it, but if not, it's never too early to start planning.

As we approach the end of another year, some things change, and some remain the same. The insurance marketplace always will move—sometimes up and sometimes down. Currently, we're in one of those up markets, and agency principals need to remember how to lead their organization with the "hard-market playbook."

The M&A marketplace through 2012 has been reasonably active, ahead of 2009 and 2010, but lagging 2008 and 2011, both active M&A periods. Any early actions by Congress relative to the potential tax changes could have a material bearing on the activity for the rest of the year.

Preparing for an owner's exit continues to be a back-burner issue in far too many agencies, and until they recognize it's a real problem—either through their own analysis or through the help of outsiders, getting movement on this front remains difficult.

As for the Cubbies, there's always next year.

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