

2009 SIGNIFICANT EVENTS

Banks Pull Back to Preserve Capital

Big Brokerages Ready to Buy

While 2009 was one of the least active M&A periods of the decade, there were still significant events worth noting.

■ Marsh formed Marsh & McLennan Agency and acquired Insurance Alliance and The NIA Group. The formation of Marsh & McLennan Agency brings strong competition to the middle-market landscape. Marsh & McLennan Agency looks to

position itself as one of the premier agencies in the highly fragmented middle-market sector. Making its first two moves in 2009, the newly formed agency acquired Insurance Alliance, one of the largest independent insurance agencies in the Southwest with \$15 million in revenue, and The NIA Group, one of the largest independent insur-

ance agencies in the Northeast with \$62 million in revenue. As the company looks to build a national presence, these transactions represent the first two in a series of planned strategic acquisitions.

■ Aon's purchase of Allied North America reinforces Aon Corp.'s leadership position in the construction sector and adds \$88.1 million in revenue to its base of \$2.6 billion. Aon's national footprint and Allied's global network enable the combined entity to provide industry-leading expertise on a local basis throughout the U.S. and to international clients.

■ Digital Insurance is one of the fastest growing employee benefits agencies in the U.S., completing 21 deals in 2009. It is creating a unique opportunity in the M&A market for benefits firms by acquiring or managing their small-group client base and delivering improved efficiencies and expanded services. Digital plans to capitalize on its 2009 momentum and accelerate its growth nationwide.


Bank acquisitions continued to decline to 21 in 2009, down from 41 in 2008. Bank deals as an overall percentage fell to their lowest in 10 years, just 11%. With such a drastic decline, one may wonder if banks remain committed to insurance distribution. Faced with their own financial crises, most banks were focused on their core business and preserving capital that previously might have been allocated to insurance acquisitions.

We continued to see several banks divest themselves of their insurance operations. Reasons for divesting varied and included: poor performance, inadequate return on investment and minimal impact on earnings, the inability to build a meaningful asset relative to bank operations, being acquired by another bank that did not deem insurance distribution as a core operation, and selling just to secure capital in bad economic times.

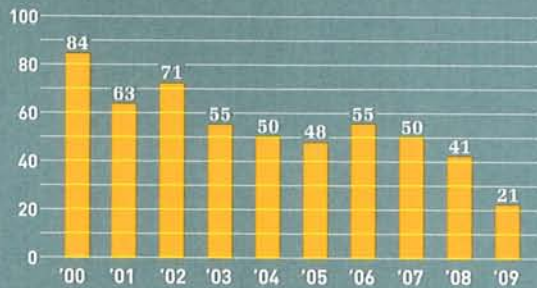
Several factors contributed to the continued decline in bank-insurance activity:

■ Most banks were more concerned with deteriorating financial positions, declining market valuations and preserving capital than spending capital on insurance acquisitions.

■ The prolonged soft market hit revenues



Bank Transactions



and profits of bank-owned insurance operations and likely the financial performance of acquisition targets.

■ Many banks chose to postpone acquiring employee benefits agencies while awaiting certainty in healthcare reform.

■ In some cases, declining stock prices hit bank valuations, lessening their ability to make a competitive offer.

■ Many banks have been victims of the economic turmoil and have been acquired themselves.

With consolidation in the banking sector combined with more banks divesting of their insurance operations, fewer bank buyers will exist over the long term.

A total of 11 banks dumped insurance operations in 2009. Some divestitures represented only a small portion of the insurance business, while others were the entire insurance operation.

With six transactions in 2009, Wells Fargo Insurance Services surpassed BB&T as the most active bank acquirer of the decade. Over the past 10 years, Wells Fargo Insurance Services has acquired a total of 51 agencies and brokerages, compared to BB&T's 47. BancWest Corp. followed with a total of 20 acquisitions, a number that hasn't budged since 2007.

Both Wells Fargo Insurance Services and BB&T are expected to continue their aggressive acquisition strategies. A potential challenge to their aggressive strategy is their parent company stock prices, which can affect deal valuations.

Three other very active acquirers during the decade are regional banks committed to growth in their respective geographic areas. They include Maine-based Northeast Bancorp, Massachusetts-based Eastern Bank Corp., and Pennsylvania-based National Penn Bancshares.

One regional bank to watch is First Niagara Financial Group, which has not acquired an agency outright in several years, but that is expected to change. First Niagara Risk Management, the company's full-service insurance agency founded in 1999, is based in upstate New York. During 2009, the bank acquired Harleysville National Corp., which included nearly \$8 million in revenue from its

subsidiary Cornerstone Cos. in Pennsylvania's Lehigh Valley. This expanded its insurance reach beyond New York. First Niagara Financial Group also acquired 57 western Pennsylvania bank branches from National City Bank in September 2009. These two bank acquisitions position it to grow its Pennsylvania relationships and newly, indirectly acquired insurance operations.

Banks have made significant inroads into insurance distribution and will continue to provide an attractive alternative for agency owners considering a sale to a

third party. Although some banks have not fared well in insurance distribution, leading banks in this arena continue to realize strong financial and operational performance. These banks view their insurance operation as an important aspect of their overall strategic and operating plan.

Many banks that are committed to the insurance space are ones that are committed to expanding and growing their territories as well as their product offerings. These banks will continue to be active acquirers of insurance distribution in the near and long term. ■

GUARANTEED CASH DECLINES

Do the Math

Transaction price multiples are not multiplying.

What a difference a year makes! A year ago the industry was celebrating the record year of 2008, which concluded with 307 transactions. Valuations were still high, but the red flags were up and pointing to a much different year for 2009. Those warning flags were accurate.

Pricing decreased for the average agency, primarily in the amount of guaranteed money paid at closing. The overall deal multiple, which includes the earn-out, did not change as significantly. However, the challenge for most sellers was their concern about the ability to achieve the earn-out targets and receive additional purchase price. High-performing agencies that executed strategic plans focusing on organic growth, revenue and profitability growth, and investments designed to build long-term value continued to receive high valuations in 2009.

The real story of 2009 is lower valuations for many average agencies that were

hit hard by the economy. A combination of reduced profitability and lower multiples left many agencies with values down 20% to 30% from a year earlier.

The most important step to understanding pricing trends is to categorize agency and brokerage transactions. There are three major categories that fit most agency deals:

- Platform agency to national brokerage and/or bank,
- Revenue/fold-in agency to national brokerage and/or bank, and
- Privately held agency to local or regional agency.

A platform agency to a national brokerage or bank is a larger, high-performing firm (generally defined as greater than \$10 million in revenue for p-c, \$5 million for employee benefits, and greater than 25% operating margins). It has a well established territory, brand recognition, seasoned professionals, ample markets and a scalable infrastructure.

[2009: YEAR OF CONFUSION]

Agency Value as a Multiple of EBITDA

GUARANTEED PURCHASE PRICE

Type of Transactions	2008	2009	Predicted 2010
Platform Agency to National Broker / Bank	6.50 – 7.50	6.00 – 7.00	6.25 – 7.25
Revenue / Fold-in Agency to National Broker / Bank	5.75 – 6.50	4.75 – 5.75	5.00 – 6.00
Privately Held Agency to Local or Regional Agency	4.50 – 5.00	4.00 – 5.00	4.00 – 5.00

TOTAL POTENTIAL PURCHASE PRICE AFTER EARN-OUT*

Type of Transactions	2008	2009	Predicted 2010
Platform Agency to National Broker / Bank	9.00 – 10.00	8.50 – 10.00	8.50 – 10.00
Revenue / Fold-in Agency to National Broker / Bank	8.50 – 9.50	7.50 – 9.00	7.50 – 9.00
Privately Held Agency to Local or Regional Agency	6.00 – 8.00	6.00 – 7.50	6.00 – 7.50

*Assumes 20-30% compound annual growth over 2-3 years earn out.

EXPECTED PURCHASE PRICE AFTER EARN-OUT

Type of Transactions	2008	2009	Predicted 2010
Platform Agency to National Broker / Bank	7.25 – 8.25	7.00 – 8.00	7.50 – 8.25
Revenue / Fold-in Agency to National Broker / Bank	6.50 – 7.50	6.00 – 7.00	6.25 – 7.50
Privately Held Agency to Local or Regional Agency	5.25 – 6.25	5.00 – 6.00	5.25 – 6.25

Agency Value as a Multiple of Revenue

GUARANTEED PURCHASE PRICE

Type of Transactions	2008	2009	Predicted 2010
Platform Agency to National Broker / Bank	1.75 – 2.25	1.50 – 2.00	1.75 – 2.25
Revenue / Fold-in Agency to National Broker / Bank	1.50 – 2.00	1.25 – 2.00	1.50 – 2.00
Privately Held Agency to Local or Regional Agency	0.75 – 1.25	1.00 – 1.25	0.75 – 1.25

TOTAL POTENTIAL PURCHASE PRICE AFTER EARN-OUT*

Type of Transactions	2008	2009	Predicted 2010
Platform Agency to National Broker / Bank	3.00 – 4.00	2.50 – 4.00	2.50 – 4.00
Revenue / Fold-in Agency to National Broker / Bank	2.00 – 3.00	1.75 – 3.00	2.00 – 3.00
Privately Held Agency to Local or Regional Agency	1.00 – 2.00	1.00 – 2.00	1.00 – 2.00

*Assumes 20-30% compound annual growth over 2-3 years earn out.

EXPECTED PURCHASE PRICE AFTER EARN-OUT

Type of Transactions	2008	2009	Predicted 2010
Platform Agency to National Broker / Bank	1.75 – 3.00	1.75 – 3.00	2.00 – 3.00
Revenue / Fold-in Agency to National Broker / Bank	1.50 – 2.50	1.50 – 2.25	1.75 – 2.50
Privately Held Agency to Local or Regional Agency	1.00 – 1.50	1.00 – 1.50	1.00 – 1.50

Sources: Mergerstat, Pratt's Stats, public filings, and Hales & Company proprietary databases

A revenue or fold-in agency sold to a national brokerage or bank will either remain a standalone entity based on size or geographic location or could be consolidated into one of the acquirer's existing operations. We also refer to these types of transactions as second-tier acquisitions.

The sale of a privately held agency to a local or regional agency will often

be referred to as a book-of-business or roll-up transaction.

VALUATION MULTIPLES

Industry professionals generally reference two forms of purchase price as a "low common denominator." Multiple of earnings, or EBITDA, is the most widely used reference to translate the overall purchase price of an agency. This essentially represents "free cash flow" of the agency at the time of purchase. Acquirers generally determine purchase price based upon the trailing 12-month period of free cash flow, adjusted for certain "add backs" (non-recurring or atypical expenses within the agency).

The second form of valuation multiple is based upon revenue. This is less scientific and merely a baseline by which to "translate" the value of the deal. No acquirer values an agency in the form of multiple of revenue, and we simply reference it as a "translation" of the purchase price.

To fully understand transaction pricing, it is important to break down the transaction structure into three key components.

■ **Guaranteed Purchase Price**—The dollar amount the seller will receive at closing or at a future date regardless of future performance.

■ **Total Potential Purchase Price**—The total dollar amount the seller could receive based on future performance.

■ **Expected Purchase Price**—This represents the dollar amount the seller can expect to receive after the applicable earn-out period. For example, while the maximum purchase price may be 9 times EBITDA, it consists of a guaranteed purchase price of 5.5 times EBITDA and an earn-out based on a compound annual growth rate of 20% during the earn-out period. Therefore, based on historical growth rates of 8%, the expected purchase price may only be 7 times EBITDA.

Furthermore, it is important to note that the tables and data included in this section represent the "average" multiple for each category. That average does not represent the upper end or the lower end within each category. In addition, the effect of unique transactions that may not be reflective of a "normal" transaction in

the market are excluded from our “average” multiple.

Because of the uncertainty related to the earn-out, sellers and buyers often hit an impasse during 2009, with sellers wanting more money upfront and buyers wanting more money in the earn-out. For most of 2009, this expectation gap was large enough that few deals were being completed.

While the overall “average” purchase price has decreased from last year, it should be pointed out that acquirers will continue to pay a premium above the average purchase prices noted herein for the high-quality, high-performing independent agency. Our definition of such firms would be those agencies that, despite difficult economic and market conditions, continue to generate above average organic growth rates, revenue and profitability compared to their peer group. In addition, the larger the agency from a revenue standpoint, the more likely it is that the valuation will be higher than that of a smaller agency. Our benchmark for a “larger” agency is generally defined as an agency with revenues, excluding contingents, greater than \$10 million for property-casualty firms and \$5 million for employee benefits firms.

It is also critical to understand the percentage of deals within certain multiple ranges. The charts on the left present an analysis of deal prices within various multiple ranges, along with a comparison to 2008. Please note that the percentages in these charts are based on the “expected” total purchase price and not the guaranteed price or the total maximum purchase price.

AGENCY VALUATION IN PERSPECTIVE

The average transaction value since 1980 and the trends tie very closely to certain key events in the industry. These events are discussed below.

■ For nearly 20 years, the average transaction value fell within a fairly narrow range of 5.0–5.5 times EBITDA. The pool of acquirers was primarily limited to public brokerages and large, privately held agencies. Supply was adequate for demand, and there were not external factors to drive premium values.

■ Upon the passage of Gramm-Leach-Bliley in 1999, banks entered the insurance acquisition market and drove up demand and multiples. To compete with banks, the historical buyer group of public brokerages and large, privately held firms was forced to increase their price to be competitive.

■ Rates started to decrease by the second quarter of 2003, and by the end of 2004, we became entrenched in the soft market that still exists today. Demand became greater with limited supply, which further drove up multiples from 2006 through 2008.

■ By 2006, private equity groups became active in insurance acquisitions, and by 2007 high demand, limited supply, low organic growth, easy access to capital, and low interest rates drove multiples to an all-time high.

■ By the second half of 2008, demand began to decline, supply increased slightly, and we began to see a decrease in pricing from the record year of 2007.

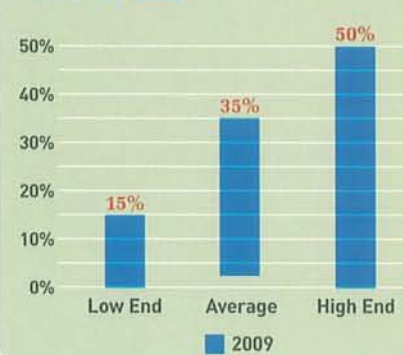
■ In 2009, the economic crisis was really felt in the M&A market. The number of buyers decreased across all market segments, and economic, market and political challenges affected acquisition appetite as well as multiples. Many sellers determined they were better off waiting on any exit strategies.

■ Looking at 2010, we expect that the various economic, market and political dynamics will begin to improve. Furthermore, to meet growth goals, buyers will reenter the market more aggressively, and multiples will begin to inch up slowly. Sellers that held off on their exit strategies will begin to put their feet back into the market, we will begin to see a convergence of “ask and bid” prices between buyers and sellers, and the number of transactions will increase during the year.

DEAL STRUCTURES, EARN-OUTS

The percentage of purchase price that is “at risk” for transactions that include earn-outs or other variable pricing components does not attempt to state the percentage of deals that use variable pricing. For those that do, they constitute the low-end, average and high-end percentage of the price that is at risk. For example, a transaction

PERCENTAGE OF TOTAL PURCHASE PRICE “AT RISK”



[2009: YEAR OF UNCERTAINTY]



price of \$10 million that includes \$3 million in deferred payments based on future performance would have a variable pricing component of 30%.

Due primarily to economic conditions, the continued soft market and the uncertainty related to healthcare reform, the percentage of the "at risk" purchase price increased slightly in 2009. The post-closing performance of many prior year acquisitions, particularly those in 2007 and 2008, have been significantly less than what buyers expected. Therefore, acquirers have reduced guaranteed pricing and have tried to shift as much of the potential purchase price to the earn-out, where the risks and rewards are shared equally between buyer and seller.

Given the volatility in the market today, most sellers have reduced expectations regarding future performance and, therefore, are significantly discounting any future proceeds tied to future performance.

OUTLOOK FOR PRICING BRIGHT

It is clear that agency valuations that reached previously unheard of highs during the time period from 2006 to 2008 are behind us for a while, if not forever. However, the future for pricing fundamentals is still bright. While current multiples are below the historical highs of the past few years, they still are significantly higher than the 20-year historical average from 1980 through 2000. In addition, top-performing agencies will continue to receive a premium, and we will not be surprised to continue to see overall transaction values reach 9 or 10 times baseline EBITDA

(defined as trailing 12 months EBITDA). Such multiples will be obtained only if the seller achieves post-transaction compound annual growth rates of 15% or greater during the earn-out period. Those firms that fail to implement a results-driven culture (defined as an agency with a strong sales culture, organic growth greater than their peer group, a history of reinvestment, and increased revenues and profits regardless of market conditions) will continue to be disappointed by the valuation gap between the average agency and the high performers. In some cases, they will continue to see their overall shareholder value diminish during 2010 and beyond. This is due not to lower multiples, but to revenue compression and reduced profitability.

CONSOLIDATION COMING

The demographics of the industry all point to significant consolidation in the years to come. National brokerages will continue to lead industry consolidation. Banks and private equity groups will remain relatively quiet for the near future. Consolidation will build size and scale, drive down costs and improve efficiencies. As clarity develops in the areas of credit availability and cost, regulation, and overall market health, M&A activity will once again pick up steam.

PRODUCT PRICING DRIVERS

The first quarter of 2010 will mark the beginning of the sixth year that the property-casualty industry is entrenched in a soft market.

Here are several of the significant items that will continue to affect product pricing and rate environment:

Net Written Premium—Growth in 2009 is expected to be approximately -3.5%, representing the third consecutive year of decline. The forecast for 2010 is -1% to -2%, based on product pricing and economic factors.

Catastrophic Losses—These were minimal in 2009, about \$10.3 billion through September. The total is expected to be \$12 billion. Expect losses to return to more normal levels in 2010 and beyond. If catastrophic losses exceed \$30 billion, it could cause a relatively quick return to increased product pricing.

Note: Only business and personal property claims, business interruption and auto claims are included for 2001.



Combined Ratio—Industry analysts expect the combined ratio will be 101% in 2009, compared to 105% in 2008, 95% in 2007 and 92% in 2006. While the combined ratio approaches a break-even point, insurance carriers' investment portfolio returns—while favorable compared to the prior year—are extremely low due to a more conservative approach in investment philosophy coupled with today's low interest rate environment. Investment returns are expected to be less than 5%. Carriers must begin to generate more profitable underwriting results to offset low investment returns.

Return to Surplus—Near break-even underwriting, coupled with low investment income, means an expected a return on surplus of 4%–5%. This is considered too low to be an acceptable risk-adjusted return on capital. Most industry analysts believe that an acceptable return on surplus must be in the range of 10%–12% at a minimum.

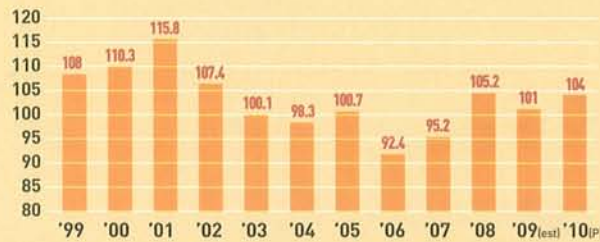
Most experts predict a gloomy 2010. Underwriting results are not expected to improve. Investment returns will remain low. And barring a significantly costly catastrophic event, product pricing will remain soft.

For 2010, Fitch Ratings projects:

- Net written premiums will decline 1.3%
- Loss ratios will increase to 104%
- Underwriting will be affected by higher expense ratios, less favorable reserve development and a return to average catastrophe losses
- Investment income will be lower and realized losses will decline significantly
- Net income will increase modestly, and return on surplus will come in below average at 5.2%
- Policyholders' surplus will grow by 4.1%.

So what does this mean for M&A activity in 2010 and beyond? We expect to continue to see flat to negative organic growth rates that will result in declining revenues and profits for the majority of “average” agencies. It is likely the challenges may not be as great as they were in 2009, but we would not count on this. The rate environment will continue to create operational disparity between the average agency and high performers and will likely cause non-perform-

COMBINED RATIO



Sources: Insurance Information Institute and Fitch Ratings

NET WRITTEN PREMIUM GROWTH



Sources: Insurance Information Institute and Fitch Ratings

CATASTROPHE LOSSES (IN BILLIONS)



Sources: Property Claims Service/ISO and Insurance Information Institute

ing agencies—particularly smaller agencies without the capital to withstand the market pressures—to seek a joint venture, partnership or outright acquisition by a larger, better-capitalized competitor. This will cause a significant increase in the number of agencies considering a sale during 2010 and beyond, which will result in the continued consolidation of the distribution industry in the years to come. ■