Weak growth & profitability results put pressure on perpetuation

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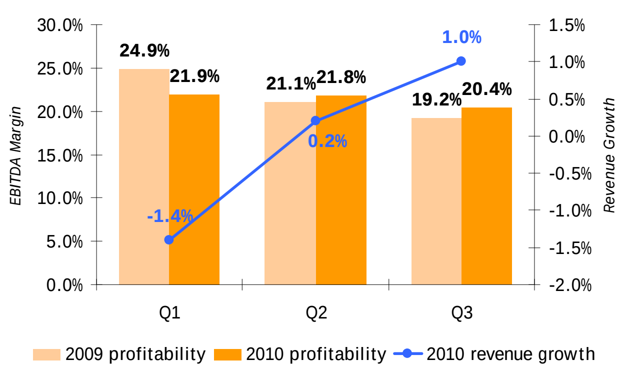
There is some positive momentum in this quarter's Organic Growth & Profitability Survey results: agency profitability in 2010 continues to outpace 2009 and organic growth improved for the third straight quarter. However, despite these encouraging trends, strong organic growth and high profit margins largely remain elusive for the agent & broker community.

Through the first three quarters of 2010, organic growth was only 1.0% for the typical OGP firm and profitability, as measured by EBITDA, was 20.4% - a number which is likely to decrease when 4th quarter results are examined. Agencies are still struggling with the weak economy and soft property & casualty market.

Growth and Profitability Results Remain Weak Despite Some Positive Momentum



Source: OGP Surveys, Bureau of Labor Statistics

These growth and profitability struggles don't just impact shareholder returns in the present, they also impact an agency's ability to remain independent in the future. A growing profit stream is essential to a successful internal perpetuation strategy. As such, the industry's current lackluster growth and profitability results are putting real pressure on many agencies' plans to perpetuate internally. At best, these perpetuation pressures are compelling agencies to reevaluate their perpetuation plans and at worst they are forcing agencies to seek outside help in the form of a third-party buyer.

Pressure on Agency Valuations

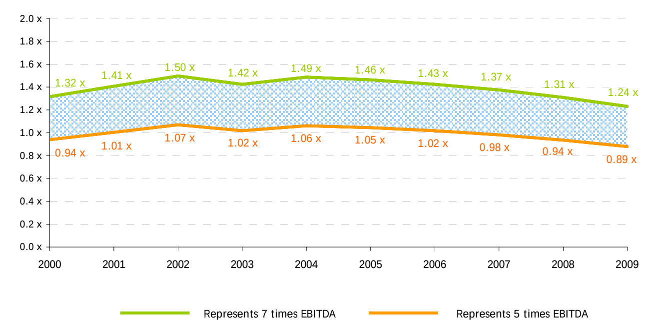
Although an agency's business risk and balance sheet play a large role its valuation, by far the largest variable in an agency's valuation calculus is that of projected profitability growth. Simply put, the higher the profit margins and higher the projected growth of those profits, the higher an agency's value (all other things being equal).

For many agency owners today, especially those close to retirement, general expectations are that their agencies have values in line with historical industry revenue multiples - frequently expressed at 1.5 times revenue. This is problematic in that, for most agencies, today's growth and profitability results do not come close to supporting such a value expectation.

An appropriate valuation multiple for internal ownership transfers is better expressed in terms of EBITDA rather than revenue. And for most firms, the appropriate internal valuation falls within a range of 5-to-7 times EBITDA (5 for a slower growing agency, 7 for a faster-growing agency). Therefore, the EBITDA margins necessary to support a 1.5-times revenue valuation fall between 21% (7 times EBITDA) and 30% (5 times EBITDA) , with a midpoint of roughly 25% (6 times EBITDA).

However, only about a quarter of OGP firms have profit margins at 25% or higher through the first three quarters of 2010. And because few agencies are operating at this level of profitability, few agencies can justify a valuation of 1.5 times revenue. For many agency owners, particularly those close to retirement, this can come as bitter news. As the following chart illustrates, the average agency's value, as a multiple of revenue, has declined steadily since the peak of the last hard market in 2004.

Internal Perpetuation Values Expressed as a Multiple of Revenue (2000 – 2009)



Source: Reagan Value Index, Reagan Consulting Organic Growth & Profitability Survey

Pressure on Perpetuation Funding

Modest growth and profitability results also make internal perpetuation funding a real challenge. A majority of internal buyers rely heavily on financing to make their purchases of stock, and the source of funds necessary to service this debt becomes all-important. For this reason, many firms committed to perpetuating internally rely heavily on profit distributions to buyers to fund their perpetuation plans.

In order to assess the importance of profit distributions in the typical agency's perpetuation plan, we developed a metric called the Buyer Coverage Ratio, which is the percent of a buyer's first annual payment (principal & interest) that is covered by shareholder bonuses or distributions. The Buyer Coverage Ratio provides a sense as to how much of a buyer's payments are typically covered by shareholder bonuses and distributions versus what the buyer must fund from his or her personal resources (salary, commissions, savings, etc.).

For example, let's assume that a purchaser of stock enters into a financing arrangement whereby his or her first year principal & interest payments total $50,000. If the total shareholder distributions and bonuses to the buyer total $30,000, this generates a Buyer Coverage Ratio of 60%. The remaining 40% of the obligation will have to be satisfied out of the buyer's personal financial resources. The higher the Buyer Coverage Ratio, the more affordable the stock proves to be.

We recently surveyed the industry to determine what typical Buyer Coverage Ratios in the marketplace are today. While firms varied widely in their individual Buyer Coverage Ratios (some as low as 0%, others well in excess of 100%), the typical firm using ownership purchases to perpetuate internally had a 100% or higher Buyer Coverage Ratio. In other words, the most typical arrangement among firms committed to internal perpetuation is to distribute 100% or more of the buyers' principal and interest payments to its buying group.

A healthy Buyer Coverage Ratio, while impacted by a host of factors, is made possible by a robust stream of distributable profits. Today's relatively weak profit margins are limiting the resources agencies can direct to buyers to allow them to purchase shares – putting pressure on internal perpetuation funding.

What It All Means

The industry's current growth and profitability realities are requiring many agencies to adapt their internal perpetuation plans. Sellers' alternatives range from simply accepting lower valuations to abandoning valuation realities and demanding a higher valuation that cannot be economically supported. In between these two extremes, some sellers are delaying retirement until growth and profitability results support a more acceptable valuation or focusing their attention on improving operations to the point where profit margins support a more palatable valuation.

In cases where today's growth and profitability results are generating fewer dollars to support their stock purchases, buyers, too, are having to adapt - buying smaller blocks of stock, dipping into other personal financial resources, requiring more generous financing terms from sellers, or passing on the opportunity altogether until better times arrive.

As both buyers and sellers must be satisfied in order for an agency to have a viable long-term internal perpetuation plan, it is clear that today's growth and profitability realities are putting more pressure on agencies than ever before to monitor and adapt their perpetuation plans.