BDO MERGERS & ACQUISITIONS

INSURANCE BROKING

Market update | June 2016

55 Baker Street
London
W1U 7EU

June 2016

Dear Sir

Welcome to the latest of our regular updates focused on the insurance broking industry.

This edition looks at the increasing involvement of private equity and institutional investors in the broking market and the key attributes and attractions that the right broker offers to these investors.

Also included is our quarterly update of the BDO Private Company Price Index – highlighting the latest trends in pricing multiples being paid for both independently owned and private equity backed businesses.

Our Corporate Finance M&A team at BDO have considerable knowledge and experience of the broking sector and we have advised many notable transactions in the mid-market. We understand the dynamics of the industry and the issues that brokers face, and we continue to maintain and develop long term relationships with our clients to help them achieve their strategic goals.

Ultimately our aim is to assist our clients in increasing and realising their company's capital value, and we look forward to the opportunity to work together.

Yours faithfully,

ADAM WHISTANCE
M&A Director

For and on behalf of BDO LLP

ADAM WHISTANCE
M&A DIRECTOR

+44 (0)780 068 2036
adam.whistance@bdo.co.uk

I lead BDO's sector focused M&A team which specialises in insurance distribution, broking and services to the wider insurance industry.

I have a wealth of experience as a corporate financier focussed on the corporate midmarket, having worked for fifteen years transacting MBOs, sale mandates, acquisitions, PE and debt fund raising and solvent restructuring.

A SELECTION OF OUR RECENT DEALS

Sale
Sale of Doodson Broking Group to Integro

Acquisition
Acquisition of Keegan & Pennykid Insurance Brokers Limited

Sale
Sale of Churchill Insurance to Brokerbility

Investment
Investment by Carlyle Group

Sale
Sale of Perkins Slade to Howden

THE RISE AND RISE OF PRIVATE EQUITY

TRADE BUYERS DOMINATE M&A TRANSACTIONS…

Whilst the insurance broking industry has been no stranger to M&A activity, in recent years the transactional market has been largely dominated by trade consolidation at both a national and regional level.

Although the increasing burden of regulation, fragmented industry demographics and the focus of insurers on larger, lucrative accounts creates a steady “supply” of acquisition opportunities, the “demand” has often been led by the fundamental economics of buying power, cost rationalisation and the desire for growing investor returns.

During this intense period of consolidation industry heavyweights have all accumulated significant transactional experience and have developed a slick, streamlined, process orientated approach to completing deals. Their appetite for M&A has also filtered down into the wider market with many smaller regional independents seeing acquisitions as a viable growth strategy.

However the well-publicised travails of some of the market super powers and the resulting board-room carousel have led to a rethink in many acquisition strategies and an increasing focus on integration and good old organic growth.

…BUT PRIVATE EQUITY IS EXTENDING ITS REACH

Against this changing backdrop the market has also seen the increasing and widespread emergence of the “new kid on the M&A block” – private equity.

Institutional investors and private equity funds are no strangers to the broking market. Before its final consumption by AJ Gallagher, Giles had utilised two separate rounds of private equity funding to support its acquisition strategy and other users of similar funding include Hyperion, Admiral and even Smart & Cook back in the day.

However in more recent times interest in the sector has grown significantly and institutional investment is no longer the sole domain of large scale national brokers. It is now equally applicable for smaller intermediaries that have a valuable market position and a compelling growth story.

Whilst the investment in PIB and significant financial commitment by Carlyle may have occupied the headlines of the recent trade press, Stackhouse Poland, Nexus, Kingsbridge, Aston Scott, Iprism, Barbon, GRP, Tasker Group and more recently Innovation and Lorega have all taken private equity partners on board.

SCALING UP OF BROKERS PROVIDES GOOD RETURNS

So what is it that makes the broking market so attractive to private equity investors?

In its simplest form traditional private equity investors are seeking to make substantial financial returns through a 3 to 5 year investment window. In order to achieve the levels of required return private equity houses are looking for investment opportunities that can deliver profitable growth and have the management team to deliver a strategic plan against the backdrop of positive market conditions.

Neil Cox, the Sovereign Capital partner leading their insurance sector activity commented:

“Despite the significant changes to the insurance distribution market resulting from the growth of price comparison aggregator websites, brokers who provide customers with a more personal, tailored and human service continue to thrive with large numbers of privately-owned businesses continuing to grow strongly both organically and by acquisition.

With smaller businesses increasingly struggling under the ever-increasing burden of regulatory compliance, and the increased commissions associated with larger premium spend, the merits of increased scale are clear.”

THE RISE AND RISE OF PRIVATE EQUITY

LARGER GROUPS GAIN ECONOMIES OF SCALE

Big can be beautiful – as a broker grows it can benefit from arbitrage in commission rates with underwriters. Put simply the bigger you are the better rates you can command for retaining and placing new business. Therefore if private equity investment can be used to stimulate growth then this can have a compound effect on profitability, overall business value and resulting shareholder returns.

At a basic level brokers are essentially “fixed cost” businesses and have a level of cost and infrastructure associated with simply being in the market. However beyond the breakeven point incremental levels of commission and income do not have to be met with similar levels of duplicated cost and therefore this additional revenue can largely convert direct to profitability.

This means that as a broker grows its overall profit as a percentage of income can increase significantly whilst generating surplus cash that is not locked up in stock, work in progress or other working capital assets to the same level as say, a manufacturer. An investment in a broker to increase its cost base and stimulate growth can generate significant incremental profits when compared to alternative businesses. From an investors perspective you get a bigger bang for your buck.

BROKERS TEND TO BE RESILIENT INVESTMENTS

Despite the significant levels of consolidation experienced during the last 10 years, the market remains fragmented. Industry demographics combined with the spiralling cost of regulation and compliance all present potential acquisition opportunities for those with the skills and the necessary financial clout. For private equity investors acquisitions not only accelerate the benefits of scale but also provide the opportunity to deploy further capital to support existing investments and management teams.

Tom Elliott, Investment Director at Bowmark Capital commented:

“We see the commercial insurer broker model as having a high quality of earnings thanks to the strong levels of client retention that can be achieved. In addition, given the fragmented nature of the broking space we believe this market is set for continued consolidation.”

Whilst the focus for a private equity investor will be on growth it is also important that their investment has market resilience and significant downside protection. Most brokers will be dealing with a large volume of comparatively low value transactions when compared to their total commission revenue.

This revenue profile is often coupled with strong client relationships and high retention rates. Whilst brokers may have a number of significant clients the overall dependency on these accounts is low and not business critical. Brokers are essentially stable businesses and once they have achieved a critical mass they are largely resilient to negative market pressures.

From an investment perspective there are clear attractions to the broking industry with positive market dynamics that support private equity interest. However that is not to say that all brokers are of interest to private equity.

Strong management teams with a demonstrable track record of delivering growth and a clear business strategy are vital ingredients to any investment. Niche products and services and access to specialised markets are of particular interest – in these markets the broker retains a strong reason to exist. Their product and service is non-commoditised which helps mitigate the impact of price based competition.

THE RISE AND RISE OF PRIVATE EQUITY

THE KEY TO A SUCCESSFUL BUY & BUILD STRATEGY

Those seeking investment on the basis of a pure consolidation model – buy them cheap and stack them high – are unlikely to generate significant interest. This has arguably already been done in the commercial sector with varying degrees of success. Any buy and build strategy must have a clear objective, tangible benefits from integration and compelling reasons other than pure cost savings.

For those businesses with the right credentials, the current interest of private equity in the broking space is unlikely to diminish any time soon. The reasons and rationale to invest remain strong and it would be no great surprise to see the number of investments increasing as well as those already with private equity partners completing a secondary round of funding with new investment partners in the future.

At BDO we have significant experience of helping brokers with their strategic funding requirements as well as advising on a wide variety of corporate transactions including both acquisitions and disposals. If you would like to discuss what private equity could offer as an option for your business, we would be delighted to meet with you and answer any of your questions.

PCPI Q1 2016

M&A ACTIVITY STAYS STRONG DESPITE BREXIT UNCERTAINTY

EU REFERENDUM HAS NOT STILTED DEALFLOW

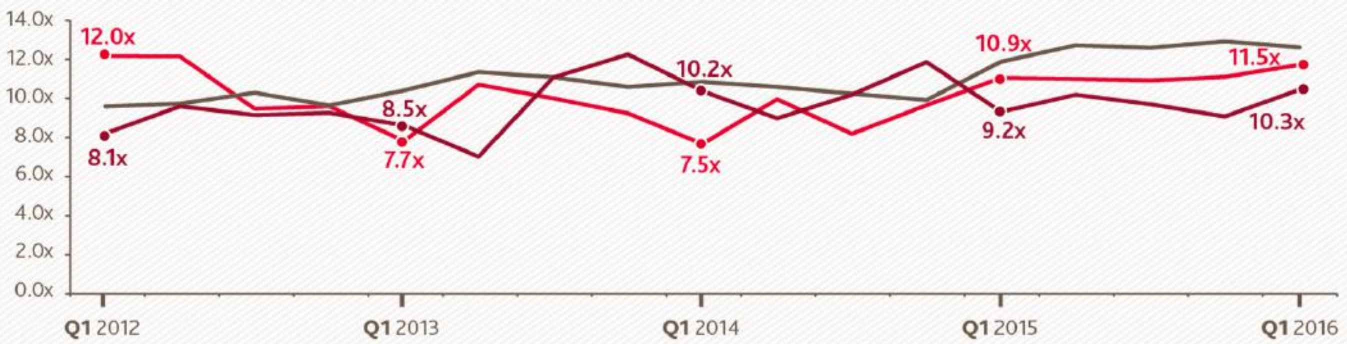
2015 ended on a high with 642 deals and the highest deal volume since before the recession. The first quarter of 2016 saw a slight drop to 629 deals but still reflects a strong and active M&A market despite a backdrop of global instability and Brexit uncertainty.

The PCPI/PEPI index, which tracks multiples paid by trade and private equity buyers for private companies, saw both trade (10.3x) and private equity (11.5x) prices increase.

We continue to see strong appetite for quality businesses from UK buyers, international buyers and private equity investors. There is a real desire to pursue inorganic growth strategies and, with debt markets being firmly open, there is real competition in auction processes at present.

Despite recent currency fluctuations, private business owners are taking Brexit uncertainty in their stride. As yet, we have not seen a direct impact on deal volumes in the mid-market or on values achieved. Based on current activity, we predict another strong year for M&A.

PCPI V PRIVATE EQUITY | Q1 2012 – Q1 2016



Source: Capital IQ and BDO Research

VOLUME OF DEALS COMPLETED | Q1 2014 – Q1 2016

Source: Corpfin

MAKING THE MOST OF THE PCPI/PEPI

The PCPI has been updated to incorporate Enterprise Value to EBITDA multiples as the method of valuation, replacing the previously used Price to Earnings ratio. These changes have been made to incorporate the level of debt in deals and to use a less subjective measure of profitability. Historical data has been incorporated to ensure comparability and to identify trends.

The PCPI/PEPI tracks the relationship between the Enterprise Value (EV) to Earnings Before Interest Tax Depreciation and Amortisation (EBITDA) multiple (EV/EBITDA) paid by trade and private equity buyers when purchasing UK private companies.

The private company EV/EBITDA is calculated from publicly available financial information on deals that complete in the quarter. At present, the Private Company Price Index (PCPI) indicates that, on average, private companies are being sold to trade buyers for 10.3x historic EBITDA. The PEPI indicates that, on average, private companies are being sold to private equity buyers for 11.5x historic EBITDA.

As private companies are generally owner-managed, reported or disclosed profits tend to be suppressed by various expenses that may be non-recurring under a new owner. This will have been factored into the price the purchaser paid, but may not be reflected in the profits declared to the public. The effect of this is that the EV/EBITDA paid as calculated from the publicly available information may be overstated.

The PCPI/PEPI is calculated as the arithmetic mean of EV/EBITDA for deals where sufficient information has been disclosed. Over the five years to December 2015, the included deals for the PCPI have had a mean Enterprise Value of £78.3m and a median Enterprise Value of £15.8m. This included deals for the PEPI have a mean Enterprise Value of £112.1m and median Enterprise Value of £33.5m.

The PCPI/PEPI is an average measure and a guide, not an absolute measure of value, as there are many other factors that can have an impact on value.

1. Independent research (Mid Market Monitor 2012-15) undertaken by Meridian West shows BDO has the highest client satisfaction rating among its peers
2. Client Listening Programme 2014/15

FOR MORE INFORMATION:

ADAM WHISTANCE

+44 (0)780 068 2036
adam.whistance@bdo.co.uk

www.bdo.co.uk