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Q&A

2002: More broker/agency deals, but maybe not much else, adviser says

Kevin P. Donoghue is the managing principal at Mystic Capital Advisors Group LLC, a New York-based M&A advisory firm that opened in October. In that capacity, he guides companies as they decide whether to merge or acquire and, when they do, advises on the transactions.

Before he founded Mystic Capital, Donoghue started and developed BMG Capital Advisors Group LLC, part of the Hartford Financial Services Group Inc. (HIG), where he oversaw dozens of transactions. He has also worked at the national accounting firm KPMG Peat Marwick. He is a certified public accountant.

Donoghue does not expect big increases in M&A activity this year, except in the area of broker/agency sales — the retail sector — where he says the numbers make consolidation a sure bet.

"Banks have bought brokers and there are a number of other financial players that are looking in that space to try to bank on what they think are natural synergies," Donoghue said. "So I think you'll continue to see a large amount of M&A activity in the retail space."

He discussed these and other consolidation issues with Insurance Mergers & Acquisitions *Editor Dail Willis recently. What follows is an edited transcript of that conversation.*

IMA: Tell me about what Mystic Capital does.

Donoghue: We're a mergers-and-acquisitions consulting firm focused on the retail insurance and financial-services industries. Our clients include insurance agencies and brokers, banks, microcap insurance companies, third-party administrators and insurance wholesalers.

How do you define microcap?

Under $100 million in annual premium.

What do you see in the way of M&A activity for 2002?

We try to break the industry down into three sectors: the life insurance companies, property & casualty and the retail space. In the life space, I think there's going to be a huge increase in the demand for those products, but I don't think that increase is going to spur an increase in consolidation because you're really rolling the dice generally … that your products are going to be competitive with that acquisition, and your products are going to be organically competitive. It just doesn't make sense to overpay for something that you don't know if you would have already got that business ahead of time. So I don't think there's going to be an enormous amount of consolidation.

However, there may be a company or two that wants to add a certain product line in that life [business] that might feel compelled to pay up in this marketplace. But in a rising-pricing market, as far as expectations go, companies really need to beware about making acquisitions.

And that really dovetails right into property & casualty, where I personally believe that the expectations of the magnitude of the pricing increase, and the longevity of that pricing sustainability, is overinflated in both instances. I think property & casualty firms would be best … to sit on the sideline for now and see what companies are going to actually lose volume, and which companies are going to have reserves further deteriorate, before they go and try to make acquisitions. I think those property & casualty companies for the most part, their stocks are inflated with that overexuberance of pricing already — so to further pay a premium for a company would be dangerous.

You don't think the 30% to 50% increases will happen and/or they may be of shorter duration than expected?

Yes. There's a lot of money that's flowed into the marketplace post-Sept. 11, and that is going to keep pricing down to some extent, just because of the competitive nature that expects to buy premium dollars. You don't buy premium dollars at above-average premium rates.

What about on the retail side; what do you think will happen there?

Retail — it's just the law of numbers. It's going to continue to consolidate. A lot of people are looking at the space, as well as the peer brokers buying brokers.

What about big deals like the American General Corp.-American International Group Inc. (AIG) one? Do you think we'll see any more of those?

I don't think we'll see any in the next 12 months. A lot of things would have to go wrong for something like that to happen. So I would think that right now, the deals you'll see are more on the small side of the insurance sector, where it's companies buying a product offering or certain demographic or regional customer base.

Why do you say a lot of things would have to go wrong? Explain that part.

Because I can't foresee a reason why two large insurance companies would get together right now. There's few up there, and they're competing against each other pretty viciously for business. So with the pricing increases, it just doesn't make sense for that merger to happen right now. Insurance companies should be keeping their operating expenses pretty lean right now, so if there's someone buying into a true merger, and true cost reduction, I think they might be quick to overinflate those reductions.

What about the demutualizing companies that are coming to the end of their quiet periods? I'm thinking specifically of John Hancock (JHF) and Prudential (PRU).

I think those two are pretty well positioned in this marketplace right now — especially with the increased demand in life and annuity prod-

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ucts coming up — to grow organically. So they're going to have enough benefits inside without having to stray too far, to make a mistake with an acquisition or two.

The foreign acquirers — where will they be in the coming year?

A couple of years ago when a number of companies were deflated, that was an attractive time, maybe even a missed opportunity, for some of those folks. But now, with the pricing expectations, a lot of these property & casualty companies are trading at somewhat historical premiums. And if those price increases don't hit, they're trading at really significant premiums to what their true value is. So I think that's going to keep the European buyers on the other side of the pond for a little bit longer.

A lot of capital is being put into the reinsurance sector — it might be accurate to call it a river of capital. What's that going to do to market activity and M&A?

If it's smart, that capital is going to keep the M&A down. Just because of supply and demand — you can acquire the premiums through the sales channel without having to go buy a company. So certain folks may desire to buy retail or wholesale distribution, vs. going to buy a company, because that product distribution is probably more important than underwriting capabilities and premium dollars.

Banks have not gotten into the insurance business in the way expected after financial services reform a couple of years ago. Why do you think that is?

I think banks have really avoided the balance-sheet risks associated with owning an underwriter. With Travelers now being spun off, I think Citigroup (C) now sees that. The Citigroup-Travelers [matchup] was supposed to start the dominoes flowing in one direction. I think what happened is, it proved just the opposite — that banks aren't ready to have the credit risks associated with underwriting losses on their balance sheets. They're more apt to buy the distribution channel, where they understand it quickly and they can see it's pure fee-based revenue. That dovetails more in line with what Wall Street and folks are dictating towards banks — you know, increase more fee-based revenue than traditional percentage-of-interest revenue. I don't necessarily subscribe [to the idea] that that's the right attitude, but it's the attitude that people are embracing.

Do you think that banks are making wise purchases in this area?

I don't think banks are making wise purchases; I think the multiples that they're paying are far in excess of what they're worth. The idea that you sometimes have to overpay to get into a marketplace is a fallacy. Smart acquisition is smart in the financial terms; it has to have a financial reward. Just to say you have a capability, does that justify paying an exorbitant premium? The banks that have been successful are those ones that go above and beyond in the planning stages and really drill down into the demographics of their commercial loan portfolio and commercial customer base, to see by size and region what types of customers they have — and then go match those customers' needs, whether it be small commercial or middle-market commercial or real national account-style customer base — with a product-distribution solution, whether it be an acquisition of a regional-size agency or a joint venture with a major commercial brokerage house.

Life and financial products really is a natural for banks. They can sell it, it does make a lot of sense, they can be sold through the mail with statement-stuffers, they're very competitively priced products across the board. The affluent products can be sold through their private-client services in a very cost-efficient manner. The life insurance companies out there have found the banks and financial institutions to be the ideal distribution vs. a traditional retail-insurance model, so the banks seem to be the best model already for that. To create that, you can create it inhouse, organically, so you don't have to go and buy a retail-distribution model. ■

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