Rumor Mill: Going for brokers

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By Kelly Durkin

As the insurance market picks up the pieces from a dismal third quarter and observers indicate the beginning of the end of a soft market, a prime opportunity may be appearing for public insurance brokers looking to grow and recover through consolidation.

Industry consultants and observers have begun to see anecdotal evidence of rate stabilization, or even hardening, amid eroded balance sheets and higher reinsurance prices.

Kevin Donoghue, managing partner with Mystic Capital LLC, said he sees the market as "leveling off," with signs it might harden in the middle of 2009, and he believes that threat of tightening could lead to more deals. Marsh Berry & Co. Inc. President John Wepler told SNL that he believes evidence of rate hardening is already appearing and would be conclusive to the market in the first quarter of 2009. Wepler's firm expects to close on eight broker and agency-related transactions in the fourth quarter, with a supply of "high-quality" sellers lined up for 2009. According to SNL data, 20 deals for insurance broker companies and insurance broker assets have been announced since Sept. 30.

With high expectations from Wall Street and organic growth for public brokers of about 1% or less, growth through mergers and acquisitions may be the only plausible move, said Brian Deitz, a consultant with Reagan Consulting Inc.

Arthur J. Gallagher & Co. and Brown & Brown Inc. have both been active in expanding through M&A activity, with 26 broker deals and 24 broker deals announced, respectively, in 2008, according to SNL data. Yet if the market hardens, Deitz said, their drive to grow through deals could decrease if the opportunity arose for strong organic growth.

"I think, simply put, they won't need to do it as much," he said. "I think it's a great strategy for them to get into markets they're not in, to supplement their product line capabilities, so I don't think we'll see deal activity stop in a hard market, but I do think the public brokers will be under less pressure to do deals to satisfy Wall Street's growth expectations."

Any demand for brokers to sell might not necessarily be matched by a larger pool of buyers. With capital restrictions on buyers at every turn, whatever acquirers do arise will be looking more closely and critically for companies with the best valuations.

Historically, bank-owned agencies have been active participants in broker deals, but Wepler said, many have stalled in their willingness to allocate capital to a broker acquisition, and some banks have even begun to question their investments in the insurance business altogether. Private equity has also been a fixture in the space, but the credit crunch has significantly increased the cost of leverage, forcing private equity firms to use more equity to finance deals.

One potential trend Deitz said he sees in the broker market is for privately held regional and local brokers to take a lead in pursuing deals in 2009. As valuations for agencies and brokerages have increased, private equity firms or larger banks that can see large returns in the public markets have outpriced many regional and local brokers. Since the issue of capital has put constraints on splashier deal pricing, local and regional brokers may regain their footing deal-wise.

Consolidation in the broker space may not be solely for survival, but also for the benefit of being a larger company with more power at the negotiating table. In the future, Deitz said, the brokerage field will consist of a smaller number of large companies growing for both leverage reasons, but also in consideration for the next generation of shareholders. As aging baby boomers decide whether to perpetuate their shares internally to eager up-and-coming shareholders or sell to a third party, the possibility of deals will always be a constant in the marketplace.

"This is just an industry where there are benefits to being bigger," Deitz said. "We've seen the average size of agencies grow pretty quickly over the last 10 to 15 years, and to be a $15 million agency as opposed to a $2.5 million agency, you've increased your competitive ability."

But the time for larger broker deals may have passed, at least for now, with the closing of Willis Group Holdings Ltd.'s acquisition of Hilb Rogal & Hobbs Co. in October. With Gallagher, Brown & Brown, Aon Corp., Marsh & McLennan Cos. Inc. and Willis as the five big play-

Top 10 insurance broker deals announced between Sept. 30, 2007, to Sept. 30, 2008
Ranked by deal value at announcement

Buyer	Target	Seller (if different)	Ann. date	Comp. date (if applicable)	Ann. deal value ($M)
Willis Group Holdings Ltd.	Hilb Rogal & Hobbs Co.		06/07/08	10/01/08	1,706.9
Aon Corp.	Benfield Group Ltd.		08/22/08		1,583.3
Enstar Group Ltd.	Reinsurance & insurance operations	AMP Ltd.	12/10/07	03/05/08	514.3
Assurant Inc.	Signal Holdings LLC	Investor Group	07/31/08	10/01/08	250.0
Evercore Partners Inc.	Bollinger Inc.		03/31/08	03/31/08	250.0
QBE Insurance Group Ltd.	Deep South Holding LP		06/04/08	06/04/08	189.7
RenaissanceRe Holdings Ltd.	Agro National LLC	Agro International Inc.	04/11/08	06/02/08	80.5
White Mountains Insurance Group Ltd.	Answer Financial Inc.		04/01/08	04/01/08	72.0
Stone Point Capital LLC	Westwood Insurance Agency	Centex Corp.	09/30/08	09/30/08	55.0
Arthur J. Gallagher & Co.	RSI		05/01/08	05/01/08	54.8

Excludes deals for which a deal value is not available.
Source: SNL Financial

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ers on the block, Deitz said it is more unlikely than not that these companies would be bought.

"I would have told you if we were having this talk a year ago that we would most likely see another private equity deal," Deitz said. "It wouldn't have shocked me if someone had come in and purchased Gallagher, but now I'm not so sure. Gallagher doesn't want to be bought, and they've made that pretty clear."

In the current environment, acquiring a company the size of Aon and Marsh would be difficult but not out of the question, Deitz said. "I don't think you would eliminate private equity doing one of those deals, but I think the odds of that — just given how difficult capital is to come by right now — aren't great."

But a hardening market and "bigger-is-better" attitude may not be the only impetus for deals in the insurance sector. Donoghue said a possible increase in the capital gains tax during the first years of the Obama administration could cause insurers to act on potential deals. The plans of the incoming administration are unknown, but during his campaign, President-elect Barack Obama said he would consider increasing the capital gains tax from its current level of 15% to a level between 20% and a rate no higher than 28%. If the new administration is able to raise the tax, brokers and insurers in general considering deals in 2010 or 2011 may try to get their deals done before the tax hike becomes effective to keep a larger slice of the profit pie for themselves.

"I think it'll be an active '09 season, and you would think that if capital gains do in fact change in 2010, there will be a significant decline in volume in 2010," he said. "The last few months have been dramatic because the credit crisis has made it more difficult to get deals done. As credit starts to ease up, some of those deals will come back to life in '09, and that's why I think '09 in general will be a record-type year for M&A." *i*

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