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No M&A malaise for MGAs

BY AA&B SPECIAL REPORT

Published 11/17/2010

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By Dale A. Myer, senior vice president, Gill and Roeser Holdings, Inc.

Merger and acquisition activity began heating up in the managing general agency (**MGA**) and managing general underwriting (**MGU**) sector during 2010. The continuing soft market, the long and steady decline in insurance rates plus the effects of the recent recession have led to reduced exposures, smaller books of business and lowering premium prices for many property and casualty insurers. The combination of these factors is forcing insurance company executives to explore new ways to improve top-line growth, while maintaining underwriting discipline, generating adequate profits, and putting underutilized surplus to work effectively and efficiently. MGAs and MGUs are increasingly being viewed as targets for mergers and acquisitions because of their perception as "virtual insurance companies" and their ability to generate underwriting profits.

Today, many insurance companies are sitting on balance sheets that carry extremely **low underwriting leverage** (premiums/surplus) and relatively **low levels of ROE** (return on earnings). To compensate, insurers are keeping higher net retention levels at the primary level. Reinsurance pricing continues to be weak and the current low premium/surplus ratios are forcing reinsurance markets around the world to aggressively price their products and services to deploy their capacity. Even in light of minimal catastrophe losses in the U.S., reserve takedowns have in all probability run their course. Going forward, it's doubtful that reserve takedowns will continue to be a viable tool to enhance bottom-line performance. Finally, with extremely anemic investment returns, the asset side of an insurance company's balance sheet is not able to offset poor underwriting results.

Read related: "Have you updated your agency valuation?"

In acquiring MGAs and MGUs, insurers see a way to retain (for defensive purposes) or purchase (for offensive reasons) **gross written premium dollars**. The ability to evaluate the MGA/MGU business model and perform detailed actuarial due diligence on underwriting results eliminates many of the real or perceived risk factors when looking at the acquisition of an MGA or MGU. Some of these deals also add specialized underwriting teams and even capture technology efficiencies that many MGAs and MGUs have developed or refined over time. It is not all uncommon to see MGAs and MGUs posting operating margins as measured by pro forma earnings before interest, taxes, depreciation and amortization (**EBITDA**) of 20 to 40 percent of gross revenues.

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As for MGAs and MGUs, they have generally gotten stronger over the past 10 years. Many focused on being a good underwriting partner with their issuing carrier and its reinsurers. Some have even established profit and risk-sharing structures that aligned the interests of all parties on building long-term appointments with stable markets. The most successful MGAs and MGUs have reinvested their capital back into operations, making them more efficient and profitable. This investment included embracing technology to enhance operating margins and EBITDA.

Read related: "Deals in the balance."

There are other factors that make the valuation of an MGA or MGU even more compelling for an insurance company versus other buyers such as another MGA or MGU or a private equity firm. These include the addition of underwriting profits and investment income to the acquiring insurance company.
When these two value sources are added to the underlying EBITDA of the MGA or MGU, the resulting purchase price can be significantly enhanced. The firms generating interest produced annual gross written premiums as low as **$10 million to well over $200 million**. Many of these entities consistently posted very desirable underwriting results. In addition, the technology enhancements and various profit sharing arrangements in place with these MGAs/MGUs increasingly makes them look attractive to insurance company executives.

Read related: "Deals or no deals."

When all of the factors outlined in the preceding paragraphs are taken into consideration, the owner of an MGA or MGU in today's market may be sitting on an asset with higher potential value than he/she might have otherwise recognized. As we see it, the demand for MGAs and MGUs is strong and will even increase, while the supply of well- run MGAs and MGUs is finite. This market imbalance should lead to an intersection of the supply and demand lines at a higher point, equating to higher valuations for MGAs and MGUs.

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If an MGA or MGU owner wants a change in his/her ownership position, there is a good reason to be hopeful for a positive outcome and a substantial financial reward for years of toil and sacrifice.

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Dale A. Myer is senior vice president at Gill and Roeser Holdings, Inc, a member of FINRA. He has extensive experience in insurance M&A, banking, and structuring M&A transaction. He holds Series 7 and 63 licenses. Gill and Roeser Holdings works with its sister company, Gill and Roeser, Inc, a reinsurance intermediary. Dale can be reached at 212-972-4880 or dmyer@grholdings.com.

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