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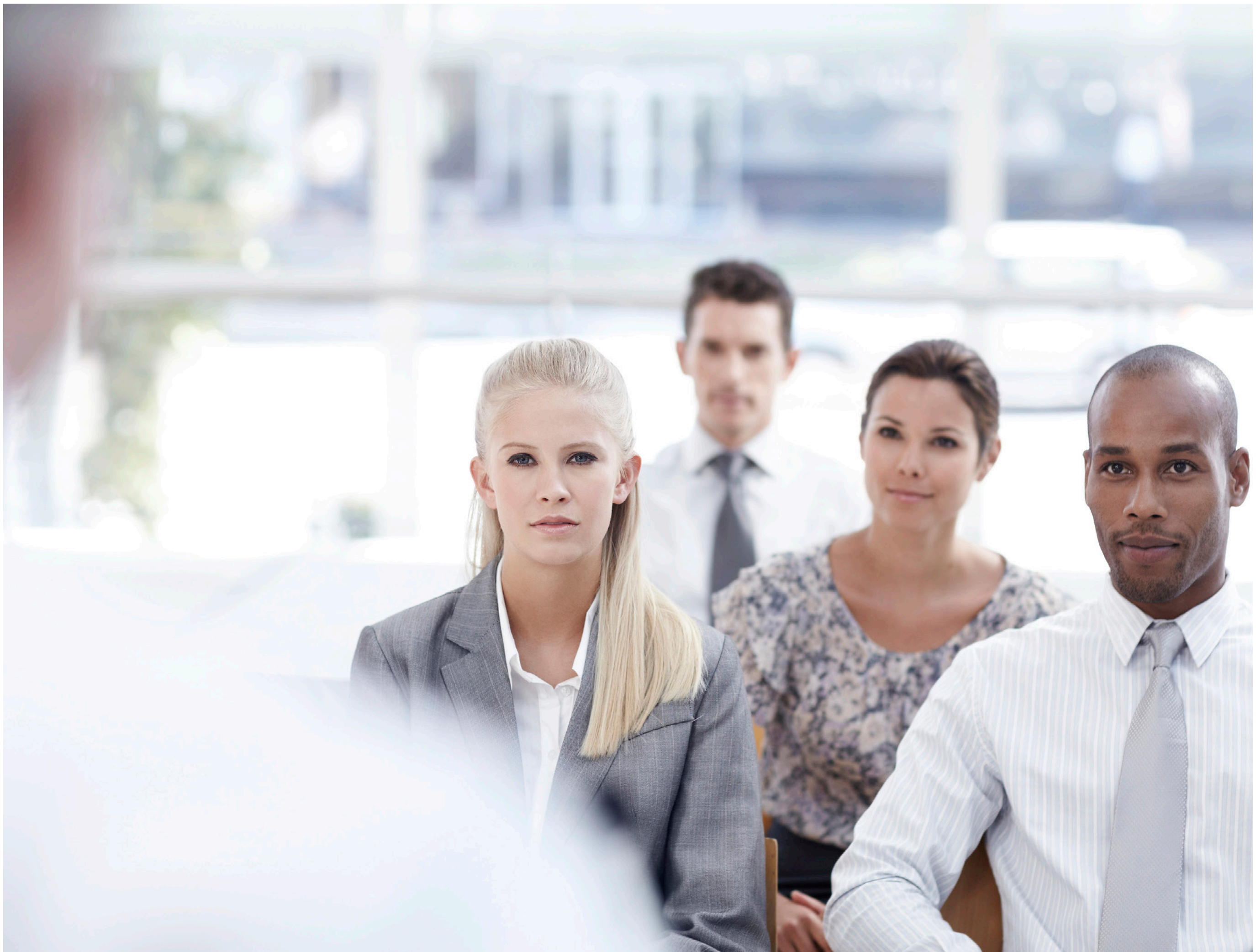

INSURANCE PROFESSIONALS GUIDE TO FINANCE

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A GUIDE TO FINANCE FOR INSURANCE PROFESSIONALS

Every business needs capital. It's your stake in that big lifelong game called Success. Your capital empowers you to do a lot more than keep the lights (and computers) on: it's the foundation for your future growth, and your protection during future economic downturns.

Traditional industrial companies have both liquid capital—their cash and financial assets—and capital goods: the buildings, equipment and inventory that could be sold off in a pinch to raise funds. In addition to accumulating profit, these companies raise capital in order to expand or to endure hard times by taking loans or inviting direct investment. The bigger the business, and the more capital it already has, the more likely it is to obtain more.

Access to capital is difficult for small businesses, for new businesses, and particularly for service businesses whose assets are primarily intellectual. This includes insurance agencies. These businesses need to leverage their ability to generate consistent cash flow to gain access to capital. Recently, the task has become a little easier, as the business community developed a better understanding of the value of intellectual capital and the sustainability of insurance agencies' cash flow.

For Insurance agents, the issue of capital is far from academic. We are at a time when the average age of a principal of an insurance agency is 54.3 years, and 56% of agencies plan to transition books of retiring producers, with a transition period of approximately 3.25 years. "There's a lot of action in the world of inorganic growth. Some is first-generation owners passing to the second generation, and some is strategic," says Michael Strakhov, CPCU, Insurance Domain Expert at Live Oak Bank.

According to SNL Financial, 326 insurance agencies changed hands in 2014, and 377 deals had been announced for the 2015 calendar year as of late October that year. This is well above the average 262 transactions per year that took place from 2004-2014. These numbers, however, count for only about 10 to 20% of insurance agency transactions—the remainder are not recorded because they are small and private. Clearly, as agency principals approach retirement age, insurance is an industry facing considerable transition in ownership in the coming decades.

Financing business activities is an area that leaves a lot of professionals confused and uncertain. If a principal wants to transition his or her book within the agency, finding appropriate financing at a reasonable cost is crucial. This paper will outline the various forms of capital available to insurance agency principals for expanding, acquiring, or modernizing a business, as well as recruiting and other activities.

Of course, both buyers and sellers need to work closely with appraisers, tax professionals and attorneys to ensure they formulate a deal structure that works for their needs, as well as the needs of the business and their clients.

SELLER FINANCING: A POPULAR WAY TO CLOSE A DEAL

As its name describes, agency owners often find that in order to close a business sale, they have to finance at least part of the transaction themselves. Typically, this includes a percentage of the purchase price as a down payment and the rest will be paid back over time, with interest.

Incentives for financial performance will be built into the deal. Buyers may protect their investment with an "earn-out." This can require that the seller stick around to facilitate a smooth transition to new management and peg the final payout to the performance of the business over the next three to five years. Earn-outs can be based on retention, top-line revenue growth, profitability—or a combination of criteria. Buyers need to understand the book of business being acquired and the potential risks associated with the transition. For example, how likely will the largest accounts stay with the agency after acquisition, is there risk of producers leaving the agency, how will the carriers react to the announcement, etc. Both buyer and seller need to understand that they are equally vested in the firm's success—and trust one another to be equally committed.

For buyers, the advantage of seller financing with an earn-out is motivating the seller to do his or her best to help the new owner succeed. The disadvantage of an extended transition is that the seller may overstay his or her welcome, preventing the buyer from modernizing or otherwise upgrading the agency. This can lead to tension in the office and even buyer's remorse.

FRIENDS AND FAMILY: LOVE SAVES THE DAY

Many businesses begin with funds put up by family and friends—the original angel investors. Some of these businesses will make their financiers rich. Friends and family of insurance agents, however, will find that their potential rewards are somewhat lower but so are their risks.

The ups and downs of raising capital among one's inner circle are obvious. The lenders must be comfortable with the idea of investing in the agent's business--or Thanksgivings and other holiday gatherings could become tense. The agent has to live up to the expectations of loved ones. It can be an easygoing process or extremely emotional.

Nevertheless, loans from family and friends are still business transactions. For legal and financial reasons, it is essential to have written loan or equity agreements with family and friends reviewed by attorneys. The lenders need to charge interest or the IRS may view the loan as a gift. If the venture is not successful, family and friends will rely on the paperwork for their tax deductions. If the venture is extremely successful, the paperwork will protect the borrower, who will want to repay the loans and share the profits as agreed—and not necessarily beyond.

SBA LOANS: BORN IN THE USA

An agent who applies for an SBA loan is not borrowing from the government directly. Instead, the Small Business Administration guarantees bank loans to small businesses that meet the SBA's criteria. These criteria vary by industry, but are notably more lenient than a bank's typical loan standards, which fits with the SBA's mission to expand business ownership and create jobs. Terms are generous, up to 10 years for a business loan with no prepayment penalty.

SBA loans can be used to acquire a book of business from a retiring principal or from another agency, as long as that agent's practice is based in the United States. The loans can be used for working capital to expand the firm, accommodate a new producer, fund a technology upgrade, refinance existing debt or even build or buy an office.

Many banks may offer SBA loans but not be adept at handling the paperwork. Although a bank with

conventional capital, Live Oak Bank specializes in SBA loans and has developed expertise in how to guide insurance professionals through the application process. In addition, Live Oak's online portal technology makes the application process much faster, easier and more transparent than the typical loan experience. The key is being able to go beyond collateral to evaluate agency cash flow, which depends not only on the book of business, quality of the insurance carriers, historic profitability, and product mix, but also on the quality of the client list, among other variables. For acquisitions, the bank requires agencies to obtain a third-party valuation just prior to loan closing.

For insurance professionals who are acquiring an agency or book of business, an SBA-backed loan can serve as leverage for negotiating a better purchase price by reducing the need for seller financing. "Say you're buying a practice for a million dollars," says Kelly Drouillard, Senior Loan Officer at Live Oak Bank. "In a traditional seller-finance situation, you may see cash at close to the seller of $250,000 and a note for $750,000. With a loan, cash at close to the seller may be $750,000 with a note of $250,000. Cash is king. This is typically much more attractive for the seller."

BANK LOANS: IT'S A WONDERFUL LIFE?

Banks are the primary source of credit and the first lending institution that comes to mind for most borrowers. Here, however, a business based on intellectual capital that lacks tangible assets may have trouble qualifying for a loan. Banks want their business loans to be collateralized, and an agency's laptops and file cabinets typically won't suffice.

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Commercial loans have never been easy for small businesses to obtain, but since the financial crisis of 2008, banks have further tightened their lending standards. Expect to supply several years' worth of financial statements and to show a history of consistent growth. Also expect a general lack of comprehension of an insurance agency's business model, unless the agency has an ongoing relationship with the banker. Furthermore, be hopeful that your bank has an FDIC charter that will allow for collateral shortfalls.

An insurance agent who qualifies for a bank loan will enjoy several advantages. Interest rates, despite the recent rise, remain at near historic lows, so the cost of the loan is relatively affordable. Although borrowers may have to show a plan for how they plan to use the funds, they also have more flexibility in deal structure.

MEZZANINE CAPITAL: FUELING RAPID GROWTH

Agencies seeking to borrow at least $2 million for external acquisitions may qualify for mezzanine capital, which is a type of debt that is best used by firms that are growing rapidly. Mezzanine debt is subordinated debt, which means that the lender's rights to the borrower's money come after he or she has paid off other, more senior loans. Generally, mezzanine loans are expensive and terminate with a balloon payment after about 7 years, which can be stressful for the borrower.

Why would a borrower seek mezzanine financing? For firms that are serial acquirers, for instance, mezzanine capital can be an additional source of capital to complement senior bank debt. A firm that gains access to mezzanine debt could be able to execute acquisitions without being limited to senior debt or new investments by its principals. Mezzanine capital, while bearing higher costs than senior bank debt, is less expensive and dilutive to ownership than outside equity capital.

For mezzanine lenders, these loans have the potential to generate high returns. In addition to paying interest, the borrower is typically required to provide warrants that enable the lender to purchase equity (typically "penny" warrants) with a put option to sell their equity stake back to the firm at a pre-defined price (agreed upon multiple of cash flow) in 5 to 7 years.

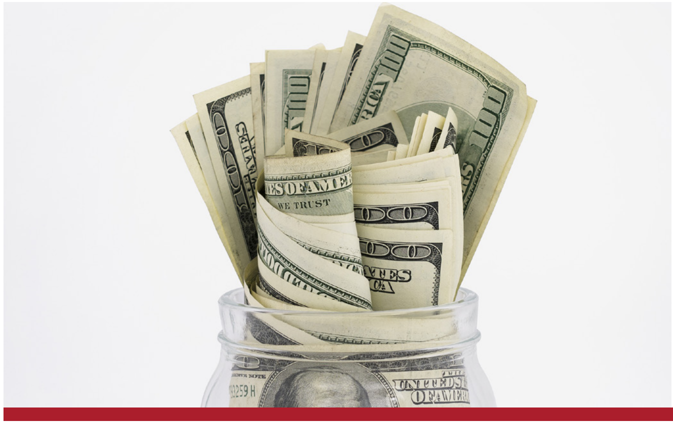
While mezzanine lenders expect a wide range of returns, they generally target an overall Internal Rate of Return (IRR), based upon interest rate and equity return (or some other form of "kicker") of at least 10%. For example, if a lender targets an IRR of 12% and receives interest of 6% on a five year investment, the lender would also require warrants that attach to an equity ownership position in order to reach the target IRR. If the lender projects firm equity value in Year 5 (the "exit" year) to be $5 million and needs the equity position to be worth $500K to drive a 12% IRR, the investor would take warrants, upfront, equal to a 10% equity position in the firm. The mezzanine lender exceeds its IRR target if the firm valuation in Year 5 is worth more than $5 million; on the contrary, the lender does not achieve the IRR target if the firm is valued at less than $5 million in the exit year. While we've addressed equity warrants in this paper, there are certainly other structural options with mezzanine debt that do not dilute ownership, such as sharing in profit or cash flow, to meet IRR expectations in excess of the interest rate.

PRIVATE EQUITY: THE POWER PLAYER

Private equity ("PE") firms have been making a splash in the insurance industry for the past few years and now account for almost 40% of large-agency acquisition activity . They've discovered the high profit margins and sustained cash flow, and they want in.

Bear in mind, however, that private equity is the most expensive form of capital available to the business owner. Outside equity may come from PE firms that may take a passive (minority) ownership position or from strategic sources such as aggregators (consolidators) who desire to own the firm, or a controlling interest, at some point.

Private equity, like mezzanine debt, can be a source of capital for the serial acquirer to enhance acquisition



capacity and accelerate growth. For the owner desiring to retain control of the firm over the long term, private equity is more desirable than strategic equity, which seeks ownership control at some future date.

Insurance agents who are considering a private equity infusion should study the cultural ramifications of aligning with an outside equity partner, whether a PE firm or strategic capital. PE firms are focused on generating target returns based on a firm's valuation in the exit year (typically 5-7 years from the initial investment). To achieve that, they aim to maximize free cash flow (EBITDA). The exit valuation is typically based on a pre-agreed multiple of EBITDA, so the bigger, the better. If your ownership horizon is longer term, you may want to make investment decisions which enhance your value proposition and client experience, but that don't bolster short term profitability. Although the additional discipline around creating scale and maximizing profitability that comes with outside investors can be positive for the business, insurance agents need to reconcile in advance that different time horizons may create tension. It is up to both sides to ensure that this remains constructive.

In the end, private equity or strategic equity can be an additional source of capital to accelerate growth and build firm value. It is not, however, for the faint of heart!

PREPARING FOR A STRATEGIC MOVE

It takes time to prepare for a transaction and apply for capital. Insurance professionals would be well-served to use that time to examine their own businesses and make them as efficient as possible. A focus on standardizing office processes and accelerating organic growth will make the agency more valuable and possibly help the firm qualify for additional credit.

Both buyers and sellers should get their firms appraised by an objective third party. "A typical insurance agent's firm valuation comes as a range with a middle line," Strakhov explains. "Obviously a well-run, growing agency with strong carrier partnerships and historic profitability will bring the most attractive valuation. Taking the necessary action to best position the agency well before you seek any form of financing will lead to the best possible outcome for the borrower."

Using capital wisely can be the key to healthy growth for a firm and wealth for an owner. Have certainty in your financing partner, a bank uses its own capital and financing obligations are binding. Take time to work through options and consult with experts to ensure your next steps are successful.

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