

## Low Interest and Capital Gains Tax Rates Continue to Drive the M&A Market

*Salem Five's Andrew Drayer Discusses the State of the M&A Market*

Insurance agency merger and acquisition (M&A) activity has been trending upward in the last several years with the number of agency transactions in 2021 up 30% from 2020. Favorable interest rates, investors flush with capital and low capital gains tax rates have been driving the M&A market, according to Andrew Drayer, SVP, strategic growth, Salem Five Insurance.

“The number one driver really has been that borrowing money has been fairly inexpensive to do,” said Drayer. He recently took part in a webinar with members of the Central Massachusetts chapter of the CPCU Society. Large private equity (PE) organizations have been able to borrow money at a very favorable interest rate. Coupled with the high retention rates of many agencies — around 90% — PE firms are seeing strong returns on their investments. Banks and large agencies recognize the opportunities as well and have entered the insurance space in earnest.

Not long ago, many independent agencies were family run businesses, passed down from one generation to the next. This type of transfer is happening less frequently today in part because the sons and daughters of agency owners

do not have the capital to buy out their parents, noted Drayer.

### Timing the Market

When an entity is considering acquiring an agency, there are numerous financial components to consider. The buyer is acquiring a book of business and assets to grow their own business, but they are acquiring talent as well. Do buyers look for an acquisition opportunity simply because they are hoping to acquire the talent that comes with it? Talent may not be the only reason to pursue an opportunity, but it does factor into the equation, according to Drayer.

Choosing which agency to acquire is part art and part science. It is not a matter of deciding to pursue these three potential opportunities while ignoring 15 others, explained Drayer. What it ultimately comes down to is timing. “It’s really about being opportunistic. We see agencies that we would love to acquire all the time, but whether or not the opportunity to acquire that agency is going to present itself at the time that we’re ready to approach it doesn’t necessarily sync up.”

### Acquisition Models Vary

Acquisition models vary depending on

the buyer — PE firms, non-PE firms, banks, agencies, etc. Regardless of the model, it is critical that all parties involved in the transaction be upfront and transparent about expectations. Some buyers choose to leave processes and personnel in place while others intend to make changes.

“Our goal — not immediately but ultimately — is to make that agency a part of Salem Five and to have a similar set of processes, culture and behaviors,” said Drayer.

Some deals are structured to provide an earnout over a period of time, perhaps three years. During that time, the seller will earn some portion of the acquisition cost. The buyer will remain “pretty much hands off,” but will detail what growth and profit benchmarks the agency needs to hit in a certain timeframe.

Drayer explained that earnouts can be alluring to some sellers because they feel as if they have their independence and may not have to change the way they conduct business.

While there is a segment of agency principals of retirement age who want to sell

their agency for a cash deal upfront, Drayer is hearing from an increasing number of agency owners who are not ready to retire but are looking for help handling recruiting and retention challenges, training, compensation and benefits packages, etc., all of which require considerable time and investment that take the agent away from selling and servicing clients. These agents may look to a buyer that can provide them with that kind of support.

## Communicating a Merger or Acquisition to Employees

There are different views on how many employees an agency should have per hundreds of thousands of dollars of revenue. In the three or four years leading up to an acquisition, the buyer needs to know if the agency has shrunk or grown and what the agency principal's plan is.

There are situations where there are more employees at an agency than make sense for the buyer from a profit standpoint. In those cases, M&A deals are structured in such a way that indicates that not all of the employees will be continuing on. It is critical to communicate that information upfront.

“That can be challenging because the last thing you want to do is acquire an agency and walk into a morale issue right off the bat. It's important to remember that the agency principal has decided to sell the agency. The employees haven't. The employees are part of the sale, so to speak,” said Drayer.

There are a few schools of thought on how to communicate with employees during the sale. One is not to tell them until the deal has been completed. There could be a fear that letting them know will negatively affect the deal.

Another course of action is to tell employees near the end of the process but before it is completed.

“You can't have that conversation the day before the deal closes. You certainly can't have that conversation the day after the deal closes. So, it's one of those opportunities to demonstrate what the

value is going to be to those employees. It's information that those employees really deserve to know within a reasonable period of time before the deal closes,” said Drayer.

During a negotiation it can be easy to say that very little is going to change for the agency except for the equipment they use; the agency principal may be able to run the agency in much the same manner as before the acquisition. However, employees may not view the situation in the same way.

“That's where transparency really is important — having the ability to communicate and create reasonable expectations. It doesn't do anybody any good to create a false sense of security for employees, who are going to very quickly feel as though the whole world has changed for them.”

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Salem Five Insurance

Transparency between all of the players involved in the M&A deal is equally critical. The participants all need to follow through and do what they say they are going to do from both a contractual and an ethical standpoint.

“The currency of relationships is trust. Plain and simple. So we do that with our business partners whether they're on the other side of the negotiating table or not, and we certainly do that with our employees, whether they are current or future employees. Those are really important behaviors as you go through a process like this,” explained Drayer.

## The Day After the Deal

The challenge of M&A is what happens the day after the deal has been finalized, according to Drayer.

“Employees are your most important asset. They are also, at times, the most challenging asset to manage because people have high expectations for their employer, and they want to be some-

place that they want to be. All of a sudden, they find themselves in this relationship that they didn't sign up for. You have to do a lot of work to build their trust.”

In addition to employees, there are often technical issues that need to be ironed out, such as synching agency management systems.

When the purchaser is a bank, there are regulatory compliance and information security system issues to be addressed as well. The reality is that a small agency is unlikely to have invested in security the way a \$6 billion bank needs it to be. While these challenges are real, the buyer should be investing the time to get everything set up correctly.

The key for Drayer is to have a good change management team in place and to take seriously the concerns of new employees.

## The Future of M&A

In 2021, one of the primary drivers of M&A transactions was the expectation that the federal government's Build Back Better legislative framework would include a change in the capital gains tax structure. Some agency principals feared that if they did not sell their agency by a certain date, they would incur a large capital gains tax.

That never materialized, but it is too early to say whether M&A deals will slow significantly this year.

Drayer believes the pace of M&A transactions may continue as long as interest rates remain low. Even with the Federal Reserve nudging rates upward, they are historically low.

Drayer likened the M&A environment to the housing market. Currently, the lack of inventory in the housing market has driven prices up. If the housing market bubble bursts, it may cause prices to level or flatten a bit but not really dip.

The insurance industry is similar in that there is a finite amount of inventory. There are 1,200 to 1,400 independent insurance agencies in Mass.; however, they are not all for sale. The agencies that are for sale are not necessarily the

ones a particular buyer is interested in.

Very few agencies with \$30 million or \$50 million in premium exist these days. What does exist are a number of agencies with \$2 million to \$5 million in premium.

“If you’re up for the long game, for incrementally building by buying smaller agencies, I do think there’s a pretty good bit of runway there,” said Drayer.

One webinar participant asked at what point a buyer is big enough to stop

acquiring agencies.

Drayer explained that there are short- and long-term goals to consider. For Salem Five, it is having enough scale and generating enough profit to be a meaningful part of the bank’s financial offerings.

Most buyers fall into the mid- to larger-size agency category. However, he noted that there are small agencies that find creative ways to grow through acquisition because of how difficult it is to grow organically in today’s incredibly

competitive marketplace.

Drayer noted that even an agency with a great retention rate could still be losing upwards of 10% of the business every year. One way to counter that is through acquisition.

“But, that only lasts so long, right? In my view, you do have to eventually be able to grow organically. Otherwise, you’re on this treadmill of constantly finding yourself losing more out the back door than is coming in the front door.” ■

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